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

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Introduction

Under the Securities Act of 1933, as amended (Securities Act), any offer to sell or sale of securities must be registered with the U.S. Securities and Exchange Commission (Commission) or qualify for a registration exemption. Securities Act Regulation D encompasses three such exemptions: Rules 504 (17 C.F.R. § 230.504), 505 (17 C.F.R. § 230.505), and 506 (17 C.F.R. § 230.506).

Companies that sell unregistered securities pursuant to Regulation D are called issuers, and the offer of securities under Regulation D is generally called a private placement or unregistered offering. Private placements are often a quick and inexpensive way for small and medium sized businesses to raise capital.

There are risks, however, ***associated*** with private placements. For example, since private placements are not registered offerings, disclosure is minimal and may subject investors to increased risks. To alleviate those risks, the Financial Industry Regulatory Authority (FINRA) imposes a duty on broker-dealers (BDs) to conduct a reasonable investigation of private placements. See Hanly v. SEC, 415 F.2d 589, 595–96 (2d Cir. 1969) (finding that failure to conduct a due diligence investigation may subject a broker to discipline).

FINRA's reasonableness standard turns on the circumstances of the private placement. Shortly after the economic collapse of the late 2000s, FINRA provided increased guidance on complying with this investigative duty in FINRA Regulatory Notice 10-22 (April 2010) (the Notice), which can be found at *https://www.finra.org/sites/default/files/NoticeDocument/p121304.pdf*. In the Notice, FINRA explained that the amount and nature of the investigation turns on various factors, including, but not limited to, "the nature of the recommendation, the role of the broker in the transaction, its knowledge and relationship to the issuer, and the size and stability of the issuer." Id. at 3.

As the Notice explains, the duty to investigate furthers the antifraud provisions of the Securities Act. Id. at 2. Consequently, a breach of this investigative duty may constitute a violation of "Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and Rule 10b-5, thereunder." Id.

In addition to regulatory scrutiny, BDs may also face civil liability for failing to conduct proper due diligence investigations. Such liability may take the form of claims for breach of fiduciary duty or private causes of action for violations of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, as amended (Exchange Act). Other rules implicated by this investigative requirement are FINRA Rule 2010 (requiring faithfulness to just and equitable principles of trade) and FINRA Rule 2020 (prohibiting manipulative and fraudulent devices).

Furthering Suitability Obligations

In the Notice, FINRA reinforced the suitability obligations BDs have regarding Regulation D offerings. A BD's suitability obligations are found in FINRA Rule 2111, which requires that BDs "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or ***associated*** person to ascertain the customer's investment profile." The emphasis on suitability in the Notice was meant to combat the view among many BDs that they could avoid or relax the suitability requirements in Regulation D offerings because such offerings are often comprised of more sophisticated, that is, accredited investors. Various regulators had found that many BDs were stopping far short of performing a complete and thorough suitability analysis in these offerings because the investors were sophisticated.

In particular, the Notice emphasized that the contours of the duty to investigate are molded, in part, by BDs' suitability obligations. For example, the level of investigation will be impacted by the individual needs and characteristics of the client. At a minimum, a BD must investigate the following: (1) the issuer and its management, (2) the business prospects of the issuer, (3) the assets held by or to be acquired by the issuer, (4) the claims being made, and (5) the intended use of proceeds of the offering. See the Notice at 5.

To prove that they undertook an adequate investigation, BDs should make and retain detailed records documenting their investigation as well as the results. As always, sound compliance protocols are of critical importance in complying with BDs' due diligence and suitability obligations.

Points of Emphasis: Red Flags and Blind Reliance

In the aftermath of the Madoff scandal, many were left asking how such a massive fraud was not detected earlier. It soon became evident that there had been numerous red flags that had been ignored by many within the financial industry. The Notice specifically addresses "red flags," defined as any information "that would alert a prudent person to conduct further inquiry." See the Notice at 6. It should come as no surprise that common red flags include inaccurate financial statements or instances when expected rates of return exceed industry benchmarks. Id.

When confronted with red flags, the necessary level of investigation increases substantially. Although the inquiry is case-specific, BDs may not blindly rely upon the representations of the issuer or even the due diligence report of its counsel. Id.

A red flag may even arise where the issuer takes advantage of the relaxed requirements of Regulation D offerings. For example, Rules 505 and 506 do not require issuers to release investment memoranda in private placements. However, as a practical matter, many issuers do issue private placement memorandum. When an issuer declines to issue a private placement memorandum or otherwise make certain information available, the BD should be on alert and continue to investigate.

When there are gaps in a BD's investigation, they must attempt to fill them, and, if they cannot, they must rethink whether it is still advisable to recommend the investment. If BDs recommend private placements despite the absence of material information, they are required to disclose the gaps in their investigation to investors and explain the risks of not having such information. See Hanly, 415 F.2d at 597 (when one lacks essential information, they must disclose this as well as the risks that arise from the lack of information); see also SEC v. Kenton Capital Ltd., 69 F. Supp. 2d 1, 9 (D.D.C. 1998).

Other Factors that Define the Investigation

The Notice explicitly identifies several additional factors BDs should consider in defining the contours of an investigation. These factors include:

- **Affiliation with the issuer.** If a BD is affiliated with the issuer, there is an increased chance for conflicts of interest. A BD with a current or prior affiliation with the issuer must maintain independence when conducting due diligence. In fact, the need for due diligence may be heightened, as investors may assume that a BD's prior affiliation with an issuer vests the BD with increased knowledge about the issuer and offering. BDs should not take any shortcuts when conducting due diligence on issuers with whom they have pre-existing relationships.

- **BD preparation of the private placement memorandum.** FINRA Rule 2210 establishes standards for a BD's communications with the public and prohibits BDs from making material misrepresentations or omissions in such communications. BDs that prepare a private placement memorandum (PPM) for a Regulation D offering should be aware that PPMs are considered communications with the public. Consequently, BDs must ensure that they comply with the strictures of FINRA Rule 2210. This means that BDs must include all information that a BD would find important in addition to ensuring that any information contained in the PPM is accurate. Such information can include information concerning (i) the financial condition, solvency, and profitability of the securities and underlying property; (ii) prior affiliation between the issuer and BD; and (iii) the litigation history of the issuer and any of its alter egos. See Kunz v. S.E.C., 64 Fed. Appx. 659, 664–666 (10th Cir. 2003) (affirming disciplinary action against a BD that prepared a private placement memorandum for a Regulation D offering because of misrepresentations and omissions relating to these three categories of information).

- **Reliance on counsel or syndicate managers.** A common practice among BDs is to hire due diligence firms to conduct investigations into private offerings. NASD Notice 05-48, which can be found at *http://www.finra.org/sites/default/files/NoticeDocument/p014735.pdf*, permits BDs to delegate due diligence to third-party vendors. Nonetheless, as the Notice makes clear, BDs cannot delegate responsibility for the results. Thus, if a third-party vendor does not adequately investigate a private placement, BDs will be subject to discipline and the use of such a firm is no defense. This principle echoes the overall message of the Notice that the onus is on BDs to fill the gaps left by the relaxed reporting requirements in Regulation D offerings.

Recommended Policies and Practices

The Notice also reinforces the principle that the general requirements of supervision and documentation apply when BDs participate in Regulation D offerings.

As to supervision, the Notice reminds BDs that they must have supervisory procedures. Currently, the requirements for supervisory procedures can be found in FINRA Rules 3110 and 3170. Among the various supervisory requirements set forth in these rules, BDs must have procedures to ensure that firm personnel:

- Engage in a rigorous investigation sufficient to meet the above-referenced "reasonable investigation" standard
- Ensure that the investors are qualified to participate in Regulation D offerings
- Perform an adequate suitability analysis by, *inter alia*, ensuring that the securities offered via Regulation D are suitable for every investor to whom it is made
- Do not violate the antifraud provisions of the federal securities laws and/or FINRA rules

As to documentation, the Notice recommends that BDs document and retain records of the investigation process and the results of the investigation. Examples of such records include (i) meeting minutes along with descriptions of the meeting date and attendees and (ii) logs of what documents were reviewed, who reviewed them, and the results of that review. Ultimately, if called upon, a BD should be able to prove that it performed a reasonable investigation.

Checklist for Reasonable Investigation Practices

The Notice also provides a checklist containing highlights of investigatory practices that have been utilized by other firms in order to discharge their responsibilities. These practices are related to three topic areas: (i) investigation of the issuer and its management, (ii) investigation of the issuer's business prospects, and (iii) investigation of the issuer's assets. However, it is important to remember that each investigation will turn on the facts of the specific case, and mere reliance on the checklist will not suffice. BDs must tailor their investigation to the facts of the specific offering. With that in mind, performing the following practices will assist in complying with the investigatory obligations under Regulation D.

Investigation of the Issuer and its Management

A BD must investigate the issuer and its management, including management's background and qualifications to conduct the business. Investigation of these issues should include an examination of:

- The issuer's governing documents (e.g., charter, bylaws, partnership agreement), with a specific focus on the amount of authorized stock and restrictions on the issuer's activities
- The historical financial statements of the issuer and its affiliates, preferably centered on financial statements audited by an independent certified public accountant and any auditor correspondence to the issuer's management
- Trends indicated by the financial statements
- The issuer's affiliates and whether the affiliates' have needs that could affect the issuer's business prospects
- The issuer's internal audit controls
- Course of dealing between the issuer and its customers and suppliers, preferably by direct questioning of the customers and suppliers themselves
- The issuer's contracts, leases, mortgages, financing arrangements, contractual arrangements with management, employment agreements, and stock option plans

- Past securities offerings by the issuer and their success
- Pending litigation of the issuer and/or its affiliates
- Previous or potential disciplinary issues
- The issuer's management, including:
    - o The expertise of management for the issuer's business
    - o The past and future prospects for management turnover
    - o Any regulatory or disciplinary history on the part of management
    - o Any transactions between management and the issuer (or its affiliates) that might affect the issuer's business
- The compensation of management and/or the board of directors, including:
    - o The forms and amount of compensation
    - o Who determines the amount of compensation
    - o Whether the form of compensation could present conflicts of interest
- The length of time the issuer has been in business
- Previous or potential disciplinary issues
- What future changes, if any, are in the issuer's business forecasts

Investigation of the Issuer's Business Prospects

The issuer's business prospects are often intertwined with the potential value of the securities being offered. As such, it is vital for the BD to not only investigate the issuer's business prospects, but also to determine whether those prospects are accurately embodied in the proposed prices of the offered securities. Investigation into these issues should include an examination of:

- The intellectual property of the issuer, including the viability of that intellectual property (e.g., patents)
- The issuer's industry, including the current climate in that industry, the prospects for that industry, the competitive position of the issuer within that industry, and existing or potential regulatory or business restrictions on the industry
- Business plans, models, or other descriptions of the issuer's business intentions and expectations, including an analysis of any assumptions on which business forecasts are based
- Financial models used to generate projections or targeted returns, including a summary of any stress tests performed on the issuer's assumptions and projections

Investigation of the Issuer's Assets

An investigation of the quality of the issuer's assets and facilities is also necessary. Such an analysis should include:

- Visits and inspections of the issuer's assets/facilities (or a sample) to determine whether the value and condition of those assets corresponds with any financial statements or representations made by the issuer
- Examination of third-party reports on, among other things, geological, land use, and/or engineering issues

In addition, FINRA recommends that BDs obtain expert opinions in order to assist in a suitability analysis. This carries special weight for issuers involved in the energy and/or exploration business.

FINRA Disciplinary Actions

FINRA continues to discipline BDs that fail to conduct a sufficiently thorough investigation. In this regard, FINRA has disciplined BDs for the following:

- Failure to follow up on red flags such as conflicts of interest, transactions between the issuer and its affiliates that could affect the issuer, failure to investigate previous actions that could have led to a default, and blind reliance on statements in the offering document (see In the Matter of Donald J. Anthony, Jr., Release No. 745 (Feb. 25, 2015), which can be found at *https://www.sec.gov/alj/aljdec/2015/id745bpm.pdf*)

- Failure to conduct a public records search of a corporate officer—which would have disclosed a conviction—and parallel reliance on the statements of the officer and his/her attorney as to the officer's past conduct (see In the Matter of the Application of Mitchell H. Fillet, Release No. 75054 (May 27, 2015), which can be found at *https://www.sec.gov/litigation/opinions/2015/34-75054.pdf*)
- Failure to conduct an investigation into the issuer's financial statements (see FINRA Disciplinary Proceeding No. 2011028647101 (Jan. 20, 2015) (BD "could and should have requested" financial data), which can be found at *https://www.finra.org/sites/default/files/OHO_Web_Decision-ProceedingNo.2011028647101_0_0.pdf*)

While the above-referenced failings are clear, other FINRA cases establish that even facially thorough investigations can be deficient if they aren't tailored to the facts of the specific case. For example, a BD agreed to settle with FINRA over claims that it violated its due diligence and supervisory responsibilities in a private placement despite the fact the BD's investigation included (i) obtaining due diligence reports from outside vendors, (ii) consulting with BDs who had previously worked with the issuer, and (3) discussing the issuer's facilities with people who had previously inspected them. Workman Securities Corporation Acceptance, Waiver and Consent Settlement (AWC), FINRA No. 20090188184 (Feb. 1, 2011), which can be found at *http://disciplinaryactions.finra.org/Search/ViewDocument/10368*. Consistent with its mandate to tailor each investigation to the underlying facts, FINRA's disciplinary action focused on what the BD failed to do in light of the facts of the case. In particular, FINRA found that the investigation failed on the following grounds:

- Failure to investigate red flags present in the due diligence report, including previous defaults and a failure to pay interest payments
- Reliance on conversations with individuals who had visited the issuer's facilities instead of personally inspecting them
- Reliance on other BDs who had worked with the issuer without verifying (i) what due diligence was actually performed and (ii) whether documentation existed to support this due diligence
- Failure to verify whether the BD's representatives who conducted due diligence were qualified to do so
- Failure of the BD's supervisors to actually supervise the due diligence
- The fact that the due diligence reports were prepared months after the BD had already started selling securities

The *Workman* case exemplifies the problems that can arise from a cursory due diligence investigation. The responsibility is on BDs to not only verify the facts underlying even their most basic of assumptions, but to make additional inquiries once troubling facts are uncovered. Simply relying on the fact that the issuer was previously able to complete Regulation D offerings will not suffice.