



2017 FINRA Annual Conference

Washington, DC | May 16 – 18, 2017

Enhancing Your Product Knowledge

Tuesday, May 16

1:45 p.m. – 2:45 p.m.

This session focuses on due diligence obligations and effective practices in connection with sales of alternative investments, including private equity, real estate and energy investments; business development companies, closed-end funds and UITs; Regulation D private placements; and structured products. Industry practitioners discuss their practices and procedures when vetting complex products.

Moderator: Joseph Price
Senior Vice President and Counsel
FINRA Corporate Financing/Advertising Regulation

Panelists: Nathan Headrick
President
Triloma Capital

Deborah Schwager Froling
Partner
Kutak Rock, LLP

Matthew Vitek
Vice President, Legal
FS Investments

Enhancing Your Product Knowledge Panelist Bios:

Moderator:

Joseph E. Price is Senior Vice President, Corporate Financing/Advertising Regulation, at the Financial Industry Regulatory Authority. The FINRA Corporate Financing Department regulates capital-raising activities of broker-dealers; including equity, debt, REIT, closed-end fund, limited partnership offerings and private placements. The FINRA Advertising Regulation Department regulates broker-dealer sales materials, mutual fund advertisements, social media and other communications with the public. Mr. Price previously worked in various capacities at the Securities and Exchange Commission. He was an assistant general counsel and a special counsel in the Office of General Counsel and he was the Deputy Chief of the Office of Disclosure and Investment Adviser Regulation in the Division of Investment Management. Prior to working at the SEC, he was a litigator in the Bureau of Competition at the Federal Trade Commission. Mr. Price also worked as a compliance investigator at the Coffee, Sugar & Cocoa Exchange. He was an Adjunct Professor at Georgetown University Law Center from 1994 to 2002, where he taught "Current Issues in Securities Regulation" and "Disclosure under the Federal Securities Laws." He graduated with distinction in economics from the University of Wisconsin and received his law degree from Fordham University.

Panelists:

Nathan Headrick is a Managing Partner of Triloma and President of Triloma Securities, an alternative investment platform with opportunities across multiple asset classes including private equity, real estate, restaurants, capital markets, and energy. Mr. Headrick is a recognized advocate and leader in the alternative investments industry. Prior to joining Triloma, he served as President of Bluerock and held numerous leadership roles within the CNL companies. Under Mr. Headrick's leadership, these firms raised over \$6 billion in public alternative investment capital, representing hundreds of thousands of investors within the retail broker dealer channel. Mr. Headrick also served as Chief Legal Officer to Corporate Capital Trust, a public business development company. To date, Mr. Headrick has placed \$12.5 billion of public and private equity securities into the alternative investment marketplace, including syndication of public joint ventures with KKR, The Macquarie Group and CB Richard Ellis. Mr. Headrick is the founder and current chairman of the IPA Policy Advocacy Committee (IPAPAC), which acts as the alternative investment industry's primary lobbying voice. He was also the co-founder of DDWizard.com, a securities due diligence software firm he sold in late 2014. Mr. Headrick earned his Juris Doctor from Georgetown University Law Center, where he was elected student body president. He additionally holds a Masters of Theology from Harvard University and BAs from the University of North Carolina in political science and international studies. In 2008, Mr. Headrick was inducted into the bar of the United States Supreme Court. The same year, he received the Orlando Business Journal 40 Under 40 Award, recognizing the forty most influential business persons in Central Florida under the age of forty. He is a member of the DC Court of Appeals bar and the Florida bar. In 2012, Mr. Headrick was appointed to a term on the FINRA Corporate Finance Committee.

Deborah S. Froling is a Partner in Kutak Rock LLP's Washington, D.C. office. Ms. Froling is a member of the firm's Corporate Securities and Real Estate practice groups. She has more than two decades of experience in public and private offerings of debt, equity and convertible securities as both issuer's and underwriter's counsel primarily for real estate companies. She also has extensive experience in the tenant-in-common syndication industry and the non-traded REIT, equipment finance, and oil and gas industries. Ms. Froling also has worked with public and private company clients providing general corporate counseling and advising on periodic and annual reporting and other Securities and Exchange Commission (SEC) disclosure requirements. Previously, Ms. Froling worked for two national law firms in Washington, D.C. and a nationally recognized law firm in real estate securities in Richmond, Virginia. She also was an attorney-advisor in the Division of Corporation Finance at the SEC where she examined and analyzed transactional and periodic filings for compliance with federal securities laws, primarily for REITs and syndicated limited partnerships. Ms. Froling is a member of numerous professional associations and is a past president of the National Association of Women Lawyers. Her memberships include the Alternative and Direct Investment Securities Association (f/k/a the Real Estate Investment Securities Association) where she has previously served as the treasurer, a member of the board of directors and chair of the Legislative and Regulatory Committee; and the American Bar Association's Section of Business Law, where she is a part of the leadership of the State Securities Subcommittee. Ms. Froling

received a B.A. from The College of William & Mary, and earned her J.D. from the Columbus School of Law at The Catholic University of America. She is admitted to practice in the District of Columbia and Virginia.

Matthew Vitek is the Vice President of Legal at FS Investment Solutions, FS Investments' wholly-owned broker-dealer subsidiary. Mr. Vitek is also a member of FS Investments' Government Affairs team where he supports the company's regulatory and legislative initiatives. Prior to joining FS Investment Solutions, Mr. Vitek served as Associate General Counsel in the Office of General Counsel at the Financial Industry Regulatory Authority (FINRA) where he was responsible for various policy initiatives and rule changes. Earlier in his career, Mr. Vitek was a counsel in FINRA's Department of Member Regulation where he provided interpretative advice on FINRA rules and regulatory guidance with respect to the federal securities laws and related rules and regulations. Mr. Vitek earned a BA in Communication from the University of New Mexico, a MBA from Baylor University, a JD from Drake University and a LLM in Securities and Financial Regulation from the Georgetown University Law Center.



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Panelists

■ Moderator

- **Joseph Price, Senior Vice President and Counsel, FINRA Corporate Financing/Advertising Regulation**

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Resources

FINRA Notices

- FINRA *Regulatory Notice 16-08 Contingency Offerings: Private Placements and Public Offerings Subject to a Contingency View* (February 2016)
www.finra.org/sites/default/files/Regulatory-Notice-16-08.pdf
- FINRA *Regulatory Notice 15-02 DPP and Unlisted REIT Securities: SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Program and Unlisted Real Estate Investment Trust Securities* (January 2015)
www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf
- FINRA *Regulatory Notice 12-03 Complex Products: Heightened Supervision of Complex Products* (January 2012)
www.finra.org/sites/default/files/NoticeDocument/p125397.pdf
- FINRA *Regulatory Notice 10-22 Regulation D Offerings: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings* (April 2010)
www.finra.org/sites/default/files/NoticeDocument/p121304.pdf

Contingency Offerings

Private Placements and Public Offerings Subject to a Contingency

Executive Summary

FINRA's review of securities offering documents has revealed instances in which broker-dealers have not complied with the contingency offering requirements of Rules 10b-9 and 15c2-4 under the Securities Exchange Act of 1934 (SEA). FINRA is publishing this *Notice* to provide guidance regarding the requirements of SEA Rules 10b-9 and 15c2-4 and to remind broker-dealers of their responsibility to have procedures reasonably designed to achieve compliance with these rules.¹

Questions regarding this *Notice* should be directed to:

- ▶ Joseph E. Price, Senior Vice President, Corporate Financing/Advertising Regulation, at (240) 386-4623 or Joseph.Price@finra.org;
- ▶ Paul Mathews, Vice President, Corporate Financing, at (240) 386-4639 or Paul.Mathews@finra.org; or
- ▶ Josh Bandes, Senior Investigator, Corporate Financing, at (240) 386-5431 or Josh.Bandes@finra.org.

Background & Discussion

Broker-dealers that participate in best efforts public and private securities offerings that have a contingency (*i.e.*, an underlying condition or qualification that must take place by a specified date prior to the issuer taking possession of the offering proceeds) must safeguard investors' funds they receive until the contingency is satisfied. If the contingency is not met, broker-dealers must ensure that investors' funds are promptly refunded. FINRA's reviews of these offerings and subsequent investigations have revealed instances in which broker-dealers have not complied with the requirements of SEA Rules 10b-9 and 15c2-4. Part I of this *Notice* provides an overview and explanation of best efforts contingency offerings. Part II describes a broker-dealer's responsibilities in best efforts contingency offerings. Part III describes the requirements for handling investor funds until the contingency is met.

February 2016

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Corporate Finance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Syndicate
- ▶ Underwriting

Key Topics

- ▶ Bona Fide Purchases
- ▶ Contingency Offerings
- ▶ Escrow
- ▶ Net Capital
- ▶ Underwriting

Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ Notice to Members 84-7
- ▶ Notice to Members 84-64
- ▶ Notice to Members 87-61
- ▶ Notice to Members 98-4
- ▶ Regulatory Notice 10-22
- ▶ SEA Rule 10b-9
- ▶ SEA Rule 15c2-4
- ▶ SEA Rule 15c3-1
- ▶ SEA Section 3(a)(6)
- ▶ Securities Act Section 17

I. Best Efforts Contingency Offerings

In a best efforts offering, a broker-dealer does not commit to purchase any securities from the issuer or guarantee that the issuer will receive any amount of money from the offering.² Furthermore, a best efforts offering subject to satisfaction of an underlying condition is deemed to be a “contingency offering.” The most common contingency offerings reviewed by FINRA are either “all-or-none” or “part-or-none” offerings that require all or a certain amount of the securities to be sold for the offering to close.³ Under SEA Rule 10b-9, a best efforts offering subject to either an “all-or-none” or “part-or-none” contingency must provide for the prompt return of investor funds in the event the requisite contingency fails to be met by a specific date.

II. Broker-Dealer Responsibilities in a Best Efforts Contingency Offering.

As discussed in *Regulatory Notice 10-22*, a broker-dealer that participates in an offering and recommends a security must, among other requirements, conduct a reasonable investigation of the security and the issuer’s representations about it.⁴ If the security is offered as part of a contingency offering, the broker-dealer’s reasonable investigation must include a review of the terms of the contingency, including any agreement and disclosure by the issuer regarding the contingency.⁵

FINRA has reviewed several offerings in which the broker-dealer conducting the offering failed to identify inconsistencies between the escrow agreement and the offering document as it relates to the requirements of the contingency. Such inconsistencies should be “red flags” to a broker-dealer performing a reasonable investigation.

Furthermore, FINRA has found that broker-dealers violated SEA Rule 10b-9 by failing to return subscriber funds after the issuer changed the contingency by reducing the offering minimum.⁶ FINRA has also found that broker-dealers violated SEA Rule 10b-9 by failing to take the proper steps in response to an issuer’s extension of the offering period.⁷

Broker-dealers must be aware of any attempt by the issuer to use non-*bona fide* sales in order to declare an offering sold for the purposes of an “all-or-none” or “part-or-none” offering.⁸ In general, “non-*bona fide* sales” are sales of undisclosed purchases by the issuer or broker-dealer, their affiliates or associated persons, or any entities through nominee accounts that are designed to create the appearance of a successful completion of an offering.⁹ The use of non-*bona fide* sales in “all-or-none” and “part-or-none” contingency offerings could violate the antifraud provisions of the federal securities laws.¹⁰ In one matter, FINRA found that a broker-dealer violated SEA Rules 10b-9 and 15c2-4 when it participated in an offering in which the issuer declared a contingency offering sold by counting non-*bona fide* sales made to the issuer’s employees.¹¹ Similarly, FINRA found that a broker-dealer violated SEA Rules 10b-9 and 15c2-4 when an issuer used the proceeds from a loan to purchase securities in the offering in order to meet the minimum offering amount.¹²

III. Requirements Concerning Manner of Handling Investor Funds

SEA Rule 15c2-4 requires that upon receiving money or other consideration from an investor in a contingency offering, a broker-dealer must promptly:

- ▶ deposit those funds into “a separate bank account” for which the broker-dealer is the account holder and is designated as agent or trustee “for the persons who have the beneficial interests therein”;¹³ or
- ▶ transmit those funds to a bank that has agreed in writing to act as the escrow agent for the offering.¹⁴

The manner in which a broker-dealer must handle investor funds generally will be determined by two factors. First, pursuant to SEA Rule 15c3-1, only a broker-dealer that maintains at least \$250,000 in net capital is allowed to carry customer accounts and receive or hold funds or securities for those persons. Therefore, while not a requirement of SEA Rule 15c2-4, a broker-dealer that maintains less than \$250,000 in net capital and deposits investors’ funds into a separate bank account rather than transmitting those funds to an independent bank escrow agent would violate SEA Rule 15c3-1.¹⁵ Second, when a participating broker-dealer is an affiliate of the issuer, investors’ funds must be transmitted to an independent bank escrow agent.¹⁶

a. Escrow Agreements

In contingent offerings that require an escrow agent, the escrow agreement must be executed with a bank that is unaffiliated with the broker-dealer and the issuer.¹⁷ The escrow account should be established before the broker-dealer receives any investor funds. The escrow account may not be controlled by the issuer,¹⁸ the broker-dealer¹⁹ or an attorney.²⁰ As a general matter, the escrow agent must be a financial institution that meets the definition of a “bank” under SEA Section 3(a)(6),²¹ although the SEC staff has provided no-action relief to permit certain other entities to act as escrow agents.²²

b. Prompt Transmittal of Funds

SEA Rule 15c2-4(b) requires that a broker-dealer promptly transmit funds to either an escrow agent or a separate bank account. SEC staff has interpreted “promptly” to mean by noon of the next business day.²³ Failure to promptly transmit funds to either the escrow agent or a separate bank account has resulted in sanctions.²⁴ However, in certain offerings, such as direct participation programs that require suitability determinations by the issuer, the SEC staff has provided procedural guidance under which a broker-dealer can still comply with the “promptly” component of SEA Rule 15c2-4 even if the funds are not transmitted by noon the next business day after they are received.²⁵

A broker-dealer's responsibility does not end when it promptly transmits investor funds to an escrow agent or separate bank account. A broker-dealer must also promptly refund investors' funds if the contingency is not met.²⁶ FINRA has identified a number of instances in which investors did not receive their money back in a prompt manner, if at all, when the contingency did not occur. For example, FINRA found that a broker-dealer violated SEA Rule 10b-9 after it failed to return two investors' funds, even after the investors demanded their money back.²⁷ In fact, the broker-dealer only returned a portion of one of the investor's funds after the investor sued the broker-dealer, nearly two years later.

c. Disbursal to the Issuer

Broker-dealers must segregate investor funds they receive at least until the contingency is met. FINRA has found that some broker-dealers improperly disbursed investor funds to issuers before the contingency was satisfied.²⁸

d. Issuer's Direct Receipt of Investor Funds

FINRA has observed in some contingency offerings that broker-dealers have instructed investors to transmit their funds directly to the issuer. Since SEA Rule 15c2-4 governs the broker-dealer's receipt of investor funds, funds that are not received by the broker-dealer (absent the circumstance in which there is an affiliation between the broker-dealer and the issuer) are outside the purview of this rule.²⁹ Nevertheless, FINRA reminds broker-dealers that even if SEA Rule 15c2-4 does not apply, the anti-fraud and anti-manipulation provisions of the securities laws as well as FINRA Rule 2010 apply to all of their securities transactions.³⁰ Broker-dealers that participate in contingency offerings in which the issuer does not escrow or otherwise segregate investor funds may violate the securities laws even in the absence of a violation of SEA Rule 15c2-4.

Endnotes

1. Although this *Notice* focuses on SEA Rules 10b-9 and 15c2-4, other rules are potentially applicable to contingency offerings, including rules governing suitability and communications with the public. See [Regulatory Notice 10-22](#) (Apr. 2010).
2. Unlike in a best efforts offering, an underwriter in a firm commitment offering is obligated to purchase all securities offered before distributing them to the public.
3. While the majority of contingency offerings are all-or-none or part-or-none, other underlying conditions upon which the offering is contingent may exist, such as the completion of a merger or acquisition.
4. See [Regulatory Notice 10-22](#) (Apr. 2010).
5. See [Regulatory Notice 10-22](#) at 3 (“The Securities and Exchange Commission (SEC) and federal courts have long held that a BD that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer’s representations about it.”).
6. *Security Research Associates, Inc.*, FINRA AWC No. 201303630601 (Apr. 3, 2014); *Isaac Schinazi*, FINRA AWC No. 2005000777001 (Dec. 21, 2007). See also *Tucson Hotel Associates*, 1985 SEC No-Act. LEXIS 2922 (Mar. 12, 1985) (investors must be refunded upon an issuer reducing the minimum number of units to be sold in a best efforts contingency offering); *FOLIOfn Investments, Inc.*, SEC No-Action Letter, footnote 7 of incoming letter (July 15, 2015) (providing that “if an issuer were to reduce the minimum number of units to be sold in an offering on the Platform, Folio would cancel all the outstanding Conditional Offers for that offering and require the issuer to terminate that offering on the Platform.”).
7. *Janco Partners, Inc.*, FINRA AWC No. 2011025505901 (Nov. 5, 2012); *CP Capital Securities, Inc.*, FINRA AWC No. 2007007145101 (Aug. 25, 2009); *European American Equities, Inc.*, FINRA AWC No. 2009020941102 (Feb. 28, 2012). See also Interpretative Release on Regulation D, SEC Rel. No. 33-6455 at Question 80 (Mar. 3, 1983) (an extension of an offering period in a best efforts contingency offering requires investors to affirmatively reconfirm their investments).
8. *SEC v. Coven*, 581 F.2d 1020, 1028, n.16 (2d Cir. 1978), *cert. denied*, 434 U.S. 950 (1979). See also SEC Rel. No. 33-11532 (July 11, 1975).
9. SEC Rel. No. 33-11532 (July 11, 1975).
10. *SEC v. Blinder, Robinson & Co.*, et al., 1983 U.S. App. LEXIS 16806 (10th Cir. 1983). See also *A.J. White & Co. v. SEC*, 556 F.2d 619 (1st Cir. 1977).
11. *Northland Securities, Inc.*, NASD AWC No. E042005007801 (Dec. 21, 2006).
12. *Commonwealth Church Finance, Inc.*, FINRA AWC No. 2008011619001 (Aug. 10, 2010).
13. SEA Rule 15c2-4(b)(1). Cf. *FOLIOfn Investments, Inc.*, SEC No-Action Letter (July 15, 2015) (providing that the Division of Trading and Markets will not recommend enforcement action to the SEC if, subject to certain conditions and in light of certain representations, Folio accepts money received for certain best efforts contingent offerings from its customers through its electronic platform that services privately placed and/or unlisted securities).
14. SEA Rule 15c2-4(b)(2).
15. See *Traiger Energy Investments*, SEC Rel. No. 34-25306 (Feb. 3, 1988) (a “\$5,000 broker-dealer,” or a non-carrying broker-dealer that uses a separate bank account as agent or trustee would not violate SEA Rule 15c2-4).

16. *Notice to Members 98-4* (Jan. 1998) (“...a broker/dealer affiliated with the issuer may only deposit investors’ funds in an escrow account with a bank independent of the issuer and the broker/dealer.”); *Notice to Members 87-61* at 4 (Sep. 1987) (a “broker-dealer affiliated with the issuer must forward checks to an escrow account and may not act as agent or trustee for a separate bank account.”); *Notice to Members 84-7* at 5 (Jan. 1984) (if the broker-dealer and the issuer are affiliated “the broker-dealer should not act as agent or trustee for the funds [and] instead, an escrow agent should be used.”). *See also* FOLIOfn Investments, Inc., No-Action Letter (July 15, 2015) (providing that the Division of Trading and Markets will not recommend enforcement action to the SEC based upon Folio’s representation, among other representations and conditions, that each issuer is unaffiliated with Folio).
17. *Notice to Members 87-61* at 3 (Sept. 1987) (“[Rule 15c2-4] requires that when an escrow account is used for distributions conducted on a contingency basis (e.g., best-efforts all-or-none or part-or-none offerings), the escrow agent must be a commercial bank that is unaffiliated with either the issuer or the underwriter.”).
18. *Richard Manchester*, FINRA AWC No. 2009020397101 (Aug. 29, 2013) (in multiple and separate offerings, FINRA found that the broker-dealer violated Rule 15c2-4 by depositing investor funds into bank accounts in the name of the respective issuers rather than escrow accounts). *See also Provident Asset Management*, FINRA AWC No. 2009017497201 (Feb. 19, 2010).
19. *Carl E. Lindros*, NASD AWC No. E022004004502 (Mar. 22, 2006); *Paulson Investment Company, Inc.*, FINRA AWC No. 2007007406901 (Jan. 28, 2009); *Philadelphia Brokerage Corporation*, NASD AWC No. E9A2003016102 (Feb. 14, 2006); *G.C. Andersen Partners Capital, LLC*, FINRA AWC No. 2007007256802 (Nov. 20, 2008) (FINRA found that broker-dealer violated SEA Rule 15c2-4 by holding investor funds in an account in which the broker-dealer’s employee acted as escrow agent); *Northland Securities, Inc.*, NASD AWC No. E042005007801 (Dec. 21, 2006) (FINRA found that broker-dealer violated SEA Rule 15c2-4 by using an affiliate of the broker-dealer as the escrow agent).
20. *Grant Bettingen*, NASD AWC No. E022005007302 (Mar. 7, 2007); *Accelerated Capital Grp.*, FINRA AWC No. 2011025769301 (Jan. 7, 2014); *EDI Financial, Inc.*, FINRA AWC No. 2009016266601 (Apr. 21, 2010).
21. *Notice to Members 84-7* at 7 (Jan. 1984) (a “bank” as used in Exchange Act Rule 15c2-4 refers to the definition contained in Section 3(a)(6) of the [Exchange] Act).
22. *Notice to Members 87-61* at 3 (Sept. 1987). *See also Continental Stock Transfer & Trust Company*, 1989 SEC No-Act. LEXIS 662 (May 10, 1989); *Reliance Trust Co.*, 2005 SEC No-Act LEXIS 531 (Mar. 29, 2005).
23. *Notice to Members 84-7* at 4, 5 (Jan. 1984) (noting SEC staff’s statement that “[i]n contingent offerings not requiring suitability determinations by the issuer or the general partner, funds should be deposited or transmitted by noon of the next business day.”). *See also J.V. Ace & Co., Inc.*, 50 SEC at 465 n.13 (“[investor] funds should normally be deposited or transmitted by noon of the business day following their receipt.”) (citation omitted).

24. *Lowell H. Listrom & Co., Inc.*, 48 S.E.C. 360, 362 (1985) (broker-dealer violated SEA Rule 15c2-4 by retaining customers' funds for multiple days before transmitting the funds to the escrow agent). *See also Brookville Capital Partners LLC*, FINRA AWC No. 2008011678303 (June 7, 2010).
25. *Notice to Members 84-64* (Nov. 1984) (NASD published interpretive letter dated October 16, 1984, from the SEC to Linda A. Wertheimer, Chairman, Subcommittee on Partnerships, Trusts and Unincorporated Associations, Federal Regulation of Securities Committee, American Bar Association, defining "prompt transmittal" as applied to contingency offerings of interests in direct participation programs requiring an escrow account).
26. *See, e.g., Reid S. Johnson*, FINRA AWC No. 2011025504301 (Oct. 21, 2013).
27. *Dept. of Enforcement v. Kaweske*, NASD Discip. Proceeding No. C07040042 (Feb. 10, 2006).
28. *Richard Manchester*, FINRA AWC No. 2009020397101 (Aug. 29, 2013); *Woodrock Securities, L.P.*, FINRA AWC No. 2009016279401 (Jan. 28, 2011); *Janco Partners, Inc.*, FINRA AWC No. 2011025505901 (Nov. 5, 2012).
29. *See Notice to Members 84-7* at 2, 5 (Jan. 1984) ("Direct receipt of an investor's funds by an issuer...is not a circumstance addressed by the Rule"... "[however] [w]here an investor sends his check directly to an issuer that is affiliated with a participating broker-dealer, 'receipt' of the funds is considered to be made by the broker-dealer when the issuer receives the check. Therefore, the Rule applies and the broker-dealer is responsible for ensuring that the issuer promptly transmits the funds to an independent escrow agent.").
30. *See, e.g., SEA Rule 10b-5; Section 17 of the Securities Act of 1933.*

DPP and Unlisted REIT Securities

SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Program and Unlisted Real Estate Investment Trust Securities

Effective Date: April 11, 2016

Executive Summary

The SEC approved amendments to NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of per share estimated values for direct participation program (DPP) and unlisted real estate investment trust (REIT) securities on account statements, and to FINRA Rule 2310 (Direct Participation Programs) to make corresponding changes to the requirements applicable to members' participation in public offerings of DPP or REIT securities.¹ The amendments become effective on April 11, 2016.

The amended rule text is available at www.finra.org/notices/15-02.

Questions concerning this *Notice* should be directed to:

- ▶ Joseph E. Price, Senior Vice President & Counsel, Advertising Regulation and Corporate Financing, at (240) 386-4642 or Joseph.Price@finra.org;
- ▶ Paul M. Mathews, Vice President & Director, Corporate Financing, at (240) 386-4639 or Paul.Mathews@finra.org; or
- ▶ James S. Wrona, Vice President & Associate General Counsel, Office of General Counsel, at (202) 728-8270 or Jim.Wrona@finra.org.

Background & Discussion

NASD Rule 2340 currently requires a general securities member to include on account statements an estimated value of a DPP or REIT security from the annual report, an independent valuation service or any other source, unless the member can demonstrate the estimated value is inaccurate. FINRA Rule 2310 provides that a member may not participate in a DPP or REIT offering unless the general partner or sponsor will disclose a per share estimated value in each annual report.

January 2015

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Customer Account Statements
- ▶ Direct Participation Programs
- ▶ Unlisted Real Estate Investment Trusts

Referenced Rules & Notices

- ▶ FINRA Rule 2310
- ▶ NASD Rule 2340

The general industry practice is to use the offering price (or “par value”) of DPP and REIT securities as the per share estimated value during the offering period, which can continue as long as seven and one-half years. The offering price, typically \$10 per share, often remains constant on customer account statements during this period even though various costs and fees have reduced investors’ principal and underlying assets may have decreased in value.

The SEC recently approved FINRA’s proposed amendments to Rule 2340 and Rule 2310 that require general securities members to provide more accurate per share estimated values on customer account statements, shorten the time period before a valuation is determined based on an appraisal and provide various important disclosures. The effective date of the amendments is April 11, 2016.

I. NASD Rule 2340 (Customer Account Statements)

NASD Rule 2340 generally requires that general securities members provide periodic account statements to customers, on at least a quarterly basis, containing a description of any securities positions, money balances or account activity since the last statement. Paragraph (c) addresses the inclusion of per share estimated values for DPP and REIT securities held in customer accounts or included on customer account statements. The rule also provides for several disclosures regarding the illiquidity and resale value of DPP and REIT securities.

The SEC has approved amendments to Rule 2340(c) to require, among other things, general securities members to include in customer account statements a per share estimated value for a DPP or REIT security developed in a manner reasonably designed to ensure that the per share estimated value is reliable. In addition, the amended rule provides two methodologies for calculating the per share estimated value for a DPP or REIT security that is deemed to have been developed in a manner reasonably designed to ensure that it is reliable: (1) the net investment methodology and (2) the appraised value methodology. The amended rule also imposes various enhanced disclosure obligations, as discussed below.

A. Net Investment Methodology

The amendments to Rule 2340(c)(1)(A) require “net investment” to be based on the “amount available for investment” percentage in the “Estimated Use of Proceeds” section of the offering prospectus. Where “amount available for investment” is not provided, the amended rule requires “net investment” to be based on another equivalent disclosure that reflects the estimated percentage deduction from the aggregate dollar amount of securities registered for sale to the public of sales commissions, dealer manager fees and estimated issuer offering and organization expenses. In addition, the amended rule clarifies

that when an issuer provides a range of amounts available for investment, a member may use the maximum offering percentage unless the member has reason to believe that such percentage is unreliable. If the member has reason to believe that it is unreliable, the member must use the minimum offering percentage. The rule permits the net investment value to be used until 150 days following the second anniversary of breaking escrow in the public offering.

B. Appraised Value Methodology

The appraised value methodology, which can be used at any time, consists of the appraised valuation disclosed in the issuer's most recent periodic or current report filed with the SEC. As amended, Rule 2340(c)(1)(B) requires that the per share estimated value disclosed in an issuer's most recent periodic or current report be based on valuations of the assets and liabilities of the DPP or REIT, and that those valuations be:

- ▶ performed at least annually;
- ▶ conducted by, or with the material assistance or confirmation of, a third-party valuation expert or service; and
- ▶ derived from a methodology that conforms to standard industry practice.

Where a DPP is subject to the Investment Company Act of 1940 (1940 Act) (e.g., business development companies), instead of a valuation that meets the appraisal requirements listed immediately above, the rule requires that the appraised value must be consistent with the valuation requirements of the 1940 Act and the rules thereunder.

C. Disclosures

New Rule 2340(c)(2)(A) requires members that use the "net investment" methodology to provide, if applicable, enhanced disclosure relating to the return of investors' capital (often referred to as "over distributions") in order to address potential misunderstanding by customers when their capital is returned to them through a distribution that otherwise could appear to represent earnings on their investment. Rule 2340(c)(2)(A) requires an account statement that provides a "net investment" per share estimated value for a DPP or REIT security to disclose, if applicable, prominently and in proximity to disclosure of distributions and the per share estimated value the following statements: "IMPORTANT – Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement."

The disclosure under new Rule 2340(c)(2)(A) applies only to an account statement that provides a "net investment" per share estimated value where part of the distribution includes a return of capital. Thus, for example, this requirement does not apply to an account statement that provides an "appraised value" for the per share estimated value, which already would reflect returns of capital.

However, the disclosures under new Rule 2340(c)(2)(B) are required for all account statements that provide a per share estimated value for a DPP or REIT security. Pursuant to this new provision, a member must disclose that the DPP or REIT securities are not listed on a securities exchange, are generally illiquid and that, even if a customer is able to sell the securities, the price received may be less than the per share estimated value provided in the account statement.

II. FINRA Rule 2310 (Direct Participation Programs)

FINRA Rule 2310(b)(5) generally provides that a member may not participate in a public offering of DPP or REIT securities unless specified disclosures about the value of such securities will be made by the general partner or sponsor of the DPP or REIT in each annual report distributed to investors pursuant to Section 13(a) of the Exchange Act. FINRA amended the requirements to correspond to the amendments to NASD Rule 2340(c). As amended, Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose:

- ▶ a per share estimated value of the DPP or REIT security, developed in a manner reasonably designed to ensure it is reliable, in the DPP or REIT periodic reports filed pursuant to Section 13(a) or 15(d) of the Exchange Act;
- ▶ an explanation of the method by which the value was developed; and
- ▶ the date of the valuation.

In addition, amended Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose, in a periodic or current report filed pursuant to Section 13(a) or 15(d) of the Exchange Act within 150 days following the second anniversary of breaking escrow and in each annual report thereafter, a per share estimated value:

- ▶ based on the valuations of the assets and liabilities of the DPP or REIT performed at least annually by, or with the material assistance or confirmation of, a third-party valuation expert or service;
- ▶ derived from a methodology that conforms to standard industry practice; and
- ▶ accompanied by a written opinion or report by the issuer, delivered at least annually, that explains the scope of the review, the valuation methodology used and the basis for the reported value.

The amendments to Rule 2310(b)(5) do not apply to DPPs that are subject to the 1940 Act as such DPPs are already required to determine and publish net asset value on a regular basis.

Endnotes

1. See Securities Exchange Act Release No. 73339 (October 10, 2014), 79 FR 62489 (October 17, 2014) (Order Approving SR-FINRA-2014-006, as Modified by Amendment No. 1).

Complex Products

Heightened Supervision of Complex Products

Executive Summary

This *Notice* provides guidance to firms about the supervision of complex products, which may include a security or investment strategy with novel, complicated or intricate derivative-like features, such as structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities. These features may make it difficult for a retail investor to understand the essential characteristics of the product and its risks.

The *Notice* identifies characteristics that may render a product “complex” for purposes of determining whether the product should be subject to heightened supervisory and compliance procedures and provides examples of heightened procedures that may be appropriate.

Questions concerning this *Notice* should be directed to Tom Selman, Executive Vice President, Regulatory Policy, at (202) 728-6977.

Background

FINRA often has reminded firms of their obligation to assess the potential risks associated with products that raise specific investor protection concerns. In 2003, FINRA issued two *Notices* addressing the sale of hedge funds and non-conventional instruments to retail investors.¹ In 2005, FINRA issued [Notice to Members 05-26](#) (NASD Recommends Best Practices for Reviewing New Products), which recommends best practices for reviewing new products and describes some of the processes that firms use to assess products proposed for sale. Similarly, FINRA has issued *Notices* about equity-indexed annuities,² structured products,³ leveraged and inverse exchange-traded funds,⁴ principal protected notes,⁵ reverse convertibles⁶ and commodity futures-linked securities.⁷ These *Notices* discuss the risks raised by each of these products, including the possibility that the product will not perform as many investors anticipate, or that it might be inappropriately sold on the basis of enhanced yield, principal protection or the tracking of an index or a reference asset. The *Notices* advise firms to adopt procedures for vetting the products and supervising the sale and marketing of the products to retail investors.

January 2012

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Complex Products
- ▶ Due Diligence
- ▶ Suitability
- ▶ Supervision
- ▶ Training

Referenced Rules and Notices

- ▶ FINRA Rule 2010
- ▶ FINRA Rule 2020
- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2360
- ▶ NASD Rule 2310
- ▶ NTM 03-07
- ▶ NTM 03-71
- ▶ NTM 05-26
- ▶ NTM 05-50
- ▶ NTM 05-59
- ▶ Regulatory Notice 09-31
- ▶ Regulatory Notice 09-73
- ▶ Regulatory Notice 10-09
- ▶ Regulatory Notice 10-22
- ▶ Regulatory Notice 10-51

A consistent theme in these *Notices* is that the complexity of a product often necessitates more scrutiny and supervision by a firm. For example, [Notice to Members 05-26](#) encourages firms to consider, during the vetting process, the complexity of a new product, whether the complexity would impair investor understanding of the product, and how complexity would affect the marketing and sale of the product. The *Notice* also encourages firms to consider whether less complex products could achieve the same objectives for investors. The *Notice* states that post-approval follow-up and review may be particularly important for complex products.⁸ FINRA also has brought a number of enforcement actions involving complex products charging inadequate supervision, unsuitable recommendations and misleading sales practices.⁹

In 2010, FINRA issued [Regulatory Notice 10-22](#), which discusses the obligations of broker-dealers that sell Regulation D offerings. The *Notice* reminds firms that FINRA's suitability rule requires that a broker-dealer conduct a reasonable investigation concerning any security that the broker-dealer recommends.¹⁰ The *Notice* also explains that a broker-dealer has a duty to conduct a reasonable investigation about the security and the issuer's representations about it. The duty stems from the broker-dealer's "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."¹¹ Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws and FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.

The Securities and Exchange Commission (SEC) also has expressed concern about complex products¹² and has devoted more resources to the issues presented by complex products.¹³ In recent years, the SEC has brought a number of enforcement cases involving complex products, addressing conduct such as the misrepresentation of complex investments as appropriate for retail investors seeking safe investments, fraud in collateralized debt obligation marketing materials, and misrepresentations about the extent to which an investment exposes the owner to the subprime real estate market.¹⁴

European and Asian regulators also have issued policy statements about the sale of complex products by financial firms within their jurisdictions. For example, the Danish Financial Supervisory Authority requires that all investment products sold to Danish retail investors carry one of three labels (green, yellow or red) indicating the risk of losing the initial investment amount and the difficulty in understanding that product.¹⁵ The French Autorité des marchés financiers (AMF) has reminded firms of their marketing and disclosure obligations to investors when dealing with complex products and has established criteria to identify highly complex products.¹⁶ The Financial Services Authority in the United Kingdom (FSA) recently published its new regulatory approach to product intervention, stating that it will place heightened focus on the design, development and management of products.¹⁷ In addition, the FSA published for comment guidance to product providers regarding the

sale of structured products.¹⁸ The Financial Services and Markets Authority in Belgium has temporarily banned on a “voluntary” basis the distribution of any new “unnecessarily complex structured products” to retail investors.¹⁹ The Securities and Futures Commission (SFC) in Hong Kong has adopted a package of measures to strengthen the regulatory regime governing the sale of unlisted structured products and other investments. The regime requires, for example, the issuance of “key fact statements” that summarize the essential features and risks of investment products and a “cooling off” or “unwind” period for investors in certain unlisted structured products.²⁰

Discussion

The fact that a product is “complex” indicates that it presents an additional risk to retail investors because its complexity adds a further dimension to the investment decision process beyond the fundamentals of market forces. This may be the case even though the complexity of some products may arise from features that seek to reduce the probability of investment losses in particular situations. Regulators have expressed concern about complex products because the intricacy of these products can impair the ability of registered representatives or their customers to understand how the product will perform in a variety of time periods and market environments, and can lead to inappropriate recommendations and sales.

Although this *Notice* provides guidance about the characteristics of many complex products, it does not define a “complex product” or provide an exhaustive list of features that might render a product “complex.” Moreover, some relatively simple products may also present significant risks to investors that warrant heightened scrutiny or supervision. Each firm is responsible for determining which products require enhanced compliance and supervisory procedures.

A. Characteristics of Complex Products

Any product with multiple features that affect its investment returns differently under various scenarios is potentially complex. This is particularly true if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return.

Examples of complex products include the following:

- ▶ Asset-backed securities that are secured by a pool of collateral such as mortgages, payments from consumer credit cards or future royalty payments on popular music, may be difficult for retail investors to understand. With these securities, the creditworthiness of the underlying borrowers or the existence of prepayment risks, though critical to the evaluation of the product, may not be readily apparent to retail investors. Similarly, unlisted REITs may present liquidity and valuation issues for a retail investor.²¹

- ▶ Products that include an embedded derivative component that may be difficult to understand, such as those:
 - ▶ in which repayment of principal or payment of yield depends upon a reference asset, when information about the performance of the reference asset is not readily available to investors. An example is structured notes with an embedded derivative for which the reference asset is a constant maturity swap rate.
 - ▶ that provide for different stated returns throughout the lifetime of the product. For example, “steepener” notes typically offer a relatively high teaser coupon rate for the first year, after which they offer variable rates determined by the steepness of a yield curve. Similarly, some firms have offered structured notes with payoffs contingent on whether one or more reference asset performs within a certain range.
 - ▶ under which the investor might incur a capital loss as a result of the fall in the value of the reference asset without being able to participate in an increase in its value. So-called “reverse convertible notes” may fall into this category.
 - ▶ in which a change in the performance of the reference asset can have a disproportionate impact on the repayment of capital or on the payment of return. For example, “knock in” or “knock out” features associated with reverse convertible notes, in which a drop in the value of the reference asset to a pre-defined level, can affect determination of an investor’s gains or losses.
- ▶ Products with contingencies in gains or losses, particularly those that depend upon multiple mechanisms, such as the simultaneous occurrence of several conditions across different asset classes. An example is range accrual notes for which the return of principal can depend upon the value of two or more reference assets on certain pre-defined dates.
- ▶ Structured notes with “worst-of” features, which provide payoffs that depend upon the worst performing reference index in a pre-specified group. These notes can limit the return of principal at maturity if either the reference index falls by a stated percentage (*e.g.*, 30 percent) or if any of the reference indices decline in value since the date of issue.
- ▶ Investments tied to the performance of markets that may not be well understood by many investors. For example, some exchange-traded products offer retail investors exposure to stock market volatility. Some of these products also provide inverse or leveraged exposure. The investable form of volatility may be in the form of futures on the CBOE Volatility Index (VIX) that reflect the market’s expectation of volatility. Some investors may not understand that the product’s return may not be based on VIX fluctuations actually experienced on a given day, but on the market’s expectation of future volatility.

- ▶ Products with principal protection that is conditional or partial, or that can be withdrawn by the product sponsor upon the occurrence of certain events. Notes that can lose their principal protection based upon a stated event represent an example of a product with this feature.
- ▶ Product structures that can lead to performance that is significantly different from what an investor may expect, such as products with leveraged returns that are reset daily. Leveraged or inverse exchange-traded funds exemplify this feature. Many leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated leverage or inverse objectives on a daily basis. Their performance over longer periods of time can differ significantly from what might be expected based on their daily leverage or inverse factor.
- ▶ Products with complicated limits or formulas for the calculation of investor gains. For example, some structured notes have a payout structure that tracks the upside performance of a reference asset one-for-four, but if the reference asset’s performance exceeds a specified threshold the payoff is reduced to a much lower, pre-set level, regardless of how it performs afterward.

The list above is not exhaustive. Moreover, many products that do not possess the characteristics described may nevertheless require heightened compliance and supervisory procedures due to the risks they present. However, the general characteristics should assist firms in establishing policies and procedures to identify products that are sufficiently complex to warrant enhanced oversight.

The fundamental point for firms is that if a product has similar features of complexity, such as embedded derivative-like features or a structure that produces different performance expectations according to price movements of other financial products or indices, then firms should err on the side of applying their procedures for enhanced oversight to the product.

B. Heightened Supervision

The following discussion of supervisory and compliance procedures may help firms assess the adequacy of controls with respect to complex products.

Approval of the Sale of Complex Products

Under FINRA’s suitability rule, a firm or registered representative must perform a reasonable basis suitability determination before recommending a transaction or investment strategy involving a security.²² A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors (as opposed to the customer-specific suitability determination, which is made on an investor-by-investor basis). To discharge the reasonable basis suitability obligation, a firm or registered representative must perform reasonable diligence to understand the

nature of the transaction or investment strategy, as well as the potential risks and rewards. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the familiarity of the firm or the registered representative with the security or investment strategy.²³

Reasonable diligence must provide the firm or registered representative “with an understanding of the potential risks and rewards associated with the recommended security or strategy.”²⁴ This understanding should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. The lack of such an understanding when making the recommendation could violate the suitability rule.²⁵ Firms should have formal written procedures to ensure that their registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted. Those procedures should ensure that the right questions are answered before a complex product is recommended to retail investors.

These questions should include the following:

- ▶ For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled?
- ▶ Conversely, to whom should this product not be offered?
- ▶ What is the product’s investment objective and is that investment objective reasonable in relation to the product’s characteristics? How does the product add to or improve the firm’s current offerings? Can less complex products achieve the objectives of the product?
- ▶ What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
- ▶ What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- ▶ How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
- ▶ Does the product present any novel legal, tax, market, investment or credit risks?
- ▶ Does the product’s complexity impair understanding and transparency of the product?
- ▶ How does this complexity affect suitability considerations or the training requirements associated with the product?
- ▶ How liquid is the product? Is there an active secondary market for the product?²⁶

Post-Approval Review

A well-designed system of internal controls should include a process to periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them. While a firm's procedures for approving specific complex products will help to ensure that the solicitation of investors is properly supervised, firms also should consider developing procedures to monitor how the products performed after the firm approved them. Every product presents risks that may cause the product to perform differently than anticipated, particularly when market conditions have changed. Some firms require that complex products be formally reviewed for a specific period of time so that the firm can assess their performance and determine whether product limitations are being met and whether market conditions have altered the risks associated with each product. Firms also should conduct periodic reviews to ensure that only associated persons who are authorized to recommend complex products to retail customers are doing so.

Training of Registered Representatives

Registered representatives who recommend complex products must understand the features and risks associated with those products. For example, a registered representative who recommends a collateralized mortgage obligation should understand the various features of the instrument, including the prepayment, credit and liquidity risks associated with the collateral and the particular tranche being recommended. Registered representatives who recommend structured products with embedded options and derivatives should possess a sophisticated understanding of the payoff structure, any limit on upside potential and the risks to investors that the payoff structure presents.

Ideally, the registered representative should be competent to develop a payoff diagram of a structured product to facilitate his or her analysis of its embedded features and recognize that such a product typically can be decomposed into bond and derivative parts. For example, if a structured product promises a 100 percent return of capital at maturity plus 150 percent of any rise in an underlying index over the investment period, the registered representative should have a sufficiently sophisticated understanding of finance to appreciate that this product is similar to a bond that matures with 100 percent return of capital and an embedded call with 150 percent participation and a strike price of 100 percent.

Knowledge of the payoff structure is not equivalent to an understanding of the risks associated with a complex product. The registered representative also should understand such features as the characteristics of the reference asset, including its historic performance and volatility and its correlation with specific asset classes, any interrelationship between multiple reference assets, the likelihood that the complex product may be called by the issuer, and the extent and limitations of any principal protection. The registered representative should be adequately trained to understand not only the manner in which a complex product is expected to perform in normal market conditions, but the risks associated with the product.

Consideration of a Customer's Financial Sophistication

FINRA's suitability rule requires that a firm or registered representative determine that a recommendation to purchase a security is suitable for the particular customer involved. The rule requires that firms and their registered representatives consider, among other factors, a customer's "investment experience" and "risk tolerance" when recommending a securities transaction or investment strategy to the customer.²⁷ In recommending complex products, firms are encouraged to adopt the approach mandated for options trading accounts, which requires that a registered representative have "a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the" complex product.²⁸

Some firms make approval of complex products contingent upon specific limitations or conditions, such as investment concentration limitations or limitations on the type of investors to whom the product may be sold. Some firms prequalify retail investors through specialized investor qualification agreements that may explain the product features and risk in plain English, and often include an attestation that the customer has read the materials provided, understands the risks and wants to invest in the product. The agreement cannot mitigate the responsibility of the firm and the registered representative to conduct a thorough, customer-specific suitability analysis.

Some complex products provide various forms of principal protection. Firms should take reasonable steps to ensure that registered representatives who recommend these products understand the limitations of this protection and the fact that the protection will not alone ensure that the product is suitable for all customers. For example, the existence of the principal protection may not render the product a "conservative investment" for an elderly retail investor for whom safety is an important consideration.

Firms also should consider prohibiting their sales force from recommending the purchase of some complex products to retail investors whose accounts have not been approved for options trading, particularly the recommendation of complex products with embedded options or derivatives. Firms should consider requiring some level of supervision by a specially qualified supervisor of these recommended transactions.

Firms that permit the recommendation of complex products to retail investors whose accounts have not been approved for options trading should develop other comparable procedures designed to ensure that their sales force does not solicit retail customers for whom complex products are unsuitable. These firms should be prepared to demonstrate the basis for allowing their sales force to recommend complex products to retail investors with accounts not approved for options trading. Of course, approving an account for the purchase of complex products is not a substitute for a thorough suitability analysis.

Discussions with the Customer

The registered representative who intends to recommend a complex product should discuss with the retail customer the features of the product, how it is expected to perform under different market conditions, the risks and the possible benefits, and the costs of the product. The registered representative also should discuss the scenarios in which the product may perform poorly. The registered representative should do so in a manner reasonably likely to facilitate the customer's understanding. The registered representative should consider whether, after this discussion, the retail customer seems to understand the basic features of the product, such as the fundamental payout structure and the nature of underlying collateral or a reference index or asset.

Consideration of Whether Less Complex or Costly Products Could Achieve the Same Objectives for the Customer

Registered representatives should consider whether less complex or costly products could achieve the same objectives for their customers. For example, registered representatives should compare a structured product with embedded options to the same strategy through multiple financial instruments on the open market, even with any possible advantages of purchasing a single product.

Conclusion

The decision to recommend complex products to retail investors is one that a firm should make only after the firm has implemented heightened supervisory and compliance procedures. Firms should rigorously monitor the extent to which these procedures address the various investor protection concerns raised by the recommendation of complex products to retail investors. Firms also should monitor the sale of these products in a manner that is reasonably designed to ensure that each product is recommended only to a customer who understands the essential features of the product and for whom the product is suitable.

Endnotes

1. [Notice to Members 03-07](#) (Feb. 2003) (NASD Reminds Members of Obligations When Selling Hedge Funds); [Notice to Members 03-71](#) (Nov. 2003) (NASD Reminds Members of Obligations When Selling Non-Conventional Investments).
2. [Notice to Members 05-50](#) (Aug. 2005) (Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities).
3. [Notice to Members 05-59](#) (Sept. 2005) (NASD Provides Guidance Concerning the Sale of Structured Products).
4. [Regulatory Notice 09-31](#) (June 2009) (FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds).
5. [Regulatory Notice 09-73](#) (Dec. 2009) (FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes).
6. [Regulatory Notice 10-09](#) (Feb. 2010) (FINRA Reminds Firms of Their Sales Practice Obligations With Reverse Exchangeable Securities (Reverse Convertibles)).
7. [Regulatory Notice 10-51](#) (Oct. 2010) (Sales Practice Obligations for Commodity Futures-Linked Securities).
8. See generally, [Notice to Members 05-26](#) (April 2005) (NASD Recommends Best Practices for Reviewing New Products).
9. See, e.g., *Northern Trust Securities, Inc.* (CRD No. 7927) (June 2, 2011) (inadequate supervision of sales of collateralized mortgage obligations and certain high-volume securities trades); *Santander Securities Corporation* (BD No. 41791) (April 12, 2011) (deficiencies in structured product business and unsuitable reverse convertible sales); *UBS Financial Services, Inc.* (CRD No. 8174) (April 11, 2011) (misleading sales of principal-protected notes).
10. [Regulatory Notice 10-22](#) (April 2010) (Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings).
11. *Id.* at 3 (citing *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969)).
12. See Speech by SEC Chairman Mary Schapiro: Keynote Address at the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 Annual Seminar, May 6, 2010.
13. See Testimony on the President's FY 2012 Budget Request for the SEC by Chairman Mary Schapiro, Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations, May 4, 2011.
14. See Speech by SEC Chairman Mary Schapiro, *supra* n.12.
15. See Danish Ministry of Economic and Business Affairs [Executive Order No. 345](#) on Risk-Labeling of Investment Products (April 15, 2011).
16. See AMF Position No. 2010-05-15, [Marketing of complex financial instruments](#), October 2010.
17. See FSA Discussion Paper DP 11/1, [Product Intervention, January 2011](#). See also [FSA Feedback Statement FS 11/3 \(feedback on DP 11/1\)](#), June 2011.
18. See [FSA Guidance Consultation, Retail Product Development and Governance - Structured Products Review, November 2011](#).
19. See Financial Services and Markets Authority Communication 2011_02, [Moratorium on the Distribution of Unnecessarily Complex Structured Products, June 2011](#), updated [September 2011](#).

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20. See SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (Handbook), Section I: Overarching Principles, Chapter 6: Disclosure Requirements, Product Key Facts Statements, Sub-sections 6.5-6.8 and Handbook Part IV: Post-sale arrangements – cooling-off period, Chapter 8: Issuer to provide for cooling-off or unwind right, Sub-sections 8.1-8.6.
21. In [Regulatory Notice 11-44](#), FINRA proposed amendments to NASD Rule 2340 to address how firms report the per share estimated values of unlisted Direct Participation Programs and unlisted REITs on customer account statements.
22. FINRA Rule 2111 takes effect on July 9, 2012. Pending effectiveness of that rule, NASD Rule 2310 governs the suitability obligations of a broker-dealer.
23. FINRA Rule 2111.05(a).
24. *Id.*
25. *Id.*
26. See also [Notice to Members 05-26](#) (April 2005).
27. FINRA Rule 2111(a).
28. FINRA Rule 2360(b)(19)(B).

Regulation D Offerings

Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings

Executive Summary

FINRA reminds broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under the Securities and Exchange Commission's Regulation D under the Securities Act of 1933—also known as private placements.

Regulation D provides exemptions from the registration requirements of Section 5 under the Act. Regulation D transactions, however, are not exempt from the antifraud provisions of the federal securities laws. A broker-dealer has a duty—enforceable under federal securities laws and FINRA rules—to conduct a reasonable investigation of securities that it recommends, including those sold in a Regulation D offering.

Moreover, any broker-dealer that recommends securities offered under Regulation D must meet its suitability requirements under NASD Rule 2310 (Suitability), and must comply with the advertising and supervisory rules of FINRA and the SEC.

Questions regarding this *Notice* should be directed to:

- ▶ Joseph E. Price, Senior Vice President Corporate Financing/Advertising, at (240) 386-4623;
- ▶ Paul Mathews, Director, Corporate Financing Department, at (240) 386-4639; or
- ▶ Gary Goldsholle, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8104.

April 2010

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management

Key Topics

- ▶ Communications With the Public
- ▶ Private Placements
- ▶ Suitability
- ▶ Supervision

Referenced Rules & Notices

- ▶ Regulation D
- ▶ Securities Act Section 17
- ▶ SEA Section 10(b)
- ▶ Rule 10b-5
- ▶ FINRA Rule 2010
- ▶ FINRA Rule 2020
- ▶ NASD Rule 2210
- ▶ NASD Rule 2310
- ▶ NASD Rule 3010
- ▶ NTM 03-71
- ▶ NTM 05-18
- ▶ NTM 05-48
- ▶ Regulatory Notice 09-05

Background and Discussion

Part I of this *Notice* describes Regulation D. Part II describes broker-dealers' regulatory responsibilities to engage in a reasonable investigation of a Regulation D offering, enforceable under the antifraud provisions of the federal securities laws and FINRA rules. Part II also describes specific issues that pertain to a broker-dealer's (BD's) responsibilities and how the scope of a BD's responsibility to conduct a reasonable investigation will necessarily depend upon its affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering, including whether the offerees are retail investors or more sophisticated institutional investors.¹

Part III describes practices that some broker-dealers have adopted to help them discharge their reasonable investigation obligations. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Securities Exchange Act of 1934. BDs, however, may find that many of the practices are appropriate for other types of offerings.

I. Regulation D

The private placement market is an essential source of capital for American business, particularly small firms. According to one estimate, in 2008 companies intended to issue approximately \$609 billion of securities in Regulation D offerings.² While the private placement market is an important source of capital for many U.S. companies, especially smaller issuers, FINRA has found significant problems in several recent examinations and investigations. These problems include fraud and sales practice abuses in Regulation D offerings. Recently, for example, broker-dealers were sanctioned for providing private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions.³

Rule 504 under Regulation D provides an exemption from the registration provisions under Section 3(b) of the Securities Act for limited offerings for which the aggregate offering price of securities within a 12-month period does not exceed \$1,000,000. Rule 505 provides an exemption under Section 3(b) of the Act for limited offerings for which the aggregate offering price of securities within a 12-month period does not exceed \$5,000,000. Rule 505 permits an offering to an unlimited number of "accredited investors" and up to 35 non-accredited investors. Rule 501 defines "accredited investor" as any person who meets, or who the issuer reasonably believes meets, certain requirements, including natural persons with a net worth in excess of \$1,000,000, or annual income in excess of \$200,000 (or \$300,000 jointly with a spouse).

Rule 506 provides a legal safe harbor for an exemption from registration under Section 4(2) of the Act for the sale of securities to an unlimited number of accredited investors and up to 35 non-accredited investors. Rule 506 (unlike Rule 505) does not limit the permissible size of the offering, but requires that non-accredited investors possess a degree of financial sophistication. Specifically, Rule 506 requires that each non-accredited investor, “either alone or with his purchaser representative(s),” have “such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment,” or the issuer must reasonably believe immediately prior to making any sale that the purchaser comes within this description.

Rule 505 and Rule 506 do not require that an issuer provide any specific written information concerning the offering to accredited investors, although issuers must provide specified information to a non-accredited investor who purchases in an offering. In practice, issuers often provide a private placement memorandum that describes the offering to all prospective purchasers, including accredited investors.⁴

II. BD Regulatory Requirements in Regulation D Offerings

A. Antifraud Provisions and FINRA Rules

The Securities and Exchange Commission (SEC) and federal courts have long held that a BD that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer’s representations about it.⁵ This duty emanates from the BD’s “special relationship” to the customer, and from the fact that in recommending the security, the BD represents to the customer “that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation.”⁶ Failure 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.⁷ 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.⁸

Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer.⁹ For example, the SEC and courts recognize that a more thorough investigation is required for “securities issued by smaller companies of recent origin,”¹⁰ which could include many Regulation D issuers. While there are no “iron clad rules as to what a broker must do to meet his responsibility,”¹¹ the presence of any “red flags” also would alert the broker to the need for further inquiry.¹² Each BD must make a determination of the scope of its investigation based upon the facts and circumstances.

A BD that lacks essential information about an issuer or its securities when it makes a recommendation, including recommendations of securities in Regulation D offerings, must disclose this fact as well as the risks that arise from its lack of information.¹³ The degree to which a broker-dealer that relies on information supplied by the issuer may be found to have conducted a reasonable investigation as a basis for its recommendation will depend on the facts and circumstances. With respect to reporting companies under the Securities Exchange Act, in the absence of red flags, a BD that is not an underwriter typically may rely upon the current registration statement and periodic reports of the public company.

In general, however, a BD “may not rely blindly upon the issuer for information concerning a company,”¹⁴ nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation.¹⁵ While BDs are not expected to have the same knowledge as an issuer or its management, firms are required to exercise a “high degree of care” in investigating and independently verifying an issuer’s representations and claims.¹⁶ Indeed, when an issuer seeks to finance a new speculative venture, BDs “must be particularly careful in verifying the issuer’s obviously self-serving statements.”¹⁷

The fact that a BD’s customers may be sophisticated and knowledgeable does not obviate the duty to investigate.¹⁸ Moreover, in Regulation D offerings the SEC advises issuers to provide the same information to accredited investors as they are required to provide to non-accredited investors, in view of the antifraud provisions.¹⁹

B. FINRA Suitability Obligations

NASD Rule 2310 states that a BD must have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer.²⁰ This analysis has two principal components. First, the “reasonable basis” suitability analysis requires the BD to have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. Second, the “customer specific suitability” analysis requires that the BD determine whether the security is suitable for the customer to whom it would be recommended.²¹

In the context of a Regulation D offering, Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non-accredited investors that will take into account the investors’ knowledge and experience. The fact that an investor meets the net worth or income test for being an accredited investor is only one factor to be considered in the course of a complete suitability analysis. The BD must make reasonable efforts to gather and analyze information about the customer’s other holdings, financial situation and needs, tax status, investment objectives and such other information that would enable the firm to make its suitability determination. A BD also must be satisfied that the customer “fully understands the risks involved and is...able...to take those risks.”²²

In order to ensure that it has fulfilled its suitability responsibilities, a BD 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.²³

A BD must conduct a reasonable investigation in connection with each offering, notwithstanding that a subsequent offering may be for the same issuer.²⁴

C. Specific Issues Related to a BD's Responsibilities

The scope of a BD's investigation will necessarily depend upon a number of factors, including the BD's affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering, including whether the offerees are retail customers or more sophisticated institutional investors.

1. BD That Is Affiliated With the Issuer

A BD that is an affiliate of an issuer in a Regulation D offering must ensure that its affiliation does not compromise its independence as it performs its investigation.²⁵ The BD must resolve any conflict of interest that could impair its ability to conduct a thorough and independent investigation. Indeed, its affiliation with the issuer typically would raise expectations by its customers, particularly some retail customers, that the BD has special expertise concerning the issuer.²⁶

2. BD That Prepares the Private Placement Memorandum

A BD that prepares the private placement memorandum or other offering document has a duty to investigate securities offered under Regulation D and representations made by the issuer in the private placement memorandum or other offering document.²⁷ In a recent enforcement action, FINRA found that a BD that prepared a private placement memorandum 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 BDs to comply with just and equitable principles of trade.²⁸

A BD that assists in the preparation of a private placement memorandum or other offering document should expect that it will be considered a communication with the public by that BD for purposes of NASD Rule 2210, FINRA's advertising rule. If a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, then the BD that assisted in its preparation may be deemed to have violated NASD Rule 2210. Moreover, sales literature concerning a private placement that a BD distributes will generally be deemed to constitute a communication by that BD with the public, whether or not the BD assisted in its preparation.

3. The Presence of Red Flags

In the course of a reasonable investigation, a BD must note any information that it encounters that could be considered a “red flag” that would alert a prudent person to conduct further inquiry. Red flags might arise from information that is publicly available or information that is discovered during the course of the investigation. A BD’s reasonable investigation responsibilities would obligate it to follow up on any red flags that it encounters during its inquiry as well as to investigate any substantial adverse information about the issuer.²⁹

When presented with red flags, the BD must do more than simply rely upon representations by issuer’s management, the disclosure in an offering document or even a due diligence report of issuer’s counsel. In *Kunz and Cline*, the SEC found that the broker could not justifiably rely on financial statements in private placement memoranda that had been audited and certified by an accountant when numerous “red flags” indicated that the financial statements were inaccurate.³⁰ The broker had a duty, which it failed to discharge, to conduct a further, independent investigation of the financial condition of the issuer under the circumstances. The SEC also found that the broker acted contrary to just and equitable principles of trade when the private placement memorandum failed to disclose both the broker’s consulting relationship with the issuer and the litigation history of the issuer’s president and CEO.

An issuer’s refusal to provide a broker-dealer with information that is necessary for the broker-dealer to meet its duty to investigate could itself constitute a red flag. If an issuer is not forthcoming with information requested by a broker-dealer (or provides information that is non-responsive or out-of-date), the broker-dealer must determine whether sufficient information is otherwise obtainable. While issuers are not required to provide accredited investors with a private placement memorandum in order to qualify for the exemptions in Rule 505 or Rule 506, these memoranda typically are used in Regulation D offerings and firms may need to consider whether the absence of a private placement memorandum itself might constitute a red flag.

4. Reliance on Counsel and Syndicate Managers

A BD may retain counsel or other experts to assist the firm in undertaking and fulfilling its reasonable investigation obligation. A BD must carefully review the qualifications and competency of counsel or experts retained to perform an investigation on its behalf³¹ and must ensure that all gaps or omissions in the investigation by such counsel or experts are separately addressed by the BD. Moreover, the use of counsel or experts does not necessarily complete the BD’s investigation responsibilities, insofar as a review of the counsel’s or expert’s report may identify issues or concerns that require further investigation by the BD.

It may be appropriate in a Regulation D offering in which a BD is merely a member of a syndicate or selling group to rely upon a reasonable investigation by the syndicate manager, provided the BD has reason to believe that the syndicate manager has the expertise and absence of conflicts to engage in a thorough and independent inquiry, and that it has in fact performed such an inquiry with respect to the particular Regulation D offering. Any BD who intends to rely upon 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. A BD that relies upon the efforts of the syndicate manager retains its own responsibilities, to the extent that they are not addressed by the syndicate manager's efforts. For example, if there is reason to believe that the syndicate manager has not addressed a particular issue, then each BD participating in the offering will be responsible to the extent that it implicates the BD's own suitability analysis.

D. Supervision

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, including its registered representatives:

- engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements;
- perform the analysis required by NASD Rule 2310;
- qualify their customers 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.

These procedures must be reasonably designed to ensure that each Regulation D offering is properly supervised before it is marketed to other firms or sold directly to customers.³²

E. Documentation of Reasonable Investigation

To demonstrate that it has performed a reasonable investigation, a BD should retain records documenting both the process and results of its 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, 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.

III. Reasonable Investigation Practices

A BD's reasonable investigation must be tailored to each Regulation D offering in a manner that best ensures that it meets its regulatory responsibilities. Accordingly, a single checklist of possible practices for a BD engaged in a Regulation D offering will not suffice for every offering, and mechanical reliance upon a single checklist may result in an inadequate investigation. Nevertheless, we are providing a list of practices that some firms have adopted to help them adequately discharge their responsibilities. Many of the practices described below are designed to satisfy BDs' regulatory requirements. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Securities Exchange Act.

Industry participants that we surveyed described the following as practices that help ensure they meet their reasonable investigation obligations.

A. Issuer and Management

Reasonable investigations of the issuer and its management concerning the issuer's history and management's background and qualifications to conduct the business might include:

- Examining the issuer's governing documents, including any charter, bylaws and partnership agreement, noting particularly the amount of its authorized stock and any restriction on its activities. If the issuer is a corporation, a BD might determine whether it has perpetual existence.
- Examining historical financial statements of the issuer and its affiliates, with particular focus, if available, on financial statements that have been audited by an independent certified public accountant and auditor letters to management.
- Looking for any trends indicated by the financial statements.
- Inquiring about the business of affiliates of the issuer and the extent to which any cash needs or other expectations for the affiliate might affect the business prospects of the issuer.
- Inquiring about internal audit controls of the issuer.
- Contacting customers and suppliers regarding their dealing with the issuer.
- Reviewing the issuer's contracts, leases, mortgages, financing arrangements, contractual arrangements between the issuer and its management, employment agreements and stock option plans.

- Inquiring about past securities offerings by the issuer and the degree of their success while keeping in mind that simply because a certain product or sponsor historically met obligations to investors, there are no guarantees that it will continue to do so, particularly if the issuer has been dependent on continuously raising new capital. This inquiry could be especially important for any blind pool or blank-check offering.
- Inquiring about pending litigation of the issuer or its affiliates.
- Inquiring about previous or potential regulatory or disciplinary problems of the issuer. A BD might make a credit check of the issuer.
- Making reasonable inquiries concerning the issuer's management. A BD might inquire about such issues as the expertise of management for the issuer's business and the extent to which management has changed or is expected to change. For example, a BD might inquire about any regulatory or disciplinary history on the part of management and any loans or other transactions between the issuer or its affiliates and members of management that might be inappropriate or might otherwise affect the issuer's business.
- Inquiring about the forms and amount of management compensation, who determines the compensation and the extent to which the forms of compensation could present serious conflicts of interest. A BD might make similar inquiries concerning the qualifications and integrity of any board of directors or similar body of the issuer.
- Inquiring about the length of time that the issuer has been in business and whether the focus of its business is expected to change.

B. Issuer's Business Prospects

Reasonable investigations of the issuer's business prospects, and the relationship of those prospects to the proposed price of the securities being offered, might include:

- Inquiring about the viability of any patent or other intellectual property rights held by the issuer.
- Inquiring about the industry in which the issuer conducts its business, the prospects for that industry, any existing or potential regulatory restrictions on that business and the competitive position of the issuer.
- Requesting any business plan, business model or other description of the business intentions of the issuer and its management and their expectations for the business, and analyzing management's assumptions upon which any business forecast is based. A BD might test models with information from representative assets to validate projected returns, break-even points and similar information provided to investors.

- Requesting financial models used to generate projections or targeted returns.
- Maintaining in the BD's files a summary of the analysis that was performed on financial models provided by the issuer that detail the results of any stress tests performed on the issuer's assumptions and projections.

C. Issuer's Assets

Reasonable investigations of the quality of the assets and facilities of the issuer might include:

- Visiting and inspecting a sample of the issuer's assets and facilities to determine whether the value of assets reflected in the financial statements is reasonable and that management's assertions concerning the condition of the issuer's physical plants and the adequacy of its equipment are accurate.
- Carefully examining any geological, land use, engineering or other reports by third-party experts that may raise red flags.
- Obtaining, with respect to energy development and exploration programs, expert opinions from engineers, geologists and others are necessary as a basis for determining the suitability of the investment prior to recommending the security to investors.

Endnotes

- 1 As a general matter, any reference in this *Notice* to the obligations of a BD firm is also intended to cover the concomitant responsibilities of any registered representative who recommends a Regulation D offering to his/her customers and any registered principal who is charged by his/her firm with supervising this registered representative.
- 2 Office of the Inspector General, Securities and Exchange Commission, *Regulation D Exemption Process 2* (March 31, 2009).
- 3 See, e.g., Provident Asset Management, LLC, FINRA Case No. 2009017497201 (2010); *Pacific Cornerstone Capital, Inc.* FINRA AWC No. 2007010591701 (2009).
- 4 A note to Rule 502(b)(1) states that when an issuer provides required information to any non-accredited investor, it should consider providing the information to accredited investors, too, "in view of the anti-fraud provisions of the federal securities laws."
- 5 See *Hanly v. SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969); *SEC v. Great Lake Equities Co.*, 1990 U.S. Dist. LEXIS 19819 at *16-17 (E.D. Mich. 1990); *SEC v. North American Research and Development Corp.*, 424 F.2d 63,84 (2d Cir. 1970). See also *SEC v. Current Financial Services, Inc.*, 100 F. Supp. 2d 1, 14-15 (D.D.C. 2000); *District Business Conduct Committee for District No. 4 v. Everest Securities, Inc.*, 1994 NASD *Discip. Lexis 188* (Sept. 2, 1994), *aff'd*, 52 S.E.C.

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Endnotes continued

- 958, 962-63 (Aug. 26, 1996), *aff'd*, 116 F. 3d 1235 (8th Cir. 1997); Securities Act Release No. 4445, 27 Fed. Reg. 1415 (Feb. 2, 1962).
- 6 *Hanly*, *supra* note 5 at 597.
- 7 *See generally Hanly*, *supra* note 5.
- 8 *See Everest Securities, Inc.*, *supra* note 5.
- 9 *See Hanly*, *supra* note 5. *See also University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976).
- 10 *Hanly*, *supra* note 5 at 597.
- 11 *University Hill Foundation*, *supra* note 9 at 898.
- 12 *See, e.g., SEC v. Milan Capital Group, Inc.*, 2000 U.S. Dist. LEXIS 16204 (S.D.N.Y. 2000), where the court held that the duty to independently investigate is greater “where promotional materials are in some ways questionable, for example by promising unusually high returns.”
- 13 *See Hanly*, *supra* note 5 at 597 (“Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information”). *See also* Securities Act Release No. 4445, *supra* note 5; *Regulatory Notice 09-05* (Guidance to Member Firms Participating in Unregistered Resales of Restricted Securities) (January 2009).
- 14 *Hanly*, *supra* note 5 at 597. The duty of inquiry under the antifraud provisions is distinguished from the “reasonable investigation” that, under Section 11(b) of the Securities Act, permits an underwriter to escape liability for misrepresentations in a registration statement. Courts have compared the Section 11 reasonable investigation and the BD’s general duty to investigate and concluded that “somewhat more is required of an underwriter than a broker to discharge its obligation to the investing public.” *University Hill Foundation*, *supra* note 9 at 898-99. This is because “an underwriter’s relationship to the issuer is more substantial” than a BD that is only recommending a security, and the underwriter “plays a more central role in the marketing process.” *Id.*
- 15 *See Everest Securities, Inc. v. US*, *supra* note 5 at 1239 (“reliance on others does not excuse [the respondents] own lack of investigation”).
- 16 *Everest Securities, Inc.*, *supra* note 5 at 963.
- 17 *Everest Securities, Inc.*, *supra* note 5 at 963.
- 18 *Hanly* at 596, *supra* note 5.
- 19 Note to Rule 502(b)(1).
- 20 FINRA has previously discussed the responsibilities of a BD to conduct a reasonable investigation of securities it is recommending. *See, e.g., Notice to Members 03-71* (concerning non-conventional investments)(November 2003); *Notice to Members 05-18* (concerning private placements of tenants-in-common interests) (March 2005).
- 21 *F.J. Kaufman & Co.*, 50 S.E.C. 164, 168-69 (Dec. 13, 1989). *See also In the Matter of Michael Frederick Siegel*, Securities Exchange Act Release No. 58737 (October 6, 2008), 2008 SEC Lexis 2459, at *28.
- 22 *See James B. Chase*, 56 S.E.C. 149, 159 (2003).
- 23 BDs should analyze whether the investor’s money is likely to be applied according to the stated use of proceeds, and whether the stated use of proceeds is reasonable in light of the issuer’s business purpose and prospects. *See In Re Brian Prendergast*, 2001 SEC LEXIS 1533 (August 1, 2001); *Legend Merchant Group, Inc.*, NASD No. C10030058, summarized in NASD Disciplinary Actions (July 2004); *Shelman Securities, Inc.*, NASD No. C06030013, summarized in NASD Disciplinary Actions (February 2004).

Endnotes continued

- 24 See, e.g., *Shelman Securities*, *supra* note 23 (private placement memoranda contained material misrepresentations and omissions about use of proceeds in a previous offering).
- 25 See *In the Matter of C. Gilman Johnston*, 42 S.E.C. 217 (Aug. 14, 1964) (broker-dealer's control person prepared memorandum describing broker-dealer's own "highly speculative" securities without any reasonable basis for believing that the securities were suitable for some purchasers). See generally *Pacific Cornerstone Capital*, *supra* note 3 at 10 (person providing information for and reviewing and approving private placement memorandum and sales literature was BD's control person and issuer's founder). Regulation D generally prohibits a broker or other person that is affiliated with the issuer from serving as a purchaser representative to an investor. See Rule 501(h)(1)(definition of "purchaser representative").
- 26 Cf. FINRA Rule 5122 (requiring members to comply with certain requirements when engaging in private placement of securities issued by the member or a control entity).
- 27 *SEC v. Kunz and Cline Investment Management, Inc.* Admin. Proc. File No. 3-9960, *aff'd* 2003 U.S. App. LEXIS 6011 (10th Cir. 2003) (unpublished opinion).
- 28 *Pacific Cornerstone Capital, Inc.*, *supra* note 3.
- 29 *Everest Securities, Inc. v. SEC*, *supra* note 5 at 1239 (finding "the investigation that was performed was itself insufficient," and even a cursory investigation would have uncovered facts showing offering memorandum was materially misleading).
- 30 *Kunz and Cline*, *supra* note 27.
- 31 See *Notice to Members 05-48* (Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers) (July 2005) (discussing a member's accountability and supervisory responsibility for outsourced functions).
- 32 *Pacific Cornerstone Capital, Inc.*, *supra* note 3 at 9.