Regulatory Notice 23-08

Private Placements

FINRA Reminds Members of Their Obligations When Selling Private Placements

May 9, 2023

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- FINRA Rules 2010, 2020, 2111, 2210, 3110, 3120, 3280, 5122 and 5123
- JOBS Act
- Notice to Members 01-23
- Regulatory Notices 10-22, 11-02, 12-25, 16-08, 20-18, 20-21, 21-26 and 23-09
- Regulation Best Interest
- Regulation D
- Securities Act Sections 3, 4 and 17(a)
- Securities Exchange Act Section 10(b)
- Securities Exchange Act Rule 10b-5
- Securities Exchange Act Rule 10b-9
- Securities Exchange Act Rule 15c2-4

Summary

In this *Notice*, FINRA reminds members of their obligations when selling private placements (*i.e.,* unregistered offerings sold pursuant to the Regulation D safe harbors under Sections 3 and 4 of the Securities Act of 1933 (Securities Act)). In *Regulatory Notice 10-22* (Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings), FINRA reminded members of their obligations to conduct reasonable investigations of the issuers and the securities they recommend in private offerings made under Regulation D. In the years since FINRA published *Regulatory Notice 10-22*, the unregistered offering market and the related regulatory landscape have evolved, and FINRA has observed both areas of concern and effective practices in the sales of private placements by members. This *Notice* updates and supplements the prior guidance in light of those developments and observations. It is not intended to alter the principles or the guidance FINRA provided in prior *Regulatory Notices*.

This *Notice* highlights a member's obligation, when recommending a security, to conduct a reasonable investigation of the security. This duty has long been rooted in the antifraud provisions of the federal securities laws and is a core component of a broker-dealer's obligations under Securities and Exchange Commission (SEC) Regulation Best Interest (Reg BI) and FINRA Rule 2111 (Suitability), the fundamental standards that members must meet when recommending securities.[1] This *Notice* also addresses certain additional obligations for members when selling private placements, including FINRA's filing requirements and its communications with the public and supervision rules.

This *Notice* does not create new legal or regulatory requirements or new interpretations of existing requirements, nor does it relieve firms of any existing obligations under federal securities laws and regulations. Members may consider the information in this *Notice* in developing new, or modifying existing, practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the member's size and business model.

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FINRA notes that it is issuing a companion notice, *Regulatory Notice 23-09*, requesting comment on whether changes to FINRA rules, operations or administrative processes would enhance the capital-raising process without compromising protections for investors and issuers.[2] FINRA encourages members to provide feedback pursuant to that *Notice*.

Questions regarding this *Notice* should be directed to:

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Background and Discussion

Under the federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available.[3] Private placements are unregistered, non-public securities offerings that rely on an available exemption from registration with the SEC under either Section 3 or 4 of the Securities Act.[4] This *Notice* principally focuses on private placements sold pursuant to the Regulation D safe harbors under Sections 3 and 4 of the Securities Act (*i.e.,* Rules 504, 506(b) and 506(c)).[5]

Part I of this *Notice* provides an overview of developments in the unregistered offering market generally. Part II discusses members' regulatory requirements when participating in private placements. It focuses primarily on members' critical role, when recommending private placements, in performing reasonable investigations under the reasonable basis obligations of Reg BI, the suitability rule and caselaw interpreting the antifraud provisions of the federal securities laws. Part II also examines key member obligations applicable to private placement activity irrespective of whether recommendations are involved. For instance, Part II discusses FINRA's filing requirements for private placement memoranda (PPMs) and related documents, as well as FINRA's communications with the public and supervision rules, including the duty to investigate and act upon "red flags" revealing irregularities or potential misconduct.

Part III discusses practices FINRA has observed since *Regulatory Notice 10-22* was published that members have adopted to address their reasonable investigation obligations and related supervisory obligations when recommending private placements. These practices are examples of potentially effective measures for compliance with regulatory requirements that FINRA has observed in private placement examinations and through feedback provided by members in a recent private placement survey.[6] They add to those practices highlighted in *Regulatory Notice 10-22*.

I. Developments in Unregistered Offerings

The unregistered offering market is an important source of capital for American businesses, including small and midsize companies. In recent years, the unregistered offering market outpaced the public market. According to SEC analysis, in 2019, 69 percent of new capital ($2.7 trillion) was raised through unregistered offerings, compared to 31 percent ($1.2 trillion) through registered public offerings.[7] The amount of capital raised in Regulation D offerings alone more than doubled from 2009 to 2019.[8]

The majority of Regulation D offerings are sold directly by issuers without any broker-dealer involvement. Approximately 20 percent of Regulation D offerings involve "intermediaries," such as broker-dealers.[9] Thus, only a small percentage of investors in private placements are afforded the protections of FINRA rules and other relevant broker-dealer regulations that apply when a Regulation D offering involves a member.

However, member involvement in private placements has kept pace with the growth of the Regulation D market in general. In 2021, for example, members submitted over 3,800 unique filings for private placements pursuant to FINRA Rules 5122 and 5123, which require filings for private placements generally sold to individuals, in comparison to roughly 2,000 submissions in 2013.[10]

The growth of the unregistered market is due in part to legislative and regulatory developments that reduced barriers to capital formation. The Jumpstart Our Business Startups (JOBS) Act of 2012 required the SEC to eliminate the prohibition on general solicitation in Rule 506 offerings under Regulation D, lifting a significant restriction on the manner in which a private offering may be sold, among other initiatives to promote capital formation.[11] In recent years, the SEC also revised its rules to facilitate intrastate offerings, increased the offering limits for certain exempt offerings and established consistent guidelines across the exempt offering framework.[12] These measures were part of a larger effort by the SEC and Congress to reduce restrictions and provide issuers with capital-raising alternatives to public offerings.[13]

While these changes and the growth of the unregistered offering market have increased funding opportunities for issuers (in particular, small and midsize businesses) and investment options for investors, private offerings may present certain risks to investors. These risks include, for many private placements, their illiquid nature, the lack of access to comprehensive information with which to value the securities or a transparent market to set the market price, the absence of substantial operating histories, and the lack of independently audited financial statements.

In contemplation of such risks, the SEC and Congress also imposed measures to reduce risk to investors in recent years. These include, among other things, adopting "bad actor" disqualification provisions[14] and requiring verification of accredited investor status for offerings that involve general solicitation.[15] In addition, as discussed below, with the adoption of Reg BI, the SEC enhanced the broker-dealer standard of conduct beyond existing suitability obligations and imposed new investor protection obligations on members and their associated persons when they recommend securities, including private placements, to retail customers.

II. Member Regulatory Requirements for Private Placements

Members that participate in private placements are subject to important regulatory obligations that help ensure the protection of investors and maintain confidence in the marketplace, thereby ultimately benefiting capital formation. While key obligations are highlighted below, depending on the facts and circumstances, additional requirements could apply.[16]

A. Requirements Applicable When Recommending Private Placements—Best Interest and Suitability

Among the regulatory developments since the publication of *Regulatory Notice 10-22* was the SEC's adoption of Reg BI, which requires a member or associated person, when making a recommendation[17] of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer,[18] to act in the best interest of the retail customer without placing the financial or other interest of the member or associated person ahead of the interest of the retail customer.[19] This general obligation is satisfied only by complying with four specified component obligations: the Care Obligation, the Disclosure Obligation, the Conflict of Interest Obligation and the Compliance Obligation.

Reg BI's Care Obligation incorporates and builds on broker-dealers' longstanding suitability obligations, and like FINRA Rule 2111 (Suitability), it includes reasonable basis, customer specific and quantitative components.[20] Members and their associated persons must comply with Reg BI when recommending private placements to retail customers, and with FINRA Rule 2111 when recommending private placements to non-retail customers.

Reasonable Basis Obligations and the Duty to Conduct a Reasonable Investigation

FINRA Rule 2111 and Reg BI each require a member or associated person that recommends a private placement to have a reasonable basis for that recommendation.

FINRA's reasonable basis obligation requires a member or associated person, when recommending a security, to perform reasonable diligence to understand the nature of the security, as well as the potential risks and rewards, and to determine whether the recommendation is suitable for at least some customers based on that understanding.[21]

Similarly, the SEC's Reg BI Care Obligation requires that the member or associated person undertake reasonable diligence, care and skill to understand the nature of the recommended security or investment strategy involving a security—as well as the potential risks, rewards and costs[22] of the recommended security or investment strategy—and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers based on that understanding.[23]

To fulfill these reasonable basis obligations, a member or associated person must conduct a reasonable investigation of any security or investment strategy involving a security it recommends.[24] This duty, which also has long been recognized by the SEC and federal courts under the antifraud provisions of the federal securities laws,[25] originally emanated from the broker's "special relationship" to the customer and from the fact that, in recommending the security, the broker represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[26]

What constitutes a reasonable investigation depends on the facts and circumstances.[27] As the duty has been applied under the antifraud provisions, certain guiding principles have emerged.[28] 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.[29] For example, a more thorough investigation is required for "securities issued by smaller companies of recent origin,"[30] which could include many private placement issuers. There is no hard and fast rule as to what a broker must do to meet this responsibility, but the presence of "red flags" should alert the broker to the need for further inquiry.[31]

Regulatory Notice 10-22 explained that a member or associated person recommending a private placement 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.[32]

While these areas of review continue to be essential to a reasonable investigation, since FINRA published *Regulatory Notice 10-22*, FINRA has observed, through its examinations[33] and disciplinary actions,[34] other areas in which some members' investigations into private placements could be strengthened. Based on these observations, as part of a reasonable investigation of a private placement, members should also consider addressing, where relevant, the following:

- Regulatory and litigation history of the issuer and its management, including the criminal, disciplinary, regulatory, and litigation history associated with the issuer, its management, and any affiliate that may be materially involved in the issuer's business, as well as the issuer's compliance with the bad actor provisions under Rule 506(d)–(e).[35]
- New material developments, including events that are or should be reasonably known to the member during an offering, for example, when there are ongoing legal proceedings or regulatory inquiries involving the issuer.
- Transactions or payments between an issuer and the issuer's affiliates involving offering proceeds, including the terms of the transaction between the related parties and whether an arrangement presents a material conflict of interest for the issuer and, if so, the sufficiency of disclosure.
- Representations of past performance of the issuer, its sponsor, or its manager to identify any such representations that may be misleading or exclusively selected based on positive results (or "cherry-picking"). This is particularly important when the representations pertain to specific prior issuances.

While members are not expected to have the same knowledge as an issuer or its management, FINRA reminds members of the importance of conducting a reasonable investigation that independently verifies an issuer's material representations and claims, particularly when the member or its associated persons are affiliated with the issuer or when red flags are present.[36] A member's independent analysis of the offering should not rely solely upon representations made by the issuer or its affiliates.

Often, members rely on information provided by a third party hired by the member or the issuer. Appraisers, attorneys and due diligence experts may provide valuable assistance to a member in fulfilling its reasonable investigation obligations. However, the member should review the information from these sources with reasonable care, considering the independence, incentives and qualifications of the third party.[37] This is particularly important with regard to third parties hired by the issuer.[38]

A member may demonstrate that it has conducted a reasonable, independent investigation by:

- Documenting the inquiries, research, and analysis that the member conducted.
- Obtaining additional information from an issuer, such as primary documents, to perform an independent analysis of issuer representations.[39] For example, if the PPM contains a representation concerning the contracts or permits the issuer has in place, a reasonable independent review may involve obtaining and reviewing copies of the contracts or permits.[40]
- Critically analyzing third-party due diligence reports. When a member encounters red flags through its own review, the member must address those issues prior to recommending the offering.[41] For instance, where a due diligence report contains inconsistencies or inadequately addresses potential concerns, a member should obtain a more thorough explanation of the issue from the source of the report or by independently researching the matter.[42]

FINRA also cautions members to consider the impact an issuer's timeline for the offering may have on the quality or thoroughness of the member's reasonable investigation. For example, it may raise a concern if an issuer or managing members condition a selling member's participation in the offering on a selling schedule that does not accommodate sufficient time for the member to complete a reasonable investigation.

Finally, while in practice members often take on the operational responsibility for gathering and analyzing reasonable investigation materials to approve an offering, associated persons should be mindful that they, themselves, have an independent obligation to satisfy Reg BI or Rule 2111 when making recommendations.[43]

Customer-Specific Obligations

When members or associated persons recommend a private placement, they also have customer-specific obligations under FINRA's suitability rule and Reg BI's Care Obligation.[44]

Under FINRA Rule 2111, the customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile.[45]

Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors only if certain conditions are satisfied relating to the investors' capability to evaluate the risks, and the investors affirmatively indicating that they are exercising independent judgment.[46]

The customer specific component of Reg BI's Care Obligation requires the member or associated person to exercise reasonable diligence, care and skill to have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation and does not place the financial or other interest of the member or associated person ahead of the interest of the retail customer.[47]

As part of this requirement under Reg BI, members must obtain and analyze enough customer information to have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. Where retail customer information is unavailable despite a member's reasonable diligence, the member should carefully consider whether it has a sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the best interest of that retail customer.[48]

SEC staff guidance under Reg BI concerning risky or complex products (including private placements) provides that members and their financial professionals generally should apply heightened scrutiny to whether a risky or complex product is in the retail customer's best interest.[49] Among the relevant considerations when recommending such a product is whether the retail customer "has an identified, investor-specific trading objective that is consistent with the product's description in its prospectus or offering documents, and/or has the ability to withstand heightened risk of financial loss."[50]

In addition, a member or associated person should consider "reasonably available alternatives" offered by the member as part of having a "reasonable basis to believe" that the recommendation is in the best interest of the retail customer.[51] For complex or risky products (including private placements), this involves considering whether lower risk or less complex options can achieve the same investment objectives.[52]

Other Reg BI Component Obligations

As noted above, Reg BI's general obligation is satisfied only by complying with four specified component obligations. In addition to the Care Obligation, Reg BI also has the following component obligations: Disclosure, Conflict of Interest and Compliance.

The Disclosure Obligation requires the member or associated person, prior to or at the time of the recommendation, to provide the retail customer, in writing, full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer and all material facts relating to conflicts of interest that are associated with the recommendation.[53] Material facts relating to the scope and terms of the relationship with the retail customer that must be disclosed include, but are not limited to: (1) the capacity in which the broker-dealer is acting; (2) the material fees and costs that apply to the retail customer's transactions, holdings and accounts; and (3) the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer. Importantly, disclosure of conflicts of interests alone does not satisfy the obligation to act in the retail customer's best interest.[54]

The Conflict of Interest Obligation requires a member to identify and address conflicts of interest that may incline the member or its associated persons—consciously or unconsciously—to make a recommendation that is not disinterested.[55] Specifically, members must establish, maintain and enforce written policies and procedures reasonably designed to:

- identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate, all conflicts of interest associated with recommendations;
- identify and mitigate any conflicts of interest associated with recommendations that create an incentive for the member's associated persons to place their interest or the interest of the member ahead of the retail customer's interest;
- identify and disclose any material limitations (*e.g.,* a limited product menu) placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations and prevent such limitations and associated conflicts of interest from causing the member or the associated person to make recommendations that place the interest of the member or the associated person ahead of the retail customer's interest;[56] and
- identify and eliminate sales contests, sales quotas, bonuses and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

This process "should not be merely a 'check-the-box' exercise, but a robust, ongoing process that is tailored to each conflict[,]" including those regarding relationships with affiliates or third parties.[57]

Conflicts may be of particular concern when members recommend to retail customers private placements of securities issued by an affiliated company. However, even where the securities are not issued by an affiliated company, conflicts can arise from a close relationship with the issuer, including when a member engages in other activities for or with the issuer or when an associated person separately may be connected to the issuer. Moreover, there are conflicts inherent in any recommendation of securities, including private placements, based on the potential or actual receipt of compensation, revenue or other benefits (financial or otherwise) that must be addressed in accordance with the rule.[58]

Finally, under the Compliance Obligation, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.[59] SEC staff guidance concerning complex and risky products (including private placements) suggests, among other things, that firms should consider developing procedures outlining the due diligence process for complex or risky financial products to help ensure that these products are assessed by qualified and experienced firm personnel, and should consider establishing procedures requiring appropriate training and supervision to help ensure financial professionals understand the features, risks and costs of a complex financial product.[60] The guidance suggests, moreover, that members should consider documenting the process and reasoning behind particular recommendations of complex or risky products, including consideration of less complex alternatives, and how it fits within the retail customer's broader goals or strategy.[61]

Of course, even if a member complies with its Disclosure, Conflict of Interest, and Compliance Obligations, "it has not fully complied with Reg BI unless it has also satisfied the Care Obligation," discussed above, including the requirement "to have a reasonable basis to believe that each recommendation or series of recommendations made is in the best interest of the particular retail customer and does not place their financial or other interests ahead of the interest of the retail customer."[62] For example, some members that offer private placements may materially limit their product offerings. FINRA reminds such members that even if they have disclosed and taken steps to prevent the limitation from placing the interests of the member ahead of the retail customer, as required by the Disclosure and Conflict of Interest Obligations, they cannot use their limited menu to justify recommending a private placement that does not satisfy the obligation to act in a retail customer's best interest.[63]

B. Other Requirements Applicable to Private Placements

Members are subject to important obligations even in the absence of a recommendation. Some key requirements for members and associated persons engaged in private placement activities are highlighted below. Members and associated persons should keep in mind, however, that this list is not exhaustive.

Communications with the Public

Under FINRA rules, offering materials will be considered a communication with the public for purposes of FINRA Rule 2210 (Communications with the Public) if the member was involved in preparing the materials. If a PPM or other offering document presents information that is not fair and balanced or that is misleading, then the member that assisted in its preparation may be found to have violated FINRA Rule 2210.[64] Moreover, sales literature concerning a private placement that a member distributes generally constitutes a communication by that member with the public, whether or not the member assisted in its preparation.[65] In 2020, FINRA published *Regulatory Notice 20-21* to help member firms comply with FINRA Rule 2210 when creating, reviewing, approving, distributing or using retail communications concerning private placement offerings.

FINRA has brought enforcement actions under the federal securities laws and FINRA rules against members and associated persons in matters involving private offerings containing materially misleading information.[66] In one case, for example, a FINRA hearing panel found that a member affiliated with the issuer helped prepare the PPM and, because of its inside knowledge, had the ability to approximately calculate the issuer's costs related to drilling operations.[67] The panel found the member violated Securities Exchange Act of 1934 (Exchange Act) Rule 10b-5 and FINRA Rule 2020 for recommending a private placement using a PPM that inaccurately stated that the costs related to the drilling operations could not be reasonably predicted.[68]

Private Placement Filings with FINRA

FINRA Rule 5122 imposes disclosure and filing requirements for members that sell a private placement of securities issued by a member or a control entity.[69] Its companion rule, FINRA Rule 5123, requires members that sell any other type of private placement to file a copy of any offering documents with FINRA within 15 calendar days of the first sale, subject to various exemptions.[70] Both Rules 5122 and 5123 require filings to include retail communications used by the member that promote or recommend the private placement.[71]

Pursuant to Rules 5122 and 5123, FINRA requires members to submit a form that contains information about the member selling the private placement securities, the issuer and the offering terms as well as any offering documents, if applicable, electronically through the FINRA Gateway (the Filer Form). FINRA uses the information in the Filer Form to conduct oversight on particular areas of risk in the private placement market and enhance investor protection.

Supervision

Under FINRA Rule 3110, a member must establish and maintain a system to supervise the activities of each associated person, and must establish, maintain and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with FINRA rules.[72] In the context of private placements, these procedures must be reasonably designed to ensure that each private placement offering is properly supervised before it is marketed to other members or sold directly to customers.[73] Moreover, as has long been the case under Rule 3110 (and its predecessor), if a member were faced with "red flags" revealing irregularities or potential misconduct, including with regard to private placements, the member must investigate and act upon them.[74]

To meet their supervisory obligations, members may need to periodically update their written supervisory procedures, supervisory systems and training programs to keep pace with regulatory and business developments.[75] For example, members may need to update their procedures to incorporate SEC staff guidance on Reg BI,[76] changes to the member's business activities and customer base or to strengthen practices in areas of known concern.

Private Securities Transactions

At times, private placements are sold by an associated person outside of his or her relationship with the member. These are considered to be private securities transactions (PSTs). FINRA Rule 3280 requires that the associated person provide written notice to and receive written approval from the member when the transaction involves selling compensation. If the member approves a person's participation in the PST for compensation, the transaction must be recorded on the books and records of the member and the member must supervise the person's participation in the transaction as if the transaction were executed on behalf of the member. When recommending a private placement security in a PST to a retail customer, the associated person also must comply with the rules applicable to recommendations of securities, including Reg BI.

III. Effective Practices Relating to Reasonable Investigation and Related Supervisory Practices

A member's reasonable investigation of a recommended private placement will yield an understanding of the issuer and its prospects and reflect the member's reasonable analysis of the offering documents and the representations made to customers. *Regulatory Notice 10-22* provides examples of practices that some members adopted to help them adequately discharge their responsibilities in these areas. FINRA has observed the following additional practices from its private placement examination findings and through feedback received from its survey of members.[77]

A. Offering-Specific Investigations

A member's process for conducting a reasonable investigation of a private placement should include attention to the unique facts and circumstances of the offering. A reasonable investigation process might include:

- Reviewing the offering terms to determine if they are reasonably structured for compliance with applicable rules. For example, analyzing the escrow arrangements and termination provisions in contingency offerings as required under Rules 10b-9 and 15c2-4 of the Exchange Act.[78]
- Maintaining contact with the issuer. The vast majority of members surveyed stated that as a matter of practice they always or frequently maintain regular contact with the issuer to obtain updates on developments.
- Applying a heightened analysis when recommending an investment that involves complex features or unique benefits to investors. For example, where potential tax benefits are a critical component of an investment, many members take additional steps to understand the relevant tax requirements, the risks associated with the complex tax strategies, legal implications, valuation methodologies, or other unique factors.[79]
- Maintaining an updated due diligence file, for example, when recommending securities in follow-on offerings by the same issuer or sponsor in order to have a reasonable basis to recommend the current offering. Consistent with previous guidance in *Regulatory Notice 10-22*, members often retain records documenting both the process and results of the updated investigation.

B. Supervision of the Reasonable Investigation Process

To maintain adequate supervision of its private placement reasonable investigations under FINRA Rule 3110, or to meet the requirements of Reg BI's Compliance Obligation, members' procedures might include:

- When using a checklist, ensuring it is reasonably designed to address the private placement, requirements for filing and related documentation, assignment of staff responsible for performing functions and tasks, and evidence of supervisory approval for the reasonable investigation process.
- Assigning responsibility for the member's private placement reasonable investigation and compliance with filing requirements to specific individual(s) or team(s) and conducting targeted, in-depth training about the firms' policies, process and filing requirements.
- Creating a system that alerts responsible individual(s) and supervisor(s) about upcoming and missed filing deadlines.

- Requiring documentation of the process, completeness, and results of its investigations and retention of documents collected through due diligence. Some firms, for example, include descriptions of the meetings that were conducted in the course of the investigation, such as 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. Firms also document efforts to evaluate potential red flags and risk factors that they identified in the course of the investigation.
- Implementing standards for the reasonable investigation process that specifically address certain types of offerings sold by the member. For example, members that routinely engage in offerings that are particularly complex or risky may create guidelines to help ensure that the security is not recommended to customers whose investment profiles may not align with the security's characteristics.
- Taking steps to ensure that the member's sale of an offering does not precede the completion of its reasonable investigation.

IV. Conclusion

As the private placement market has evolved and grown in recent years, members have continued to play an important role in providing an essential source of capital for American businesses, while promoting the integrity of the offering process and protecting investors. This *Notice* discusses key requirements for members that engage in private placement activity, including obligations adopted after FINRA issued *Regulatory Notice 10-22*. Based on private placement examinations and feedback provided by members, this *Notice* also highlights potentially effective practices by members to comply with regulatory and legal requirements. Members may wish to consider the information in this *Notice* in developing new, or modifying existing, practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the member firm's size and business model.

Endnotes

1. A duty to conduct a reasonable investigation when recommending a security or an investment strategy involving a security arises under the reasonable basis component of Reg BI's Care Obligation and FINRA Rule 2111.05(a). *See Regulation Best Interest*, Exchange Act Release No. 83062 (April 18, 2018), 83 FR 21574, 21609 (May 9, 2018) (Reg BI Proposing Release) ("To meet this proposed requirement under paragraph (a)(2)(ii)(A), a broker-dealer would need to: (1) undertake reasonable diligence (*i.e.,* reasonable investigation and inquiry) to understand the potential risks and rewards of the recommended security or strategy (*i.e.,* to understand the security or strategy)[…]"); Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318, 33375 (July 12, 2019) (Reg BI Adopting Release) ("Paragraph (a)(2)(ii)(A) of Regulation Best Interest is intended to incorporate and build upon broker-dealer's existing "reasonable-basis suitability" obligations and would relate to the broker-dealer's understanding of the particular security or investment strategy recommended, rather than to any particular retail customer); FINRA Rule 2111.05(a); *Regulatory Notice 12-25* (May 2012); *see also Regulatory Notice 10-22* (April 2010). The duty also arises from caselaw interpretations of the antifraud provisions of the federal securities laws. *See Everest Sec., Inc.,* 52 S.E.C. 958, 962 (1996) ("Broker-dealers are under a duty to investigate the securities that they recommend, and their failure to do so subjects them to liability for violations of the antifraud provisions of the securities laws."), *aff'd,* 116 F.3d 1235 (8th Cir. 1997).
2. *See Regulatory Notice 23-09* (May 2023).
3. *See* SEC Investor Bulletin: Private Placements under Regulation D (August 17, 2022).
4. *See* 15 U.S.C. 77c and 77d. Section 3(b) is the exemptive authority for Rule 504 under Regulation D and Section 4(a)(2) is the exemptive authority for Rules 506(b) and 506(c) under Regulation D.
5. *See* 17 CFR 230.504, 230.506(b) and 230.506(c). Other types of unregistered offerings include those made pursuant to Regulation A, Regulation Crowdfunding, Regulation S, and Rule 144A.
6. FINRA Private Placement Survey (November 2021), distributed to approximately 500 FINRA members who had engaged in private offerings filed with FINRA under FINRA Rules 5122 or 5123. Ninety-one members responded to the survey.
7. *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets,* Securities Act Release No. 10884 (November 2, 2020), 86 FR 3496 (January 14, 2021) (Facilitating Capital Formation), at 202-203.
8. In 2009, approximately $0.7 trillion was raised under Regulation D, in comparison to approximately $1.5 trillion in 2019. *See Facilitating Capital Formation, supra* note 7; and *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA), U.S. Securities and Exchange Commission (Aug. 2018) (Capital Raising in the U.S.).
9. *See Capital Raising in the U.S., supra* note 8. The SEC's analysis of private offerings that involve "intermediaries" did not distinguish between those that involved broker-dealers versus those that involved other types of intermediaries, such as unregistered "finders." *Id*.

10. FINRA Rule 5122 requires members to make a filing when they offer or sell any security in a private placement of unregistered securities by a member or control entity. FINRA Rule 5123 requires members to make a filing when they sell a security in any other private placement. Both rules provide exemptions from filing for certain types of offerings, and for offerings sold solely to certain types of investors such as qualified purchasers, institutional purchasers, and other sophisticated investors.

11. In 2013, pursuant to the JOBS Act, the SEC established Rule 506(c), an exemption from registration that permits general solicitation in a private placement where all investors are accredited and the issuer or its agent takes reasonable steps to verify their accredited status. The SEC also adopted Regulation Crowdfunding and expanded Regulation A to facilitate smaller companies' access to capital.

12. In 2016, the SEC amended Rule 147 and adopted new Rule 147A to modernize the rules surrounding intrastate offerings. In 2017 and 2021, the SEC amended Rule 504 to increase the aggregate amount that may be offered and sold in any 12-month period from $1 million to $5 million and then to $10 million. In 2020 – 2021, the SEC amended several rules to update the exempt offering framework and further promote access to capital, including expanding the definition of accredited investor, simplifying the integration rules, increasing offering limits for Regulation A and Regulation Crowdfunding offerings as well as Rule 504, and revising the disclosure, eligibility, and bad actor requirements across the exempt offering framework. *See Facilitating Capital Formation, supra* note 7. The SEC's amendments in 2020 to the definition of "accredited investor" increased the number of categories through which an individual investor may be identified as accredited. *Accredited Investor Definition*, Exchange Act Release No. 89669 (August 26, 2020), 85 FR 64234 (October 9, 2020).

13. Other legislative actions designed to encourage business development through capital formation led to the creation and promotion of specialized investment products. For example, the Tax Cuts and Jobs Act (TCJA) of 2017 created a new tax-advantaged product, Qualified Opportunity Funds, that promote investment in economically distressed areas of the United States. The EB-5 Regional Center Program, providing opportunities for foreign capital investment in the United States, was reauthorized by Congress in 2022.

14. In 2013, the SEC adopted bad actor disqualification provisions for Rule 506 of Regulation D. Under Rule 506(d), an offering is disqualified from relying on the Rule 506 safe harbor if the issuer or related person covered by 506(d) is subject to a disqualifying event that occurred on or after September 23, 2013. Under 506(e), if there is a disqualifying event that occurred prior to September 23, 2013, the issuer may rely on Rule 506 but must comply with the disclosure requirements of 506(e). Similar disqualification provisions apply for offerings under Rule 504, Reg A, and Reg CF. In 2020, the SEC harmonized the bad actor disqualification provisions across Reg D, Reg A, and Reg CF. *See Facilitating Capital Formation, supra* note 7.

15. Rule 506(c).

16. For example, Anti-Money Laundering (AML) requirements, among others, may apply.

17. For purposes of Reg BI, whether a "recommendation" is made is interpreted consistent with precedent under the federal securities laws and with how the term has been applied under FINRA rules. Reg BI Adopting Release, *supra* note 1, at 33337. As the SEC explained, "the determination of whether a broker-dealer has made a recommendation that triggers application of Regulation Best Interest should turn on the facts and circumstances of the particular situation and therefore, whether a recommendation has taken place is not susceptible to a bright line definition. Factors considered in determining whether a recommendation has taken place include whether the communication 'reasonably could be viewed as a call to action' and 'reasonably would influence an investor to trade a particular security or group of securities.' The more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a recommendation." *Id.* at 33335 (citation omitted). *See also* NASD *Notice to Members 01-23* (March 2001); *Regulatory Notice 11-02* (January 2011); *Regulatory Notice 12-25* (May 2012).

18. "Retail customer" is defined in Exchange Act Rule 15*l*-1(b)(1) as "a natural person, or the legal representative of such natural person, who: (i) [r]eceives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (ii) [u]ses the recommendation primarily for personal, family, or household purposes."

19. Exchange Act Rule 15*l*-1(a). It is important to note, as well, that SEC staff has emphasized that Reg BI applies "to limited purpose broker-dealers, for example, broker-dealers that make recommendations of private offerings to accredited investors[.]" Frequently Asked Questions on Regulation Best Interest. SEC staff explained that the "definition of 'retail customer' does not exclude high-net worth natural persons and natural persons that are accredited investors" and that "[w]hether a broker-dealer engages in limited activity does not dictate whether or not [Reg BI] applies." *Id*.

20. In connection with the adoption of Reg BI, to provide clarity over which standard applies, FINRA amended its suitability rule to state that Rule 2111 does not apply to recommendations that are subject to Reg BI. *See* FINRA Rule 2111.08; *Regulatory Notice 20-18* (June 2020) ("FINRA's suitability rule is still needed for entities and institutions (*e.g.*, pension funds), and natural persons who will not use recommendations primarily for personal, family, or household purposes (*e.g.,* small business owners and charitable trusts).").

21. *See* Rule 2111.05(a).

22. The express requirement to consider cost in evaluating a recommendation is one of Reg BI's key enhancements to existing suitability obligations. *See* Reg BI Adopting Release, *supra* note 1, at 33327.

23. *See* Regulation Best Interest, Exchange Act Rule 15*l*-1(a)(2)(ii)(A); Reg BI Adopting Release, *supra* note 1, at 33376. A member or associated person could violate the reasonable basis obligation "by not understanding the potential risks, rewards, or costs of the recommended security or investment strategy, even if the security or investment strategy could have been in the best interest of at least some retail customers."

24. *See supra* note 1.

25. *See Hanly v. SEC,* 415 F.2d 589, 595-97 (2d. Cir. 1969) ("[Brokers] must disclose facts which he knows and those which are reasonably ascertainable."); *see also SEC v. CKB168 Holdings, Ltd.,* 210 F. Supp. 3d 421, 449 n. 31 (E.D.N.Y. 2016) ("[B]y acting as brokers, each of the promoters acquired heightened duties to investigate and disclose."); *SEC v. Milan Cap. Grp, Inc.,* 2000 U.S. Dist. LEXIS 16204, at *14 (S.D.N.Y. 2000) ("A broker is under a duty to investigate the truth of his representations to clients. . . ."); *SEC v. Great Lakes Equities Co.,* 1990 U.S. Dist. LEXIS 19819, at *18 (E.D. Mich. 1990) ("A registered representative cannot rely blindly on information provided by the issuer but must investigate further to authenticate the information."); *Everest Sec., Inc.,* 52 S.E.C. at 962; *Dep't of Enf't v. Titan Sec.,* Complaint No. 2013035345701, 2021 FINRA DISCIP. LEXIS 5 at *44 (FINRA NAC June 2, 2021) ("In the context of private placement offerings, a registered representative has an obligation to conduct a reasonable investigation. . ."); *Dep't. of Enf't v. Gomez,* Complaint No. 2011030293503, 2018 FINRA Discip. LEXIS 10, at *47 (FINRA NAC March 28, 2018) ("[I]n the context of a private placement of securities, a registered representative has an obligation to conduct a reasonable investigation of the issuer and the securities offering.").

26. *Hanly,* 415 F.2d at 597; *see also Dep't. of Enf't v. Luo,* Complaint No. 2011026346206, 2017 FINRA Discip. LEXIS 4 at *18 (FINRA NAC Jan. 13, 2017) ("This duty [to investigate] is based upon the broker's 'special relationship' to the investor."). Failures by members to comply with the duty to conduct a reasonable investigation have been found in violation of the antifraud provisions of the federal securities laws, including Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5. Failure to conduct a reasonable investigation can amount to recklessness for purposes of scienter under the anti-fraud provisions of the federal securities laws and FINRA rules. *See SEC v. CKB168,* 210 F. Supp.3d at 448 (explaining that a failure to perform a reasonable investigation "in the face of doubtful facts . . . amounts to recklessness as a matter of law."); *Alvin W. Gebhart,* Exchange Act Release No. 58951, 2008 SEC LEXIS 3142, at *27 28 (Nov. 14, 2008) (finding respondents recklessly made representations related to the safety of notes without performing a reasonable investigation into the actual securitization of the notes), aff'd, 595 F.3d 1034 (9th Cir. 2010); *Milan,* 2000 U.S. Dist. LEXIS 16204 at *15 ("A variety of circumstances may raise enough questions about the legitimacy of an investment to make a person's failure to investigate . . . reckless."); *Gomez,* 2018 FINRA Discip. LEXIS 10 at *47 (finding that Gomez acted recklessly by failing to perform an investigation of the securities and their promoters).

27. Reg BI Adopting Release, *supra* note 1, at 33376. ("What would constitute reasonable diligence, care, and skill under Paragraph (a)(2)(ii)(A) will vary depending on, among other things, the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy. . . . [B]roker-dealers generally should consider important factors such as the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of

the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy. Together, this inquiry should allow the broker-dealer to develop a sufficient understanding of the security or investment strategy and to be able to reasonably believe that it could be in the best interest of at least some retail customers."). *See also Regulatory Notice 10-22* ("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.").

28. *See generally Regulatory Notice 10-22*.

29. *See Hanly,* 415 F.2d. at 595–96. *See also University Hill Foundation v. Goldman, Sachs & Co.,* 422 F. Supp. 879, 898 (S.D.N.Y. 1976).

30. *Hanly,* 415 F.2d. at 597 ("Securities issued by smaller companies of recent origin obviously require more thorough investigation.").

31. *See generally Regulatory Notice 10-22; see also Milan,* 2000 U.S. Dist. LEXIS 16204, at *15 (explaining that broker's duty to conduct a reasonable investigation is greater "where promotional materials are in some ways questionable, for example by promising unusually high returns").

32. *See Regulatory Notice 10-22.*

33. *See, e.g.,* 2023 Report on FINRA's Examination and Risk Monitoring Program (noting failures to conduct a reasonable investigation of private placement offerings prior to recommending them to retail investors).

34. *See, e.g. Dep't of Enf't v. Carolina Fin. Securities, LLC,* Complaint No. 2014040295201, 2017 FINRA Discip. LEXIS 24, at *159-70 (FINRA Hearing Panel May 26, 2017) (finding that respondents violated FINRA Rule 2111(a) by recommending securities without conducting a reasonable investigation, including with respect to a significant contract and a pending lawsuit); *Gomez,* 2018 FINRA Discip. LEXIS 10, at *38 (finding, in connection with recommendations of securities that claim to involve pre-IPO securities, respondent violated NASD Rule 2310 and 2010 as a result of conducting insufficient diligence that, among other things, failed to uncover "significant, adverse public information about the past criminal or fraudulent activity" of relevant individuals); and *Nobles & Richards, Inc.,* Case No. 2017055743101 (Feb. 9, 2022) (FINRA AWC) (finding member violated FINRA Rules 3110(a) and 2010 as a result of failing to conduct reasonable due diligence prior to serving as the managing broker-dealer for two offerings involving a manager who was subject to a consent order and undertaking with a securities regulator.); CFD Investments, Inc., Case No. 2018057457101 (Aug. 24, 2020) (FINRA AWC) (finding member violated FINRA Rules 2111, 3010, 3110 and 2010 as a result of failing to conduct reasonable due diligence, despite the presence of multiple red flags, including with respect to the issuer's financial position, the circumstances of a lawsuit and resulting jury verdict, the issuer's prior offerings, and payment arrangements between the issuer and an affiliate associated with the project); *Mark D. Martino,* Case 2019064535602 (Aug. 15, 2022) (FINRA AWC) (finding respondent violated FINRA Rules 2111(a) and 2010 by failing to conduct reasonable due diligence of an acknowledged red flag concerning a lawsuit, and violated FINRA Rules 3110 and 2010 by failing to reasonably

supervise the firm's due diligence of the offering); *Axiom Capital Management, Inc.,* Case No. 2019064535601 (Aug. 15, 2022) (FINRA AWC) (finding the member violated FINRA Rule 2111 when it conducted due diligence and identified a "red flag," a fraud-related lawsuit by the Federal Trade Commission (FTC) against the company's founder, but failed to conduct reasonable ongoing due diligence in connection with the lawsuit during the three-month offering period, including by unreasonably relying on the lead placement agent (and the defendant in the lawsuit) to keep it apprised of material developments).

35. *See supra* note 14.

36. *See* Everest Sec., Inc., 52 S.E.C. at 963 ("When an issuer seeks funds to finance a new and speculative venture, brokers and underwriters 'must be particularly careful in verifying the issuer's obviously self-serving statements as to its operations and prospects.'"); *Newbridge Sec. Corp.,* Case No. 2016047569601 (Sept. 26, 2019) (FINRA AWC) (The member violated FINRA Rule 2111 when it failed to conduct an independent review of an affiliated investment fund, relying entirely on the issuer to conduct its own diligence); *Regulatory Notice 10-22*.

37. *See, e.g. Everest Sec., Inc.,* 52 S.E.C. at 1239 (stating that "reliance on others does not excuse [the respondents] own lack of investigation"). As stated in *Regulatory Notice 10-22*, a member may retain its own counsel or other experts to assist the firm in undertaking and fulfilling its reasonable investigation obligation. A member must carefully review the qualifications and competency of counsel or experts retained to perform an investigation on its behalf and must ensure that all gaps or omissions in the investigation by such counsel or experts are separately addressed by the member. Moreover, the use of counsel or experts does not necessarily complete the member'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 member. For a discussion of a member's reliance on a syndicate manager's investigation, see *Regulatory Notice 10-22.*

38. *See, e.g., DBCC v. Kevin D. Kunz,* Complaint No. C3A960029, 1999 NASD Discip. LEXIS 20, at *33-36 (NASD NAC July 7, 1999) (holding respondents liable for failing to reasonably investigate "red flags" of material misstatements in a financial statement in offering material even though the financials had been audited by a certified public accountant), *aff'd,* Exchange Act Release No. 45290, 55 S.E.C. 551 (2002); *Regulatory Notice 10-22* ("[A] BD 'may not rely blindly upon the issuer for information concerning a company,' nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation.") (citation omitted).

39. An issuer's failure to furnish information necessary to corroborate a claim or resolve an issue is a significant risk factor that should be considered in a member's determination of whether to recommend those securities to its customers. *See Regulatory Notice 10-22*. Nearly one-third of members surveyed indicated that the issuer's inability to supply necessary information was the most common reason not to proceed with the sale of the offering.

40. *See, e.g., Carolina Fin. Securities, LLC,* 2017 FINRA Discip. LEXIS at *161 (emphasizing that the diligence failures relating to a contract were significant factors in the hearing panel's finding that Carolina did not conduct a reasonable investigation).

41. *See, e.g., Everest Sec., Inc.,* 52 S.E.C. 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); *Kunz,* 1999 NASD Discip. LEXIS 20, at *33-36.

42. *See, e.g. First Am. Sec., Inc.,* Case No. 2015046056405 (Nov. 7, 2016) (FINRA AWC) (The member violated FINRA Rule 2111 when it failed to conduct sufficient additional due diligence after obtaining a third-party diligence report that contained no independent assessment or any substantive analysis of the issuer).

43. *See* SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (April 20, 2022) (SEC Staff Bulletin on Care) ("Although firms have duties under their care obligations, including a general responsibility to understand the investments or investment strategies that they are recommending . . . , financial professionals also have this responsibility. [F]irms should generally help ensure those financial professionals have sufficient information and training to understand the investment and investment strategies they recommend . . . ; however, financial professionals cannot satisfy their own care obligations by solely relying on the efforts of others at their firm. Rather, financial professionals remain responsible for personally understanding an investment or investment strategy before they recommend [it]."); Exchange Act Rule 15*l*-1(a)(2)(ii) (a natural person who is an associated person of a broker or dealer, in making a recommendation, is required to exercise reasonable diligence, care and skill); Rule 2111.05(a) (an associated person making a recommendation has a reasonable basis obligation). Particularly where the associated person has identified red flags, a reasonable investigation would require additional follow-up. In a FINRA disciplinary matter, a member's due diligence gathering efforts were insufficient and its associated persons who recommended the offering without resolving those deficiencies consented to sanctions for making unsuitable recommendations. *See Richard Seefried,* Case No. 2014041862703 (Dec. 4, 2017) (FINRA AWC) and *Brenton Bataille,* Case No. 2014041862704 (Dec. 4, 2017) (FINRA AWC) (finding that two associated persons conducted insufficient due diligence on the offering; each agreed to sanctions for violating FINRA Rule 2111 by lacking a reasonable basis to recommend the security). *See also Luo*, 2017 FINRA Discip. LEXIS 4; *Harry Seth Datys,* Case No. 2017054381601 (Sept. 7, 2020) (FINRA AWC). Associated persons also should not detract from or minimize the risk factors known to them or disclosed in the offering documents when recommending an offering to a customer. FINRA has found that associated persons violated suitability rules and antifraud provisions when they orally misrepresented terms of an investment that did not conform to the disclosures in the PPM. *See Dep't of Enf't v. David Joseph Escarcega,* Complaint No. 2012034936005, 2017 FINRA Discip. LEXIS 32 (FINRA NAC July 20, 2017) (finding that despite the risk disclosures in the PPM, the registered representative's recommendations were unsuitable when he misrepresented to customers that the security offered "guaranteed returns"). *See also Dep't of Enf't v. Jorge A. Reyes,* Complaint No. 2016051493704, 2019 FINRA DISCIP. LEXIS 59, at *41 (FINRA Hearing Panel Dec. 17, 2019) (finding that "written disclosures found in a PPM do not excuse Reyes's responsibility to ensure that his oral representations are not misleading").

44. Both rules also impose quantitative obligations. *See* FINRA Rule 2111.05(c); Exchange Act Rule 15*l*-1(a)(2)(ii)(C).

45. FINRA Rule 2111.05(b).

46. FINRA Rule 2111(b) and .07.

47. Exchange Act Rule 15*l*-1(a)(2)(ii)(B).

48. Reg BI Adopting Release, *supra* note 1, at 33379.

49. *See* SEC Staff Bulletin on Care, *supra* note 43 ("Examples of products where heightened scrutiny may be necessary include, but are not limited to, inverse or leveraged exchange-traded products, investments traded on margin, derivatives, crypto asset securities, penny stocks, private placements, asset-backed securities, volatility-linked exchange-traded products, and reverse-convertible notes.").

50. *Id*.

51. Reg BI Adopting Release, *supra* note 1, at 33374. As the SEC explained, under the Compliance Obligation, "a broker-dealer should have a reasonable process for establishing and understanding the scope of such 'reasonably available alternatives' that would be considered by particular associated persons or groups of associated persons (*e.g.,* groups that specialize in particular product lines) in fulfilling the reasonable diligence, care, and skill requirements under the Care Obligation." *Id* at 33381. The SEC also noted, "With respect to broker-dealers that materially limit the range of products or services that they recommend to retail customers (*e.g.,* limits its product offerings to only proprietary or other limited menus of products), the Conflict of Interest Obligation provision requires broker-dealers to have reasonably designed policies and procedures to identify and disclose the material limitations and any conflicts of interest associated with such limitations, and to prevent such limitations and associated conflicts of interest from causing the broker-dealer or associated person to make recommendations that place the interest of the broker-dealer or associated person ahead of the interest of the retail customer." *Id* at 33381-2. *See also infra* notes 56 and 63 and accompanying text. Moreover, the SEC Staff Bulletin on Care stated that, when a firm has a limited menu of investments, depending on the facts and circumstances, a financial professional considering reasonably available alternatives "generally should be familiar with each of those investments that are available to investors." SEC Staff Bulletin on Care, *supra* note 43.

52. SEC Staff Bulletin on Care, *supra* note 43. *See also* Reg BI Adopting Release, *supra* note 1, at 33381 and n.638 (citing FINRA *Regulatory Notice 12-03*).

53. Exchange Act Rule 15*l*-1(a)(2)(i). Concurrent with the adoption of Reg BI, the SEC also adopted Form CRS and related rules, which require SEC-registered broker-dealers and investment advisers to deliver to retail investors a brief customer or client relationship summary that provides information about the firm. *See* Form CRS Relationship Summary; Amendments to Form ADV, SEC File No. S7-08-18 (Sept. 10, 2019). The Form CRS obligation is triggered when a broker-dealer "offers services" to a retail investor, which can include opening a brokerage account for a retail investor, placing an order for a retail investor or recommending a security or investment strategy involving a security (including a recommendation of account type) to a retail investor. The obligation thus applies to a broader range of broker-dealers than Reg BI, which only applies to broker-dealers who make recommendations.

54. *See* SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (Aug. 3, 2022) (SEC Staff Bulletin on Conflicts).
55. Exchange Act Rule 15*l*-1(a)(2)(iii); 15*l*-1(b)(3).
56. *See supra* note 51 and *infra* note 63.
57. SEC Staff Bulletin on Conflicts, *supra* note 54.
58. *See generally* Reg BI Adopting Release, *supra* note 1; and SEC Staff Bulletin on Conflicts, *supra* note 54.
59. Exchange Act Rule 15*l*-1(a)(2)(iv). *Id.*
60. *See* SEC Staff Bulletin on Care, *supra* note 43.
61. *Id.*
62. SEC Staff Bulletin on Conflicts, *supra* note 54.
63. Reg BI Adopting Release, *supra* note 1, at 33326 ("Furthermore, we clarify that, when a broker-dealer materially limits its product offerings to certain proprietary or other limited menus of products, it must still comply with the Care Obligation—even if it has disclosed and taken steps to prevent the limitation from placing the interests of the broker-dealer ahead of the retail customer, as required by the Disclosure and Conflict of Interest Obligation—and thus could not use its limited menu to justify recommending a product that does not satisfy the obligation to act in a retail customer's best interest."). *See also supra* note 51.
64. FINRA Rule 2210(d)(1). *See also Bridge Cap. Assocs., Inc.,* Case No. 2014039283801 (Dec. 12, 2016) (FINRA AWC); *Regulatory Notice 10-22*.
65. *See Regulatory Notice 10-22; Regulatory Notice 20-21* (July 2020).
66. *See, e.g., Titan Securities,* 2021 FINRA DISCIP. LEXIS 5; *Gomez,* 2018 FINRA Discip. LEXIS 10.
67. *Dep't of Enf't v. Red River Sec, LLC,* Complaint No. 2013035344201 (FINRA Hearing Panel Feb. 9, 2017). The panel in *Red River* found Hardwick, the CEO, was the "maker" of material misrepresentations and omissions in the PPMs because he had "ultimate authority" over the content of the PPMs. *Id.* at 18 (citing *Janus Cap. Grp, Inc.* v. *First Derivative Traders,* 564 U. S. 135, 142 (2011)).
68. *Id.* The panel in *Red River* found the firm violated Exchange Act Rule 10b-5 and FINRA Rules 2020, 3110, 2111 and 2010. The panel also found the CEO violated Exchange Act Rule 10b-5 and FINRA Rules 2020, 3110 and 2010.
69. Rule 5122 requires a member to file the PPM, term sheet or other offering document with FINRA at or prior to the first time the document is provided to any prospective investor, subject to certain exemptions.
70. The date of first sale is defined as the date on which the first investor is irrevocably contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check. This is the same definition applied by the SEC in the context of the Form D filing requirement. *See* Securities Act Release No. 8891 (February 6, 2008) and the Form D filing instruction.
71. *Regulatory Notice 21-26* (July 2021) (FINRA Amends Rules 5122 and 5123 Filing Requirements to Include Retail Communications That Promote or Recommend Private Placements).

72. In addition to FINRA's supervision rule, under the Exchange Act the SEC is authorized to sanction a broker-dealer or any associated person that fails to reasonably supervise another person subject to the firm's or the person's supervision that commits a violation of the federal securities laws. *See* Exchange Act Sections 15(b)(4)(E) and (b)(6)(A). *See also* Reg BI Adopting Release, *supra* note 1, at 33397 n.809 ("The Exchange Act provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented without reason to believe those procedures and systems are not being complied with.").

73. *See Dep't of Enf't v. Spencer Edwards, Inc.,* Complaint No. 2014041862701, 2018 FINRA Discip. LEXIS 34, at *36-40 (FINRA Hearing Panel Nov. 14, 2018) (applying FINRA Rule 3110's predecessor, NASD Rule 3010); *Dep't of Enf't v. Pacific Cornerstone Cap., Inc.* Case No. 2007010591702 (Dec. 11, 2009) (FINRA AWC).

74. *See, e.g., Spencer Edwards, Inc.,* 2018 FINRA Discip. LEXIS 34, at *88-93 (stating that the duty of supervision includes the responsibility to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation and finding that "Spencer Edwards' supervisory procedures and responses to red flags signaling irregularities woefully deficient with respect to due diligence"); *Dep't of Enf't v. Fox Fin. Mgmt. Corp.,* Complaint No. 2012030724101, 2017 FINRA Discip. LEXIS 3, at *17-18 (FINRA NAC Jan. 6, 2017) (stating that the "supervisory duties imposed under NASD Rule 3010 include a responsibility to investigate and act upon 'red flags' that reveal irregularities or the potential for misconduct"); *Dep't of Enf't v. Merrimac Corp. Sec.,* Complaint No. 2009017195204, 2015 FINRA Discip. LEXIS 4, at *9 (FINRA NAC Apr. 29, 2015). *See also Kevin D. Kunz,* 1999 NASD Discip. LEXIS 20, at *33-36.

75. *See* Rule 3110(b)(7) ("Each member shall promptly amend its written supervisory procedures to reflect changes in applicable securities laws or regulations, including FINRA rules, and as changes occur in its supervisory system."). *See also* Rule 3120 (Supervisory Control System) (requiring each member to have a system of supervisory control policies and procedures that tests and verifies a firm's supervisory procedures to ensure that they are reviewed and amended regularly in light of changing business and regulatory requirements).

76. *See, e.g.,* SEC Staff Bulletin on Care, *supra* note 43; SEC Staff Bulletin on Conflicts, *supra* note 54; SEC Staff Bulletin on Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (March 30, 2022); Frequently Asked Questions on Regulation Best Interest.

77. FINRA's survey was sent to members active in the private placement market and focused on understanding industry due diligence practices and the challenges members face in meeting their reasonable investigation obligations.

78. *See Regulatory Notice 16-08* (February 2016) (Private Placements and Public Offerings Subject to a Contingency) (providing guidance regarding the requirements of Exchange Act Rules 10b-9 and 15c2-4 in the sale of contingency offerings, and reminding members of their responsibility to have procedures reasonably designed to achieve compliance with these rules); *see also McDonald Partners LLC,* Case No. 2019060692401 (June 22, 2022) (FINRA AWC). Until the appropriate contingency has occurred, investor funds must

be promptly deposited in a separate bank account, as agent or trustee for the person who has the beneficial interest therein, in accordance with Rule 15c2-4(b)(1), or transmitted to a bank that has agreed in writing to hold all such funds in escrow in accordance with Rule 15c2-4(b)(2). Escrow arrangements must therefore reflect the applicable paragraph under Rule 15c2-4 with respect to the subject offering. Depending on the payment method used, certain additional fees such as a processing fee withdrawn, prior to the deposit in an escrow account, cannot be applied toward meeting the contingency. To meet the requirements of Rule 15c2-4(b)(2), the full amount of investor funds must promptly be deposited into the escrow account.

79. Risk disclosures to customers that the investment may not successfully deliver the intended tax benefits do not discharge the member's obligation to understand those aspects of the offering. *See, e.g.,* FINRA Rule 2111.02 ("A member or associated person cannot disclaim any responsibilities under the suitability rule"); Reg BI Adopting Release, supra note 1, at 33318 ("The standard of conduct established by Regulation Best Interest cannot be satisfied through disclosure alone") and 33327 ("a broker-dealer will not be able to waive compliance with Regulation Best Interest, nor can a retail customer agree to waive her protections under Regulation Best Interest"). *See also* SEC Staff Bulletin on Care, *supra* note 43 (addressing what it means to consider the investor's tax status when providing recommendations or advice and cautioning that the existence of a tax advantage alone would not provide a reasonable belief that a recommendation would be in the retail customer's best interest, and that a factor such as a tax advantage should be considered in light of the other features of the investment or investment strategies, reasonably available alternatives, and the retail investor's entire investment profile, including time horizon.).