

## 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.<sup>1</sup>

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#### 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.

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##### 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.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup>

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.<sup>6</sup> 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.<sup>7</sup>

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.<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup>

### 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”;<sup>13</sup> or
- ▶ transmit those funds to a bank that has agreed in writing to act as the escrow agent for the offering.<sup>14</sup>

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.<sup>15</sup> Second, when a participating broker-dealer is an affiliate of the issuer, investors’ funds must be transmitted to an independent bank escrow agent.<sup>16</sup>

#### 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.<sup>17</sup> The escrow account should be established before the broker-dealer receives any investor funds. The escrow account may not be controlled by the issuer,<sup>18</sup> the broker-dealer<sup>19</sup> or an attorney.<sup>20</sup> 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),<sup>21</sup> although the SEC staff has provided no-action relief to permit certain other entities to act as escrow agents.<sup>22</sup>

#### 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.<sup>23</sup> Failure to promptly transmit funds to either the escrow agent or a separate bank account has resulted in sanctions.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup>

**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.<sup>29</sup> 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.<sup>30</sup> 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).

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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.*