



Broker-Dealer Due Diligence Responsibilities in Regulation D Offerings

By: [Brian A. Lebrecht, Esq.](#)

In April 2010, FINRA published Regulatory Notice 10-22, reminding broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in Regulation D offerings. What, specifically, should broker-dealers be doing?

[FINRA Regulatory Notice 10-22](#) was published as guidance to remind broker-dealers of their due diligence obligations in Regulation D offerings. In theory, the Regulatory Notice did not create any new obligations. In practice, however, the Regulatory Notice may have created the backdrop for upcoming FINRA enforcement actions against broker-dealers. In fact, we are starting to see an increase in claims against broker-dealers already.

There are two primary areas of responsibility for broker-dealers in Regulation D offerings. One is to investigate the issuer and the disclosure prepared by the issuer about the offering, and the other is to determine that the investment is suitable for the specific investor.

Investigation of the Issuer and its Disclosure

A broker-dealer that recommends a security is under a “duty to conduct a reasonable investigation concerning that security and the issuer’s representations about it.” Breaking this down, (i) the broker-dealer must be recommending the security, (ii) he has a duty, (iii) to conduct an investigation, (iv) that investigation must be reasonable, (v) and must cover the security and (vi) the issuer’s representations about that security.

But there are no bright line tests telling broker-dealers what exactly they must do. Instead, FINRA often talks about “red flags,” and the broker-dealers obligations to conduct further investigation whenever a red flag is present. What are examples of red flags? A newly formed issuer, inexperienced management, management with a negative criminal or regulatory background, promises or representations of an unusually high investment return, an issuer that does not freely make information available to the broker-dealer, inaccuracies in the issuer’s financial statements, and the absence of a customary private placement memorandum are all examples of red flags.

Once a red flag has been identified, what must the broker-dealer do about it? A broker-dealer's obligation is to follow-up on any red flags and to conduct an independent investigation using a "high degree of care" in investigating and independently verifying an issuer's representations and claims. A broker-dealer may not rely on representations by the issuer, the issuer's counsel (including a legal opinion), or a syndicate manager. And while a broker-dealer might hire its own counsel or advisor to conduct an investigation, the broker-dealer must review the qualifications of its own advisors before relying on them.

Suitability

Most broker-dealers are familiar with the concept of suitability because it historically has generated a large number of customer arbitration complaints. With respect to Regulation D offerings, the suitability analysis has two components. First, does the broker-dealer have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. Second, does the broker-dealer believe that the security is suitable for the specific investor to whom it is being recommended.

The second component is the most burdensome. Whether or not an investor is accredited is only one factor for the broker-dealer to take into consideration. The broker-dealer must also gather and analyze information about the customer's other holdings, financial situation, tax status, and investment objectives. The broker-dealer must also be satisfied that the customer fully understands the risks involved and is...able... to take those risks. Finally, the analysis must be done for each investor, for each offering, even if it is a subsequent offering for the same issuer.

Checklists and Forms

At a recent seminar, Lisa Roth, CEO of Keystone Capital Corporation (www.keystonecapcorp.com), a FINRA broker-dealer in San Diego, CA, provided three forms to the attendees. With her permissions, these forms have been posted to our website at the links below for your review and use:

- Due Diligence Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings;
- Product Review Checklist;
- Product Due Diligence Checklist.

Summary

In summary, I wouldn't say that the landscape has changed because these obligations have always existed for broker-dealers. However, the enforcement landscape may be changing as FINRA has put broker-dealers on notice of their obligations and, I suspect, will start to bring more enforcement actions in this area.

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Brian A. Lebrecht, Esq. is an attorney with and the founder of The Lebrecht Group, APLC, located in Irvine, California and Salt Lake City, Utah. He can be reached at (801) 983-4948 or via e-mail at blebrecht@thelebrechtgroup.com with questions or comments. Please visit our website at www.thelebrechtgroup.com for future updates and other information.