Client Alert

August 5, 2013

FINRA Actions and the Due Diligence Obligations of Broker-Dealers in Private Placements

Private placements and the due diligence obligations of broker-dealers in such transactions have recently come under increased scrutiny from FINRA as part of a broader trend reflected most notably in the filing requirements for private placements that went into effect on December 3, 2012 (FINRA Rule 5123). This trend of increased scrutiny also is likely to continue in light of the SEC's recent adoption on July 10, 2013, pursuant to Section 201(a) of the JOBS Act, of final rules relaxing the prohibition on general solicitation and general advertising for certain private placements under Rule 506 of Regulation D[1].

For example, on July 17, 2013, FINRA approved a Letter of Acceptance, Waiver and Consent submitted by Sunset Financial Services, Inc. in connection with alleged violations of NASD Rules 3010(a) and 2110 and FINRA Rule 2010[2]. This matter involved private placements for two funds, one a bridge loan lender of short-term mortgages secured by real property and the other an acquirer of discounted debt from distressed banks and other leveraged financial institutions. FINRA cited an increased default rate for the loan portfolio of the first fund of approximately 20% (which was a red flag given the relevance of default risk to the fund's business) and the broker-dealer's failure to follow-up or re-evaluate the appropriateness of retaining the fund on its approved list, even in light of subsequent suspended redemptions and monthly distributions. FINRA pointed out that the broker-dealer also did not wait for the completion of a third party due diligence report on the second fund before placing the fund on its approved list, nor did it perform enhanced due diligence even though the second fund had the same management as the first fund. FIRNA also highlighted that the broker-dealer delegated nearly all responsibilities relating to private placements to a single person, its vice president in charge of products and sales, who was responsible for conducting due diligence on private placements, determining which private placements to approve for sale by registered representatives, formulating recommendations for private placements and monitoring suitability, as well as the absence of written supervisory procedures other than a generic checklist. FINRA emphasized the broker-dealer's lack of adequate supervisory policies and procedures to review and monitor due diligence on approved private placements, suitability of the securities for customers, sales material provided to customers and internal use materials provided to registered representatives.

These facts are instructive for reminding broker-dealers of their due diligence obligations in connection with private placements. In the context of a Regulation D offering, FINRA Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non-accredited investors that will take into account the investors' knowledge and experience. In order to ensure that it has fulfilled its suitability responsibilities, a broker-dealer in a Regulation D offering should, at a minimum, conduct a reasonable investigation regarding: (1) the issuer and its management; (2) the business prospects of the issuer; (3) the assets held by or to be acquired by the issuer; (4) the claims being made; and (5) the intended use of proceeds of the offering. The scope of the broker-dealer's investigation also will depend upon a number of factors, including the

[1] For more information regarding the JOBS Act, see our JOBS Act website at http://www.mofo.com/jumpstart/.
[2] See In the Matter of Sunset Financial Services, Inc. (AWC No. 2011026915701, July 17, 2013).

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broker-dealer's affiliation with the issuer, its role in the transaction and other facts and circumstances of the offering, including whether the offerees are retail customers or more sophisticated institutional investors. In addition, a firm that engages in Regulation D offerings also must have supervisory procedures under NASD Rule 3010 that are reasonably designed to ensure that the firm's personnel, including its registered representatives: (1) engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements; (2) perform the analysis required by NASD Rule 2310; (3) qualify their customers as eligible to purchase securities offered pursuant to Regulation D; and (4) do not violate the antifraud provisions of the federal securities laws or FINRA rules in connection with their preparation or distribution of offering documents or sales literature.

In the course of a reasonable investigation, a broker-dealer must note and investigate further any information that it encounters that could be considered a "red flag" that would alert a prudent person to conduct further inquiry, and such red flags might arise from information that is publicly available or information that is discovered during the course of the investigation. When presented with red flags, the broker-dealer also must do more than simply rely upon representations by the issuer's management, the disclosure in an offering document or even a due diligence report of issuer's counsel. In order to demonstrate that it has performed a reasonable investigation, a broker-dealer also should retain records documenting both the process and results of its investigation. Furthermore, a broker-dealer's reasonable investigation must be tailored to each Regulation D offering; thus, a single checklist of possible practices for a broker-dealer engaged in a Regulation D offering will not be sufficient for every offering, and mechanical reliance upon a single checklist may result in an inadequate investigation.[3]

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[3] For more information regarding reasonable due diligence investigations, see FINRA Regulatory Notice 10-22 (April 2010), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.