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Legal Update

FINRA Releases Updated Guidance for Members Conducting Private Placements

On May 9, 2023, the Financial Industry Regulatory Authority, Inc. ("FINRA") issued Regulatory Notice 23-08 (the "Notice"), which provides supplemental and updated guidance for members conducting private placements pursuant to the Regulation D safe harbors under Sections 3 or 4 of the Securities Act of 1933, as amended.

The Notice does not change existing laws, regulations or interpretations of existing regulatory requirements. Rather, the Notice was provided as a reminder of members' obligations in light of changes in the legal and regulatory framework since FINRA published Regulatory Notice 10-22 in 2010 (the "2010 FINRA Notice").

Since passage of the Jumpstart Our Business Startups Act of 2012, Congress and the Securities and Exchange Commission (the "SEC") have reduced many of the barriers to exempt offerings. Perhaps as a result, there has been significant increased reliance on private placements rather than registered offerings for capital raising. According to the SEC's Division of Economic and Risk Analysis, between July 1, 2021 and June 30, 2022, for example, the total raised in registered offerings was just over $1.1 trillion, while, by contrast, the total raised through private offerings was $4.3 trillion. The Notice notes that while these changes have increased funding opportunities for issuers and investment options for investors, private offerings may present certain risks to investors.

Regulation Best Interest

The SEC adopted Regulation Best Interest ("Regulation BI") in 2019, well after the 2010 FINRA Notice. Regulation BI generally requires a broker-dealer or associated person thereof, when recommending any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, to act in the best interest of the retail customer without placing the financial or other interest of the broker-dealer or associated person ahead of the interest of the retail customer. In order to meet this requirement, Regulation BI contains four specified component obligations: the Care Obligation; the Disclosure Obligation; the Conflict of Interest Obligation; and the Compliance Obligation.

The Notice provides guidance on how to satisfy the Care Obligation of Regulation BI, highlighting the obligation of reasonable investigation and considering factors in making a recommendation that exceed those in FINRA's suitability rule, FINRA Rule 2111. A more detailed chart summarizing the requirements under Regulation BI and the guidance provided by FINRA in the Notice is attached as Appendix A.

CARE OBLIGATION

Reasonable Investigation. Pursuant to Regulation BI, when making a recommendation to a retail customer, broker-dealers and their associated persons must exercise reasonable diligence, care and skill to understand the potential risks, rewards and costs associated with the recommendation, and must have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers. To meet this reasonable basis obligation, a broker-dealer or associated person must conduct a reasonable investigation of any security or investment strategy involving a security it recommends. What constitutes a reasonable investigation depends on the facts and circumstances; however, according to FINRA, the presence of "red flags" should alert the broker-dealer/associated person to the need for further inquiry.

The 2010 FINRA Notice stated that a reasonable investigation should, at a minimum, include review of: (i) the issuer and its management; (ii) the business prospects of the issuer; (iii) the assets held by or to be acquired by the issuer; (iv) the claims being made; and (v) the intended use of proceeds of the offering. Based on FINRA's subsequent observations, the Notice advises that, as part of a reasonable investigation, broker-dealers 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 Regulation D.
- 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 which may be misleading or exclusively selected based on positive results. This is particularly important when the representations pertain to specific prior issuances.

The following are suggested steps to take to demonstrate that a broker-dealer has conducted a reasonable, independent investigation:

- Maintain an updated due diligence file documenting both the process and results of the inquiries, research, and analysis conducted.
- Perform an independent analysis of issuer representations and claims, which may require obtaining additional documentation from the issuer.
    - For example: if a representation includes material contracts or permits, a reasonable review may include reviewing the enumerated contacts and permits.
- Critically analyze any diligence reports provided by third parties engaged to perform diligence, such as appraisers, attorneys or due diligence experts. If the third party is engaged by the broker-dealer or issuer, the broker-dealer should consider the independence, incentives and qualifications of the third party.
- Adequately address any red flags prior to recommending the offering.
- Apply a heightened analysis when recommending an investment that involves complex features or unique benefits to investors.

Customer-Specific Obligation. Broker-dealers and associated persons must 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 broker-dealer or associated person ahead of the interest of the retail customer.[1] To satisfy the requirement, broker-dealers and their associated persons should:

- Obtain and analyze sufficient customer information to form a reasonable basis to state that the present recommendation is in the retail customer's best interest.
- If retail customer information is unavailable despite reasonable diligence, carefully consider whether they have a sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the best interest of that retail customer.
- Consider "reasonably available alternatives" offered by the broker-dealer as part of having a "reasonable basis to believe" that the recommendation is in the best interest of the retail customer.

As noted in recent SEC staff guidance,[2] broker-dealers and their associated persons should apply heightened scrutiny to whether a risky or complex product is in the retail customer's best interest. Information to consider when conducting a heightened review could include whether there are lower risk or less complex options available that would achieve the same result, and 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." Importantly, broker-dealers/associated persons should consider whether lower risk or less complex options can achieve the same investment objectives.

DISCLOSURE OBLIGATION

The Disclosure Obligation requires a broker-dealer or associated person to provide in writing prior to, or at the time of the recommendation, 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. The Notice emphasizes that disclosure of conflicts of interests alone does not satisfy the obligation to act in the retail customer's best interest.

CONFLICTS OF INTEREST OBLIGATION

The Notice highlights the SEC staff's recent guidance in the SEC Staff Bulletin that evaluation and disclosure of conflicts pursuant to Regulation BI "should not be merely a 'check-the-box' exercise, but a robust, ongoing process that is tailored to each conflict." Notably, conflicts may be of particular concern when broker-dealers 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 broker-dealer engages in other activities for or with the issuer or when an associated person separately may be connected to the issuer. Moreover, the Notice states that 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) which must be addressed in accordance with the rule.

COMPLIANCE OBLIGATION

Broker-dealers must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI. The SEC's recent guidance in the Staff Bulletin regarding complex and

risky products suggests that broker-dealers should consider developing procedures outlining the due diligence process for such products to help ensure these products are assessed by qualified and experienced firm personnel, as well as establishing procedures requiring appropriate training and supervision to help ensure financial professionals understand the features, risks and costs of complex financial products.

The SEC guidance also suggests that broker-dealers should consider documenting the process and reasoning behind particular recommendations of complex or risky products, including consideration of less complex alternatives, and how they fit within the retail customer's broader goals or strategy.

Other Requirements Applicable to Private Placements

The Notice also reminds FINRA members of certain FINRA requirements that are applicable when recommending private placements, including private placement filing requirements under FINRA Rules 5122 and 5123 and the requirement to supervise the activities of each associated person pursuant to FINRA Rule 3110. In addition, the Notice specifically discusses communications with the public and private securities transactions in the context of private placements.

Communications with the Public. If a member is involved in preparing offering materials, such materials will be considered a communication with the public for purposes of FINRA Rule 2210. Sales literature concerning a private placement that a FINRA member distributes generally constitutes a communication by that member with the public, regardless of whether the member was involved in the preparation of the materials. If an offering document presents information that is not fair and balanced or is misleading, then the member which assisted in its preparation may be found to have violated FINRA Rule 2210.

Private Securities Transactions. Private placements that are sold by an associated person outside of his or her relationship with the FINRA member are considered private securities transactions ("PSTs"). The Notice highlights the following considerations regarding PSTs:

- Associated persons must provide written notice to, and receive written approval from, the member when a PST 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 Regulation BI.

Conclusion

The Notice highlights key requirements, and potentially effective practices, for FINRA members and their associated persons that engage in private placement activities, including obligations adopted after FINRA issued the 2010 FINRA Notice. The Notice provides a helpful tool for firms to develop new, or modify existing, policies, procedures and practices to achieve compliance with relevant regulatory obligations. On the same day FINRA issued the Notice, it issued Regulatory Notice 23-09 requesting comments on FINRA rules impacting capital formation, including ways to increase efficiency and reduce unnecessary burden on the capital raising process without compromising important protections for investors and issuers. Comments are requested by August 7, 2023.

Appendix A

Regulation BI	Guidance Set forth in the Notice:
Care Obligation. Broker-dealers and associated persons, in making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, must exercise reasonable diligence, care and skill to: • Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; • 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 broker, dealer, or such natural person ahead of the interest of the retail customer; • Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.	**Reasonable Investigation**. As part of a reasonable investigation of a private placement, broker-dealers should consider addressing: • Criminal, disciplinary, regulatory and litigation history of the issuer, its management and certain affiliates 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) of Regulation D; • New material developments such as events that are or should be reasonably known to the broker-dealer during an offering (e.g., ongoing legal proceedings or regulatory inquiries); • Transactions or payments between an issuer and the issuer's affiliates involving offering proceeds and whether material conflicts of interest are disclosed; and • Misleading representations of past performance of the issuer, its sponsor, or its manager or representations exclusively selected based on positive results ("cherry-picking"). A broker-dealer may demonstrate it has conducted a reasonable, independent investigation by: • Documenting the inquiries, research, and analysis conducted; • Requesting additional information to perform an independent analysis of issuer representations; • Critically analyzing third-party due diligence reports and addressing any red flags prior to recommending the offering. Associated persons should be mindful they have an independent obligation to satisfy Regulation BI (or FINRA Rule 2111 (Suitability)) when making recommendations. **Customer-Specific Obligations**. FINRA reminds broker-dealers and their associated persons they should: • Carefully consider whether they have a sufficient understanding of the retail customer to evaluate whether the recommendation is in the best interest of that customer where customer information is unavailable despite reasonable diligence; • Apply heightened scrutiny to determine whether risky or complex products are in the best interest of the retail customer; and • Consider "reasonably available alternatives" offered by the broker-dealer.[3]

Regulation BI	Guidance Set forth in the Notice:
Disclosure Obligation. Broker-dealers and associated persons are required to provide in writing prior to, or at the time of the recommendation, full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer (e.g., the capacity in which the broker-dealer is acting, the material fees and costs of the transactions, the type and scope of services provided) and all material facts relating to conflicts of interest associated with the recommendation.	The Notice emphasizes that disclosure of conflicts of interests alone does not satisfy the obligation to act in the retail customer's best interest.
Conflicts of Interest Obligation. Broker-dealers must establish, maintain and enforce written policies and procedures reasonably designed to: • Identify and disclose, at a minimum, or eliminate, all conflicts of interest associated with the recommendation; • Identify and mitigate any conflicts of interest associated with recommendations that create an incentive for an associated person of a broker-dealer to place the interest of the broker-dealer or such associated person 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 which may be recommended to a retail customer and any conflicts of interest associated with such limitations; • Prevent such limitations and associated conflicts of interest from causing the broker-dealer or the associated person to make recommendations that place the interest of the broker-dealer or the associated person ahead of the retail customer's interest; 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.	The conflicts check process should be a robust and ongoing process that is tailored to each conflicts (no "check-the-box" exercise), including those regarding relationships with affiliates or third parties. Although conflicts are of particular concern when broker-dealers recommend private placements of securities issued by an affiliated company to retail customers, conflicts can also arise from a close relationship with an (unaffiliated) issuer. Importantly, 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). Such conflicts must be addressed in accordance with Regulation BI.
Compliance Obligation. Broker-dealers must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI.	The Notice specifically highlights recent SEC staff guidance in the SEC Staff Bulletin that broker-dealers should consider developing procedures outlining the due diligence process for complex or risky financial products to help ensure these products are assessed by qualified and experienced firm personnel. In this regard, broker-dealers should consider requiring training and supervision to ensure financial professionals understand the features, risks and costs of a complex financial product. In addition, broker-dealers should document the process and reasoning behind particular recommendations of complex or risky products, including consideration of less complex alternatives, and how they fit within the retail customer's broader goals or strategy.

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Endnotes

[1] Regulation BI also imposes quantitative obligations. See SEC Rule 15l-1(a)(2)(ii)(C).

[2] See Securities and Exchange Commission, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations* (April 20, 2023) (the "SEC Staff Bulletin") available at: https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers. See also Mayer Brown LLP, *Legal Update: SEC Issues Staff Bulletin Clarifying Care Obligations of Broker-Dealers* (May 3, 2023) available at: https://www.mayerbrown.com/en/perspectives-events/publications/2023/05/sec-issues-staff-bulletin-clarifying-care-obligations-of-broker-dealers-and-investment-advisers.

[3] The Notice does not specifically focus on the quantitative obligations of the Care Obligation.

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