

CORPORATE AND SECURITIES LAW

ALERT

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

FINRA Reminds Broker-Dealers of Due Diligence Obligations in Private Placements

May 21, 2010

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued Regulatory Notice 10-22 (the "Notice") reminding broker-dealers of their obligation to conduct a reasonable investigation of the issuers and securities that they recommend when conducting or participating in private placements of securities made in reliance upon Regulation D of the Securities Act of 1933 ("Private Placements").

Private Placements are exempt from the registration requirements of Section 5 of the Securities Act; however, they are not exempt from the anti-fraud provisions of the federal securities laws. A broker-dealer has a duty — enforceable under federal securities laws and the rules of FINRA — to conduct a reasonable investigation of any issuer and its securities that the broker-dealer recommends, including those sold in Private Placements. Further, any broker-dealer that recommends securities offered in a Private Placement must also comply with additional FINRA rules and requirements which address, among other things, investor suitability and record-keeping.

The full text of the Notice is [available here](#).

FINRA's Renewed Interest in Private Placements

Private Placements historically have been an essential source of equity and debt capital for issuers, particularly private and non-listed issuers. According to the SEC's Office of Inspector General, during 2008 issuers proposed to offer approximately \$609 billion of securities through Private Placements. Private Placements are attractive to issuers because of the speed and efficiency with which they can be conducted. However, FINRA has recently discovered significant deficiencies in the manner in which certain broker-dealers have conducted Private Placements. In recent investigations and routine examinations of broker-dealers, FINRA has found fraudulent and abusive tactics such as false and misleading offering documents and has sanctioned the broker-dealers who engaged in such practices. Based upon the recent investigations and sanctions coupled with the Notice, issuers and broker-dealers alike should be cognizant of FINRA's intent to more proactively monitor the activities and conduct of broker-dealers participating in Private Placements.

Due Diligence Duties of Broker-Dealers in Private Placements

A broker-dealer that recommends the purchase of a security must conduct a reasonable investigation of the security offered and representations made by the issuer regarding such security. This affirmative duty arises from the broker-dealer's "special" relationship with its customer and

from the fact that, in recommending the security, the broker-dealer represents (explicitly and/or implicitly) to its customer that a reasonable investigation of the issuer and the security has been made and that the broker-dealer's recommendation is founded upon such investigation. Consequently, a broker-dealer's failure to satisfy its investigative duties may constitute a violation of the anti-fraud provisions of the federal securities laws and the rules of FINRA.

The scope of any due diligence review logically depends upon factors specific to the Private Placement including, among other considerations: (i) the specific role of the broker-dealer in the Private Placement; (ii) the relationship of the broker-dealer with the issuer; (iii) the nature of the securities recommended; (iv) the size and stability of the issuer; and (v) the presence of any "red flags" identified prior to or during the conduct of a due diligence review. Accordingly, a broker-dealer must tailor its due diligence review to the facts and circumstances existing in and applicable to each Private Placement.

A common practice for broker-dealers who combine distribution resources and efforts as part of a syndicate is to rely upon the lead placement agent or syndicate manager to conduct the due diligence review. While FINRA recognizes this practice, it also warned broker-dealers that they must have a reasonable basis to believe that the syndicate manager has the expertise and lack of conflicts necessary to conduct the due diligence review and must ascertain that the syndicate manager has actually performed a reasonable investigation.

Notably, a broker-dealer may not exclusively rely upon the issuer for information concerning the issuer and its business or upon the information provided by the issuer and its legal counsel in lieu of conducting its own reasonable investigation. Though generally not expected to have knowledge equivalent to that of an issuer and its management, broker-dealers are required to exercise a "high degree of care" in investigating and independently verifying an issuer's representations and claims. Moreover, Private Placements of securities to persons comprised solely of "accredited investors" (as defined in Rule 501 of Regulation D of the Securities Act) do not obviate the broker-dealer's obligation to conduct a reasonable investigation.

Additional Duties of Broker-Dealers in Private Placements

In addition to conducting a reasonable investigation of the issuer and its securities, a broker-dealer must also have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for both accredited and non-accredited investors. This suitability analysis is comprised of two components: (i) the broker-dealer must have a reasonable basis to believe following its due diligence investigation that the recommendation is suitable for at least some customers; and (ii) the broker-dealer must determine whether the security is suitable for the particular customer to whom it would be recommended. In order to ensure compliance with suitability responsibilities, FINRA stated that a reasonable investigation by a broker-dealer should concern, at a minimum, the following:

- The issuer and its management;
- The business prospects of the issuer;
- A review of assets held by or to be acquired by the issuer;
- All claims being made by the issuer; and
- The intended use of proceeds of the Private Placement.

Further, to evidence its due diligence investigation and suitability analysis, broker-dealers should maintain due diligence files which contain copies of documents reviewed (including customer-specific financial and tax documentation), any analyses undertaken by broker-dealer staff and summaries of meetings and communications with issuers and its management and syndicate members. We recommend to broker-dealers that they develop a standardized due diligence review process but also that they ensure that each due diligence review is adequately tailored for each Private Placement in a manner that best ensures that all regulatory responsibilities will be satisfied.

Recommended Practices

The Notice also provides a list of practices that, according to a survey conducted by FINRA, broker-dealers have adopted to assist in conducting a reasonable investigation and in complying with other regulatory requirements. The Notice provides that these practices are most relevant for investigations of non-reporting companies and include a review of the following areas:

- The issuer and its management;
- The issuer's business prospects; and
- The issuer's assets.

Though each of the investigative practices specified are advisable, for many private and non-listed issuers, the scope and breadth of certain investigative practices are considerable and may ultimately prove to be cost-prohibitive to such issuers who wish to utilize the services of broker-dealers who are members of FINRA.

Corporate Finance/1933 Act Subgroup

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