

8.11.2: FINRA Issues Guidance on Broker-Dealer Obligations concerning PPOs

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The Financial Industry Regulatory Authority, Inc. (FINRA) recently released a notice reminding members of their obligations to investors when participating in transactions made pursuant to Regulation D under the Securities Act of 1933 (Securities Act), also known as private placement transactions.^[1] This guidance was released after recent examinations and investigations revealed significant problems, including fraud and sales practice abuses, taking place in private placement transactions. Recently, for example, broker-dealers were sanctioned for providing private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions. FINRA's guidance highlights a broker-dealer's responsibility to thoroughly investigate the private placement transactions that it recommends, and suggests practices to help ensure that the broker-dealer performs an adequate investigation before recommending such transactions to investors.

Although the FINRA notice was specifically geared towards FINRA member broker-dealers, it is important for other participants involved in private placements to take note of such guidance as well. All participants in a private placement transaction should take steps to satisfy themselves that they fully understand the transaction taking place and know the parties involved. Therefore, the investigative practices and techniques identified in the FINRA guidance and outlined below, are not only relevant to broker-dealers, but can be useful to all other parties involved in a private placement transaction as well.

In its notice, FINRA reminded its members that the US Securities and Exchange Commission (SEC) and federal courts have long held that a broker-dealer that recommends a security is under a duty to conduct a reasonable investigation regarding the security and the issuer's representations about it. Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws. FINRA noted, however, that the extent and nature of the investigation required, depends upon, among other factors, the nature of the recommendation, the role of the broker-dealer in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer. In addition, FINRA cautioned that the presence of any "red flags" found in the broker-dealer's inquiry should signify to the broker-dealer the need for further investigation. One example provided by FINRA of such a red flag, includes an issuer's refusal to provide the broker-dealer with information that the broker-dealer believes is necessary to fulfill its duty to investigate. Regardless of the extent of the investigation required however, FINRA advised broker-dealers to retain records documenting both the process and results of its investigation.

FINRA also cautioned broker-dealers against relying "blindly" upon an issuer for information concerning the company instead of conducting its own investigation. FINRA noted that while broker-dealers are not expected to have the same depth of knowledge as an issuer or its

management, broker-dealers are required to exercise care in investigating and independently verifying an issuer's representations. If a broker-dealer lacks essential information about an issuer or its securities when it makes a recommendation, it must disclose this fact, as well as the risks that arise from its lack of information.

Additionally, FINRA reminded broker-dealers of their obligation to have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the investor. A broker-dealer's suitability obligation has two parts. First, the broker-dealer must have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors, and second, that the security is suitable for the investor to whom it would be recommended. The broker-dealer must also be satisfied that the investor fully understands the risks involved with the purchase, sale or exchange of the security and the investor is able to handle those risks. In order to ensure that a broker-dealer has fulfilled its suitability responsibilities in a private placement transaction, FINRA advised broker-dealers to, at a minimum, conduct an investigation as to the issuer and its management, the assets held by or to be acquired by the issuer, the claims being made, and the intended use of proceeds of the offering.

FINRA also noted, however, that the proper scope of the broker-dealer's investigation will depend upon the particular facts of the offering. The broker-dealer should consider, among other things, whether the broker-dealer is affiliated with the issuer, the broker-dealer's role in the transaction, and whether the investor is a retail or a sophisticated institutional investor. FINRA also provided a list of practices that some broker-dealers have adopted to help adequately satisfy their investigatory responsibilities. These practices include, among others, examining the issuer's governing documents, examining historical financial statements of the issuer and its affiliates, inquiring about the business of affiliates, contacting customers and suppliers regarding their dealing with the issuer, inquiring about past securities offerings by the issuer, inquiring about the industry in which the issuer conducts its business, requesting financial models used to generate projections or targeted returns, and visiting and inspecting a sample of the issuer's assets and facilities.

In addition, FINRA reminded member firms that they must have written supervisory procedures in place that are designed to ensure that the broker-dealer's personnel engage in reasonable investigations in connection with private placement transactions and perform the suitability analyses required under FINRA rules.

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^[1] FINRA Regulatory Notice 10-22 available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf>.

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