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SECURITIES INDUSTRY AND TECH & VENTURE FINANCE PRACTICE

ALERT

Broker Beware: New FINRA Guidance Suggests Renewed Regulatory Focus on Broker-Dealers Involved in Regulation D Offerings

Even before the economic turmoil of the last two years, private placements were a principal source of funding for small and mid-sized businesses. Given the recessionary effects on the commercial credit-based lending market, now, more than ever, private placements are playing an even greater role in facilitating the capital needs of these businesses.

The Financial Industry Regulatory Authority's (FINRA) latest regulatory guidance, Notice to Members 10-22, reminds broker-dealers of their obligations when recommending securities exempt from registration pursuant to the U.S. Securities and Exchange Commission's (SEC) Regulation D, promulgated under the Securities Act of 1933 (Securities Act), as well as suggesting a renewed focus by FINRA on monitoring broker-dealers' anti-fraud compliance in the post-bailout economy.

Pursuant to the Securities Act, any offer to sell securities must either be formally registered with the SEC, or meet an exemption from this registration obligation. Regulation D permits three exemptions from the registration requirements. See 17 CFR § 230.501 et seq. These exemptions allow some securities issuers to offer and sell their securities without having to register the securities with the SEC. While the inquiry into whether a particular offering is exempt under Regulation D involves a careful analysis of objectively ascertainable criteria regarding both the activities of the issuing company and the investors, Regulation D offerings, generally, include:

(1) When a given issuer only offers and sells up to, in the aggregate, $1 million worth of their securities in any 12-month period;

(2) When a given issuer only offers and sells up to, in the aggregate, $5 million of their securities in any 12-month period and the investors meet the definition of "accredited investor" by establishing certain sophistication and wealth standards, or the investor is one of up to 35 "non-accredited investors" as specifically defined in the regulatio; or

(3) When a given issuer satisfies the so-called "safe harbor" from registration under the Securities Act by establishing that, although the offering's aggregate dollar value was not limited, it was made only to "accredited investors," and up to 35 non-accredited investors that exhibit a degree of financial sophistication.

Further, Regulation D issuers are limited in both advertising to and the solicitation of investors. For example, these issuers, among other requirements, must complete and file the SEC Form D, an abbreviated notice, containing the names and addresses of the company's officers and stock promoters, as well as the date of the first issuance.

While there are probably many reasons for an increased FINRA broker-dealer surveillance program in connection with Regulation D offerings, FINRA Notice to Members 10-22 clearly articulates the suitability obligations that every broker-dealer involved in this

particular type of securities issuance must follow. FINRA's guidance on Regulation D offerings also foreshadows that those broker-dealers who do not revisit their organizational compliance protocols will be at a substantial risk of regulatory enforcement action.

NASD Rule 2310 requires that broker-dealers "have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." This means where broker-dealers take an active role in suggesting investments to their clients, the broker-dealer must undertake a level of due diligence regarding the needs, risks and expectations of the investor prior to making a recommendation. Practically speaking, this investigation must be well documented and include disclosure forms from the broker-dealer to the investor.

Regulation D offerings have, however, historically presented an "opportunity" for some broker-dealers to avoid their suitability obligations due to the emphasis upon the sophistication of the investor inherent in Regulation D offerings. Simply stated, some broker-dealers may have stopped short of performing a complete and thorough suitability analysis for Regulation D offerings based upon the erroneous belief the investor being an "accredited investor" satisfied the broker-dealer's obligations pursuant to Regulation D and NASD Rule 2310. FINRA Notice to Members 10-22 makes clear that a broker-dealer must undertake a complete suitability determination when recommending Regulation D offerings to a customer, and the "accredited investor" determination is only a small piece of that analysis.

FINRA Notice to Members 10-22 provides five factors any broker-dealer recommending a Regulation D offering to a customer must satisfy. FINRA specifically states that, "[i]n order to ensure that it has fulfilled its suitability responsibilities, a BD in a Regulation D offering should, at a minimum, conduct a reasonable investigation concerning" an examination of:

(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 the proceeds of the offering.

FINRA Notice to Members 10-22 at p. 8. FINRA also acknowledges that "a single checklist of possible practices for a BD engaged in a Regulation D offering will not suffice for every offering . . . [.]" *Id*. Accordingly, broker-dealers must examine a host of potential issues when recommending investments in Regulation D securities to customers, and sound compliance protocols are of critical importance.

At Fox Rothschild, the Securities Industry Practice Group is prepared to assist those broker-dealers engaged in Regulation D offerings with the necessary guidance, including, but not limited to, assistance in formulating the required compliance protocols that are necessary to ensure full adherence to all regulatory obligations imposed upon them in connection with their roles in Regulation D offerings, given FINRA's pronounced efforts to aggressively regulate in this area.

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