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Private Placements Under FINRA Scrutiny

The Financial Industry Regulatory Authority ("***FINRA***") announced in its Annual Regulatory and Examination Priorities Letter from January 11, 2013 that it would prioritize policing private placements in 2013. Of particular concern to FINRA is enhancing its risk-based supervision of the private placement market, and addressing inadequate disclosures and due diligence procedures, which can mislead and/or harm investors.

FINRA's announcement is in keeping with the increase in both private placement regulation and enforcement actions in the past few years. In fact, FINRA enforcement actions relating to private placements have increased significantly in recent years, with the number of enforcement actions quadrupling between 2010 and 2012. Generally, recent enforcement actions have been related to member firms' obligations to maintain both adequate procedures for conducting due diligence, including the review of sales materials, and systems for monitoring suitability. Under the current regulatory regime, there are several FINRA and NASD rules that govern due diligence and suitability, some of which are:

FINRA Rule 5123: Requires each FINRA member firm that sells an issuer's securities in a private placement to file with FINRA a copy of its private placement memorandum, or other offering document, within 15 calendar days of the date of a sale.

NASD Rule 2110 (now FINRA Rule 2010): Requires each FINRA member firm to observe "high standards of commercial honor" and "just principals of trade" when conducting business. To abide by such standards and principals, member firms are prohibited from engaging in certain activities, such as front running (a form of insider trading), trading ahead of research reports (where such research reports pertain to the securities being traded), and trading ahead of customer market orders (accepting a customer market order without executing it immediately).

FINRA Rule 2111: Requires each FINRA member firm and their associated persons to have a "reasonable basis to believe" that a transaction or investment strategy involving securities that they recommend is suitable for the customer. The requisite reasonable belief must be based on a wide variety of information from the customer's investment profile, including but not limited to, financial needs, investment objectives, time horizons, liquidity needs, and risk tolerance.

NASD Rule 3010: Requires each FINRA member firm to establish a supervisory system and adopt adequate written supervisory policies and procedures. A supervisory system must supervise the activities of each registered representative and associated person, and must be reasonably designed to achieve compliance with applicable securities laws, regulations and NASD Rules. Written supervisory policies and procedures must be tailored to the activities of the registered persons and the business of the member firm. Additionally, member firms must conduct a review, at least annually, of the businesses in which it engages. Reviews must include internal inspections pursuant to the requirements set forth under this rule, and such reviews must be documented.

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With some of the relevant FINRA and NASD rules in mind, the following are a few examples of FINRA enforcement actions relating to private placements from within the past year:

In the Matter of George Baseluos (AWC 2008011743302, February 3, 2012)

Overview: Baseluos was registered with FINRA member firm Fordham Financial from July 2007 through June 2009. In 2008, Baseluos recommended private placement interests in Six Diamond Resorts International ("***SDRI***") to customers of Fordham Financial. SDRI's private placement memorandum stated that funds were to be used for buying and developing property in Central America into resorts and retirement homes. Baseluos allegedly solicited a customer (identified as "AG" in the letter of Acceptance, Waiver & Consent) to invest in SDRI, and allegedly made misleading remarks regarding the investment's safety, referring to the investment as a "short-term bond deal" with no risk. In reality, SDRI: (i) disclosed in a March 2008 SEC filing that it had incurred a net loss of over $4.6 million in 2007; (ii) had not begun any construction projects by August 2008; (iii) was seeking additional financing through a bridge loan, and; (iv) was also raising additional capital to pay outstanding back salaries and outstanding loans owed to employees.

Findings: FINRA found that Baseluos' negligent misrepresentations to AG regarding the safety of investing in SDRI constituted a violation of NASD Rule 2110. While Baseluos claimed that his assurances and representations were based solely upon information he received from his supervisors at Fordham Financial, FINRA found that Baseluos failed to personally corroborate those representations, and failed to personally ascertain the true status of the investment in SDRI.

In the Matter of Gary Mitchell Spitz (AWC 2012030787301, May 14, 2013)

Overview: Spitz served as CEO, COO, and as a General Securities Principal for FINRA member firm Mt. Rushmore Securities, LLC, a general securities business in Iowa. As a General Securities Principal, Spitz was required to carry out Mt. Rushmore's written supervisory procedures regarding due diligence of private placements, which included reviewing all financial statements of issuers, reviewing the background and qualifications of the individuals responsible for the issuer's management and investment decisions, and determining whether the rates of return stated in the offering memorandum were viable estimates.

Findings: FINRA found that with respect to The Blue Sky Fund ("***TBSF***"), a Regulation D, Rule 506 private offering, Spitz failed to conduct adequate initial and ongoing due diligence (by failing to review any of TSBF's financial statements or formation documents, and by failing to review the qualifications of TBSF's management), failed to ensure that the TBSF offering memorandum contained audited financials, and failed to ensure that audited financials were available to TBSF's non-accredited investors prior to the time of sale (a Regulation D requirement). FINRA also found that Spitz failed to ensure that three Mt. Rushmore Securities selling representatives undertook reasonable efforts to ascertain the financial status, investment objectives, and risk tolerance of investing customers, and in fact, ten customers invested in TBSF before Spitz had reviewed those customers' subscription documents. Thus, FINRA additionally found that Spitz failed to conduct adequate suitability reviews for those customers.

In the Matter of Sunset Financial Services, Inc. (AWC 2011026915701, July 17, 2013)

Overview: Sunset Financial Services, Inc. ("***Sunset***") sold private placements of investment funds as an unaffiliated broker-dealer under Regulation D of the Securities Act. The firm delegated the

responsibilities of conducting due diligence and approving private placements for sale to its vice president, while also delegating to the vice president the responsibility of reviewing third-party due diligence reports, making recommendations for private placements, and monitoring the suitability of purchases. In 2004, the vice president approved the private placement of a fund investing in mortgage loans that was operated by the son of a registered representative of Sunset. During the next three years, Sunset allegedly ignored red flags regarding the fund's holdings (for example, the default rate of the loan portfolio had increased approximately 20%) and did not re-evaluate whether the fund should remain on Sunset's approved list. The vice president also approved a second private placement fund operated by the same sponsor without addressing the concerns raised by the first fund, or reviewing third party due diligence reports regarding the new fund.

Findings: FINRA found that the firm had both inadequate procedures for due diligence, particularly since Sunset failed to engage in adequate on-going due diligence when red flags surfaced regarding the fund it approved in 2004, and inadequate checks and balances on the vice president's activities, primarily since the vice president was responsible for both recommending private placements as well as reviewing the suitability of those recommendations. FINRA also found that Sunset's written supervisory procedures relating to its sales materials were inadequate. Sunset's procedures involved having its registered representatives forward any sales materials to its compliance department for review, before being passed on to customers. FINRA stated that there was a lack of a procedure to track the private placement materials received by registered representatives, or to ensure that sales materials were not passed on to customers before the compliance department reviewed them.

The selected enforcement actions above give some indication as to the types of violations FINRA has been focusing on in the private placement market. Other types of violations that FINRA may take action against include:

- Disclosing investment objectives that exceed the scope of, or inaccurately depict the objectives stated in the offering documents;
- Making unsubstantiated or exaggerated claims, including statement's promising investment success;
- Failing to adequately disclose risk;
- Making unwarranted performance projections;
- Providing materials with contradictory information; and
- Failing to provide a sound basis for evaluating the provided information

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