

## FINRA Increases Private Placement Scrutiny and Enforcement

The Financial Industry Regulatory Authority has sanctioned eight firms and 10 individuals for selling private placement offerings without adequate due diligence or a reasonable basis for recommending the securities. In addition, FINRA found that the firms failed to establish, maintain and enforce supervisory systems reasonably designed to achieve compliance with applicable securities laws and regulations and NASD and FINRA rules. The sanctions, announced on November 29, 2011, come on the heels of FINRA's April announcement of sanctions for two firms and seven individuals for the same alleged misconduct related to private placements. These enforcement actions are further indication of FINRA's increased scrutiny of broker-dealers in private placements, an area where enforcement has been historically left to the Securities and Exchange Commission and state securities regulators.

**Diligence and Suitability Requirements.** In April of 2010, FINRA issued Regulatory Notice 10-22 (Notice), a reminder to broker-dealers of their obligations under FINRA rules to conduct a reasonable investigation into the issuers and suitability of the securities they recommend in Regulation D private placement offerings. According to FINRA, failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws, including Section 17(a) of the Securities Act, and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The Notice, however, focuses on FINRA requirements, in particular the "suitability" requirement of NASD Rule 2310.

According to the Notice, the Rule 2310 suitability requirement has two parts: the first requires the security to be suitable for at least some investors; the second requires the security to be suitable for the particular investor to whom it is being recommended. The Notice provides guidance for a broker-dealer to ensure that it has fulfilled its suitability responsibilities in a Regulation D offering. According to the release, a broker dealer should, at a minimum, conduct a reasonable investigation concerning:

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made by the issuer; and
- the intended use of the proceeds of the offering.

The Notice indicates that this investigation should be well documented, to demonstrate that the broker-dealer has conducted a reasonable investigation of the issuer. Moreover, this investigation must be conducted by the broker-dealer with each offering, even if a subsequent offering is for the same issuer. Firms should expect that FINRA examiners will review members' compliance with this requirement.

In addition, the Notice states that the broker-dealer must "take into account the investors' knowledge and experience" in recommending investments, for both accredited and unaccredited investors, and "must make reasonable efforts to gather and analyze information about the customer's other holdings, financial situation and needs, tax status, investment objectives and such other information that would enable the firm to make its suitability determination." Before recommending a security, a broker-dealer must be satisfied that the investor fully understands the risks involved and is able to take on those risks.

**Disclosure and Filing Requirements**. In addition to providing guidance on existing rules, FINRA has recently adopted additional rules governing certain private offerings by FINRA members. In 2009, FINRA for the first time adopted a rule obligating broker-dealers and their control entities to meet certain filing, disclosure and use-of-proceeds requirements in private placements. The rule, FINRA Rule 5122, which became effective on June 17, 2009, goes well beyond SEC requirements and provides additional means for FINRA to scrutinize the offerings and operations of broker-dealers and entities under common control with a FINRA member. Under the rule, broker-dealers are required to meet the following requirements in order to offer or sell securities in a member or control entity, subject to limited exceptions:

1. **Filing.** The private placement memorandum (PPM) or term sheet, if any, for the offering must be filed with the FINRA Corporate Financing Department at or prior to the time it is provided to any prospective investor. If there is no PPM or term sheet, an offering document meeting the disclosure requirements of the rule must be prepared and filed at that time.
2. **Disclosure.** The PPM, term sheet or other offering document must be provided to each prospective investor and must disclose the intended use of offering proceeds, the expenses of the offering, and the selling compensation to the broker-dealer and its associated persons.
3. **Use of Proceeds.** At least 85 percent of the offering proceeds must be used for “business purposes” disclosed in the PPM, which does not include expenses of the offering. Offering expenses could exceed 15 percent of proceeds, but the excess could not be paid from proceeds. In a series of member private offerings, the 85 percent limit applies to each offering in a series.

While Rule 5122 applies only to private placements of FINRA members and related control entities, FINRA has filed for approval by the SEC new FINRA Rule 5123, which would extend the Rule 5122 filing and disclosure requirements to all private placements in which a member is involved, without regard to whether the issuer is a FINRA member or a control entity.

FINRA will announce the implementation date of the proposed rule change no later than 90 days following SEC approval. The implementation date will be no more than 180 days following SEC approval.

If you have any questions about FINRA regulation of private placements, please do not hesitate to contact your regular Ropes & Gray contact.

If you would like to learn more about the developments discussed in this alert, please contact the Ropes & Gray attorney with whom you regularly work or any partner in the Ropes & Gray Investment Management group, listed below.

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