



**2020 Examination Priorities: FINRA to
Scrutinize Private Placement Marketing Materials**

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The Financial Industry Regulatory Authority (“**FINRA**”) released its list of examination priorities on January 9, 2020. In view of FINRA’s close attention in recent months to various alternative investment related marketing materials as a part of the Rule 5123 process, it comes as no surprise to us that private placement “**retail communications**” made FINRA’s list of top examination priorities for this year.

What Materials are Subject to Review?

On a foundational front, Rule 2210 regulates the content and disclosure rules pertaining to “**retail communications**,” “**institutional communications**,” and “**client correspondences**.” Retail communications are any written communication distributed or made available to more than 25 retail investors within any 30-calendar day period. Examples of commonly-used retail communications from broker dealers include the following:

1. Product brochures provided to retail investors;
2. Non-password protected websites or communications by means of unrestricted social media;
3. Communications distributed or made available by a broker-dealer consisting of a reprint of an article from an independent publication, or a report published by an independent research firm, to more than 25 retail investors within a 30-calendar day period;
4. Telemarketing and other sales scripts used with respect to more than 25 retail investors within a 30-calendar day period; and
5. Power points shown to existing or prospective retail clients concerning products.

As a point of clarification, prospectuses, preliminary prospectuses, fund profiles and *similar documents* that have been filed with the SEC, and free writing prospectuses that are exempt from filing with the SEC, are not subject to Rule 2210’s content standards. Despite FINRA’s general historical practice to exclude PPMs and prospectuses from Rule 2210 scrutiny, Rule 2210 itself does not expressly exclude PPMs from the reach of the advertising rules either. **This begs the question as to whether or not PPMs and exhibits contained in PPMs are retail communications for purposes of FINRA’s examination priorities.**

At the time when NASD Conduct Rule 2210 was in effect (i.e., pre-Oct. 2016), some guidance on that issue was mentioned in RN 10-22 (page 5), which discusses a broker dealer’s due

diligence obligation. In that notice, FINRA explained situations where a PPM may be subject to Rule 2210's scrutiny:

A BD that assists in the preparation of a private placement memorandum or other offering document *should expect that it will be considered a communication with the public by that BD for purposes of NASD Rule 2210*, FINRA's advertising rule. If a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, *then the BD that assisted in its preparation* may be deemed to have violated NASD Rule 2210. Moreover, *sales literature* concerning a private placement *that a BD distributes* will generally be deemed to constitute a communication by that BD with the public, whether or not the BD assisted in its preparation.

Under the former NASD Rule 2210 that applied to marketing materials prior to the passage of FINRA Rule 2210 in October, 2016, there was a class of marketing materials known as *sales literature*. Under the former rule, sales literature generally included written retail communications *that had a more targeted audience*, such as brochures, performance reports, telemarketing scripts, seminar scripts and form letters. Materials that formerly fell within the definition of sales literature **became a part** of what is today referred to as retail communications.

A question unfortunately remains as to whether certain literature *prepared by a sponsor* that is contained in a PPM exhibit **but** has the **look, smell, and feel** of a retail communication is within the compliance purview of FINRA Rule 2210. Apart from the PPM, these materials unquestionably fall within the confines of the advertising rule if a broker dealer participates in the distribution of the materials.

What is FINRA Going After?

Based upon our communications with various broker-dealers, it appears that FINRA is taking a position that sponsor-prepared literature that has the look and feel of a retail communication will be treated as such, even if the literature is a part of a PPM if the broker dealer or associated person of a broker dealer participates in the distribution of the PPM and attached literature to the client. For this reason, exhibits within PPMs that have a marketing feel and that "call to action" a securities purchase will likely be treated as retail communications and scrutinized under the above-mentioned examination priorities.

In its examination letter, FINRA mentions two focus areas designated for careful scrutiny, which include (i) reviews of private placement retail communications, and (ii) reviews of communications via digital channels. In reviewing private placement related retail communications, FINRA's examination priorities letter articulates five focus points of review for 2020:

1. do the subject materials omit material information necessary to make the communications fair and not misleading by failing to, for example, explain that private placements may involve a high degree of risk, are not liquid and that investors may lose money?
2. do the materials balance promotional content with the key risks specific to the issuer's offering?

3. do the materials contain false, misleading or promissory statements or claims, such as the likelihood of a future public offering of the issuer, claims about the future success of the issuer's new or untried **business model**, or inaccurate or misleading assertions concerning the regulation or relative risk of the offering?
4. when forecasting issuer metrics, such as revenue, are the presentations reasonable and accompanied by clear explanations of both the assumptions used to create the forecasts and the risks that might impede achievement of such forecasts?
5. do the materials contain predictions or projections of investment performance to investors that are generally prohibited by FINRA Rule 2210(d)(1)(F) (unless they meet the stated criteria in the rule)?

From our discussions with broker-dealers and our reviews of FINRA's communications with the broker-dealers, we note that there are a number of marketing related faux pas that have caught FINRA's eye in recent months. These include the following:

1. statements of a target distribution or level of performance (e.g., *our target distribution for the fund is 6% of invested capital*);
2. uses of statements that tend to over-emphasize the operational goals of the fund (e.g., *after years of hard work, we have specially designed our fund to provide steady, stable cash flow, optimal diversification from public equity market risk, and institutional quality real estate market exposure*);
3. product comparisons (e.g., *our REIT is superior to that of the other REITs and real estate oriented BDCs on the market today*);
4. use of data relating to a publicly traded analog product to promote sales of non-traded securities sold through private placements (e.g., *the Alerian MLP index has moved 25% over the past year, which bodes well for our fund's assets that include several pipelines and gathering systems*);
5. statements that emphasize a sponsor's prior performance, without explaining that the pattern might not continue into the future, or the circumstances that could cause the trend to stop (e.g., *every one of our products are meeting or exceeding their targeted distribution objectives*).

Projections of Investment Performance

FINRA Rule 2210(d)(1)(F) states that communications may not *project* investment performance, *imply* that past performance *will* reoccur, nor make any exaggerated or unwarranted claim or forecast. This is an intriguing provision of Rule 2210, as it has been common practice for sponsors to provide target returns and return objectives within PPMs and sometimes within retail communications to include brochures, executive summaries, and power point presentations. On a related note, this rule provides an exception that applies to a "price target" contained in a research report on debt or equities securities. The use of a price targets is conditioned upon (i) the price target having a reasonable basis, (ii) a disclosure of the valuation methods used in the report to determine the price target, and (iii) the price target being accompanied by disclosure concerning the risks that may impede achievement of the price target.

By analogy to the price target exception of Rule 2210(d)(1)(F), one might argue that the statement by a sponsor of a distribution objective in a retail communication should be allowed if

the same controls are followed by the sponsor that otherwise apply to price targets. While we believe that this presents an interesting topic for an SEC No Action request letter, the safest course of action, of course, would be to refrain from the use of materials that provide return targets and to rely upon the sponsor's PPM pro formas that contain appropriate forward looking statement disclosures drafted by experienced securities counsel.

Misleading Statements or Claims

FINRA Rule 2210(d)(1)(B) prohibits false, exaggerated, unwarranted, promissory, or misleading statements or claims in members' communications. Communications that contain untrue statements of a material fact or are otherwise misleading may not be published, circulated, or distributed.

The use of phrases and statements strongly implying that the fund's operational objectives will likely occur in the future is deemed to violate this rule in the absence of risk disclosures at or very close to the suspect phrase or statement, which clarify facts and circumstances that may impede the fund from meeting such objectives. On a related note, the use of positive and repetitive promotional phrases in retail communications may be construed as non-compliant with Rule 2210 when the risks factors contained in the main body of a PPM otherwise suggest that there is a strong risk that such objectives will not occur.

Comparisons of a sponsor's product with competing products, or the use of comparisons of a sponsor's product to a publicly traded product, will draw FINRA's attention in the absence of a full explanation of the features/risks of the products being compared (which, in our opinion, is a tough standard to meet considering that all material differences are expected to be addressed in the subject literature). Performance related assertions or statements that emphasize a sponsor's prior performance may violate the rule, in the absence of explaining (i) that the pattern of success might not continue into the future, or (ii) the circumstances that could cause the performance trend to cease. An obvious example in commercial real estate offerings relates to the interest rate and capitalization rate compression trend that may have delivered a material portion of the prior performance metrics in the last ten years. *A sponsor's performance related statement could also violate the rule if the prior performance relates to products that are structured differently from the fund or that employed an investment strategy or operating strategy that was different from the fund being promoted.*

Fair Discussion of Features and Risks

It goes without saying that FINRA's centerpiece advertising rule is Rule 2210(d)(1)(A), which requires a member's communication with the public to be fair and balanced, and to provide the investor with a sound basis for evaluating the facts regarding the securities products or services being discussed. The Rule also prohibits the omission of material information if such omission would cause the communication to be misleading.

While it is common practice for sponsors to include a plethora of risk factors in the main body of a PPM, this does not excuse the lack of fair risk disclosures in marketing materials that promote private placements. On this point, FINRA will take issue with sales literature-like PPM

exhibits and other offering related marketing materials that fail to present a balanced discussion of the features and benefits of the products with the corresponding risks. Thus, to say that “it’s all covered in the PPM” or to refer the investor to the PPM “for a complete discussion of the risks” is not a sufficient response if the sales material itself is not appropriately fair and balanced in its nature (i.e., meaning the risk discussion needs to be close to and as prominent as the discussion that explains the products potential benefits). *In terms of Rule 2210 compliance, this point in particular is where many private placement retail communications run afoul of the rule.*

Conclusion

In finality, we encourage our readers to approach their marketing practices relating to private placements and other alternative investments with caution. As FINRA is stepping up its game in relation to its compliance expectations regarding marketing materials involving non-traded securities, so should you.

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