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Key Takeaways From Regulatory Notice 23-08 ("RN 23-08")

Thirteen years ago, FINRA issued Regulatory Notice 10-22 ("**RN 10-22**"), wherein it reminded its members of their obligations to conduct reasonable investigations of the issuers and the securities they recommend in private offerings made under Regulation D ("**Reg D**"). As times change, so do the recommendations of FINRA as to the best practices when conducting effective due diligence on both issuers and their products sold under Reg D. RN 23-08 highlights a member's critical role, when recommending private placements, "*in performing reasonable investigations under the reasonable basis obligations of Reg BI, the suitability rule and caselaw interpreting the antifraud provisions of the federal securities laws.*" RN 23-08 also examines "*member obligations applicable to private placement activity irrespective of whether recommendations are involved*" (e.g. filing requirements, duty to investigate and acts upon "red flags"). As stated in RN 23-08, FINRA members may consider the information in RN 23-08 in "*developing new, or modifying existing, practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the member's size and business model*."

Key Takeaway #1: Reasonable Basis Obligations And What Constitutes a "Reasonable Investigation" Are Both Case Specific

Both FINRA's reasonable basis obligation and the SEC's Reg BI care obligation require that the member undertake reasonable diligence, care and skill to understand the nature of the recommended security or investment strategy involving a security, as well as the potential risks, rewards and costs of the recommended security or investment strategy. Reg BI also requires that the member have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers based on that understanding.

What constitutes a reasonable investigation is case specific. The amount and nature of the investigation required depends, among other factors, "*upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer*." A newer, less established issuer may require a more thorough investigation. As always, the presence of "red flags" should alert the member to conduct further inquiry.

RN 10-22 explained that a member should conduct a reasonable investigation of: (i) the issuer and its management; (ii) the business prospects of the issuer; (iii) the assets held by or to be acquired by the issuer; (iv) the claims being made; and (v) the intended use of proceeds of the offering. Along with the above, RN 23-08 recommends that members should also consider addressing, where relevant:

⁕ *The regulatory and litigation history of the issuer and its management, including the criminal, disciplinary, regulatory, and litigation history associated with the issuer, its management, and any affiliate that may be materially involved in the issuer's business, as well as the issuer's compliance with the bad actor provisions under Rule 506(d)–(e);*

⁕ *New material developments, including events that are or should be reasonably known to the member during an offering, for example, when there are ongoing legal proceedings or regulatory inquiries involving the issuer;*

⁕ *Transactions or payments between an issuer and the issuer's affiliates involving offering proceeds, including the terms of the transaction between the related parties and whether an arrangement presents a material conflict of interest for the issuer and, if so, the sufficiency of disclosure; and*

⁕ *Representations of past performance of the issuer, its sponsor, or its manager to identify any such representations that may be misleading or exclusively selected based on positive results (or "cherry-picking"). This is particularly important when the representations pertain to specific prior issuances.*

Key Takeaway #2: Complex Products Require Heightened Scrutiny

Members and their financial professionals generally should apply heightened scrutiny to whether a risky or complex product is in the retail customer's best interest. Among the relevant considerations when recommending such a product is whether the retail customer "*has an identified, investor-specific trading objective that is consistent with the product's description in its prospectus or offering documents, and/or has the ability to withstand heightened risk of financial loss.*" In addition, a member should consider "reasonably available alternatives" offered by the member as part of having a "*reasonable basis to believe*" that the recommendation is in the best interest of the retail customer. For complex products (including private placements), this involves considering whether lower risk or less complex options can achieve the same investment objectives.

Key Takeaway #3: Reg BI's Component Obligations Of Disclosure, Conflict of Interest And Compliance Are In Addition To Its Care Obligations

The "Disclosure Obligation" requires a member, prior to or at the time of the recommendation, to provide the retail customer, in writing, full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer and all material facts relating to conflicts of interest that are associated with the recommendation. Material facts relating to the scope and terms of the relationship with the retail customer that must be disclosed include, but are not limited to: (i) "*the capacity in which the broker-dealer is acting; (ii) the material fees and costs that apply to the retail customer's transactions, holdings and accounts; and (iii) the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer. Importantly, disclosure of conflicts of interests alone does not satisfy the obligation to act in the retail customer's best interest*."

The "Conflict of Interest Obligation" requires a member to identify and address conflicts of interest that may incline the member or its representatives, consciously or unconsciously, to make a recommendation that is not disinterested. The member must: (i) identify and disclose, or eliminate, all

conflicts of interest associated with recommendations; (ii) identify and mitigate any conflicts of interest associated with recommendations that create an incentive for the member's representatives to place their interest or the interest of the member ahead of the retail customer's interest; (iii) identify and disclose any material limitations (e.g., a limited product menu) placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations and prevent such limitations and associated conflicts of interest from causing the member or representative to make recommendations that place the interest of the member or the representative ahead of the retail customer's interest; and (iv) identify and eliminate sales contests, sales quotas, bonuses and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time. Extra consideration should be given when members recommend to retail customers private placements of securities issued by an affiliated company or by a company that may share a close relationship with the member.

Finally, under the "Compliance Obligation," a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI. SEC staff guidance suggests, among other things, "*that firms should consider developing procedures outlining the due diligence process for complex or risky financial products to help ensure that these products are assessed by qualified and experienced firm personnel, and should consider establishing procedures requiring appropriate training and supervision to help ensure financial professionals understand the features, risks and costs of a complex financial product".* The guidance further suggests that "*members should consider documenting the process and reasoning behind particular recommendations of complex or risky products, including consideration of less complex alternatives, and how it fits within the retail customer's broader goals or strategy.*"

Key Takeaway #4: Look For Misleading Information In PPMs Or Other Offering Documents

If a PPM or other offering document presents information that is not fair and balanced or that is misleading, then the member that assisted in its preparation may be found to have violated FINRA Rule 2210. Sales literature concerning a private placement that a member distributes generally constitutes a communication by that member with the public, whether or not the member assisted in its preparation.

Key Takeaway #5: Continued Importance Of Member Documentation And Supervision

A member's process for conducting a reasonable investigation of a private placement should include attention to the unique facts and circumstances of the offering. Maintaining an updated due diligence file, for example, when recommending securities in follow-on offerings by the same issuer or sponsor in order to have a reasonable basis to recommend the current offering. Consistent with previous guidance in RN 10-22, members often retain records documenting both the process and results of the updated investigation. To maintain adequate supervision of its private placement reasonable investigations under FINRA Rule 3110, or to meet the requirements of Reg BI's Compliance Obligation, members' procedures might include: (i) ensuring a checklist is reasonably designed to address the private placement, requirements for filing and related documentation, assignment of staff responsible for performing functions and tasks, and evidence of supervisory approval for the reasonable investigation

process; (ii) assigning responsibility for the member's private placement reasonable investigation and compliance with filing requirements to a specific individual or team and conducting targeted, in-depth training about the firms' policies, process and filing requirements; (iii) creating a system that alerts responsible individual(s) and supervisor(s) about upcoming and missed filing deadlines; (iv) requiring documentation of the process, completeness, and results of its investigations and retention of documents collected through due diligence; (v) implementing standards for the reasonable investigation process that specifically address certain types of offerings sold by the member; and (vi) taking steps to ensure that the member's sale of an offering does not precede the completion of its reasonable investigation.

In conclusion, the position of Mick Law has always been to consider and report any facts and circumstances germane to RN 23-08's stated "additional" considerations, as well as those stated in RN 10-22, within our sponsor and/or offering level due diligence opinions. In many cases, issuers will update their Mick Law sponsor opinion every 24 months with many issuers, as part of their internal best practices, updating annually based on new financial reports, changes in performance, and business plan modifications. Many issuers we review also syndicate new offerings on a no less than annual basis which allows our firm to provide updates related to RN 23-08's additional considerations. Of course, every opinion we produce contains a litigation, disciplinary and regulatory section that would cover RN 23-08's considerations on such as stated above. RN 23-08's additional considerations highlights the need for you to push for annual, if not semiannual, updates to those offerings still in the fund raising stage. We believe that as a law firm, our obligations and duties to you, as our client, along with the qualifications and expertise of our attorneys, paralegals, real estate underwriters and engineers, significantly outweigh what others can provide in the third-party due diligence space.

Thank you for your continued confidence in Mick Law.

David M. Sengstock, President
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