Private Placements: Dos and Don’ts of Due Diligence

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Topics to Be Discussed

• FINRA and Private Placements
  • Offering document filing requirements
  • Due diligence requirements for private placements

• FINRA Enforcement Actions
  • What have brokers done improperly?
  • What should brokers be focused on?
FINRA Filing Requirements

• On June 7, 2012, the SEC approved FINRA Rule 5123, which expanded the scope of FINRA’s regulation of broker-dealer participation in certain private placements of securities.
• Rule 5123 provides that a member firm participating in a non-public offering submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions of those documents, used in connection with the offering within 15 calendar days of the date of first sale, or indicate to FINRA that no such documents were used.
• Rule 5123 provides exemptions from the filing requirement based on the type of purchaser and the type of offering, which effectively limit application of the rule to non-institutional private placements.
Application of FINRA Filing Requirements

• FINRA Rule 5123 applies to a “private placement” which means “a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act.”
• The definition does not apply to securities offered pursuant to:
  • Sections 4(1), 4(3), and 4(4) of the Securities Act (which generally exempt secondary transactions);
  • Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing) or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions) of the Securities Act; and
  • Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise entitled to the exemption from registration afforded by Section 3(a)(10) of the Securities Act).
FINRA Filing Exemptions

• FINRA Rule 5123 exempts other types of private placements from the notice filing requirement, including:
  • Offerings sold by a member solely to any one or more of the following purchasers:
    • Institutional accounts, as defined in FINRA Rule 4512(c);
    • Qualified purchasers, as defined in Section 2(a)(51)(A) of the 1940 Act;
    • Qualified institutional buyers (QIBs), as defined in Rule 144A under the Securities Act;
    • Investment companies, as defined in Section 3 of the 1940 Act;
    • An entity composed exclusively of QIBs;
    • Banks, as defined in Section 3(a)(2) of the Securities Act;
    • Employees and affiliates of the issuer;
    • Knowledgeable employees as defined in Rule 3c-5 under the 1940 Act;
    • Eligible contract participants, as defined in Section 3(a)(65) of the Exchange Act; or
  • Accredited investors as defined in Rules 501(a)(1), (2), (3) or (7) under the Securities Act;
FINRA Filing Exemptions (cont’d)

• Offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;
• Offerings made pursuant to Rule 144A under the Securities Act or Regulation S;
• Offerings of exempt securities with short-term maturities under Section 3(a)(3) of the Securities Act and debt securities sold by members pursuant to Section 4(a)(2) of the Securities Act so long as the maturity does not exceed 397 days and the securities are issued in minimum denominations of $150,000 (or the equivalent thereof in another currency);
• Offerings of subordinated loans under Rule 15c3-1 (Appendix D) under the Securities Act;
• Offerings of “variable contracts,” as defined in FINRA Rule 2320(b)(2);
• Offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in FINRA Rule 5110(b)(8)(E);
• Offerings of non-convertible debt or preferred securities by issuers that meet the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 or F-3;
FINRA Filing Exemptions (cont’d)

- Offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already-existing investor without the need for additional consideration or investments on the part of the investor;
- Offerings of securities of a commodity pool operated by a commodity pool operator, as defined in Section 1a(11) of the Commodity Exchange Act;
- Business combination transactions as defined in Rule 165(f) under the Securities Act;
- Offerings of registered investment companies;
- Offerings of standardized options, as defined in Rule 238 under the Securities Act; and
- Offerings filed with FINRA under FINRA Rules 2310, 5110, 5121 and 5122, or exempt from filing thereunder in accordance with FINRA Rule 5110(b)(7).
FINRA Private Placement Form

• To facilitate submission of the required information, FINRA developed the Private Placement Form for the processing of specified private placement filings through FINRA’s Firm Gateway, an abbreviated version of which has been in use since FINRA Rule 5123’s effectiveness on December 3, 2012.
• Member firms must complete and submit the Private Placement Form electronically through FINRA’s Firm Gateway.
• The Private Placement Form requests the following information:
  • Identifying and contact information for the member and the issuer.
  • Disclosure of any affiliate relationship between the member and the issuer or sponsor.
  • Basic information about the nature of the offering (e.g., type of security, offering size, offering period, underwriting discounts/commission, etc.).
FINRA Private Placement Form (cont’d)

• On August 19, 2013, FINRA updated the Private Placement Form to include six additional questions:
  • Is the offering a contingency offering?
  • Does the issuer have any independently audited financial statements for the issuer’s most recent fiscal year?
  • Is the issuer able to use offering proceeds to make or repay loans to, or purchase assets from, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor or any of the issuer’s affiliates?
  • Does the issuer have a board of directors comprised of a majority of independent directors or a general partner that is unaffiliated with the firm?
  • Has the issuer engaged, or does the member anticipate that the issuer will engage, in a general solicitation in connection with the offering or sale of the securities?
  • Has the issuer, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor or any of the issuer’s affiliates been the subject of SEC, FINRA or state disciplinary actions or proceedings or criminal complaints within the last 10 years?
The Private Placement Form assists FINRA in prioritizing its review of private placement reviews.

FINRA has indicated that firms can respond “unknown” to any of the questions, although we believe answering “unknown” is likely to trigger heightened scrutiny by FINRA, particularly because the questions address basic diligence questions.

FINRA’s statistics show that since July 1, 2013, on average:

- 18% of filers have answered “unknown” to at least one of the six questions.
- Of these, approximately 28% have answered “unknown” to the question regarding SEC, FINRA or state disciplinary actions or proceedings or criminal complaints within the last 10 years; and approximately 8% have answered “unknown” to the question whether the issuer has independently audited financial statements available for its most recent fiscal year.
FINRA Private Placement FAQs

• In December 2012, FINRA issued frequently asked questions on the private placement filing requirements.

• The technical questions address how firms gain access to the Private Placement Filing System, the use of third parties, such as law firms and consultants, to make the required filings, the requirement that offering documents be filed in searchable PDF format, and the maximum size of individual documents.

• In addition, while a firm can designate another member participating in the private placement to file on its behalf, it should arrange to receive confirmation from the designated filer in order to satisfy its own filing obligation.
FINRA Private Placement FAQs (cont’d)

• The substantive FAQs include the following:
  • If there have been material changes to the offering documents that were originally filed, the amended version must be filed. FINRA notes that “Typically, the issuer will offer rescission rights to investors if there is a material change in the offering document.”
  • In a contingency offering involving an escrow, FINRA, based on SEC guidance regarding Form D filings, takes the position that the “date of first sale” is the date on which the investor is irrevocably contractually committed to invest, which could be the date the issuer receives the investor’s subscription agreement or check.
  • Exemptions are applied on a firm-by-firm basis (different firms in the same private placement may have different filing obligations). For example, a firm that sells solely to institutional accredited investors (Rules 501(b)(1), (2), (3) or (7) under the Securities Act), would not have to file pursuant to FINRA Rule 5123(b)(1)(J) but another firm in the same offering that sold to accredited investors that are natural persons would be required to file under FINRA Rule 5123.
FINRA Private Placement FAQs (cont’d)

• Whether a firm that introduces a prospective investor to an issuer and receives a fee is required to file under FINRA Rule 5123 depends on the relevant facts and circumstances (no other specific guidance provided).
• Firms participating in crowdfunding offerings under the JOBS Act will not be required to file under FINRA Rule 5123.
On September 6, 2013, the SEC approved FINRA’s proposed rule regarding the public dissemination of information regarding Rule 144A offerings of corporate bonds.

- The information consists of (1) investment/non-investment grade status and (2) real time market data.
- The information will be disseminated through FINRA’s TRACE (Trade Reporting and Compliance Engine).
- TRACE is used to collect from FINRA members and publicly disseminate information on secondary OTC transactions in corporate debt securities, agency debt securities and certain primary market transactions.

- The rule is part of FINRA’s broader effort to improve transparency in the Rule 144A market.
- The rule is effective 270 days after publication by FINRA in a regulatory notice.
FINRA Communication Rules

- If a registered broker-dealer is participating in a private placement, it will want to ensure that:
  - It has identified the group within the bank that will be involved.
  - It has undertaken training to make certain that each member understands the requirements under FINRA Rules 2210 and 5123.
    - Under FINRA Rule 2210, most communications likely to be used in connection with general solicitation will be considered “retail communications.”
  - Communications must be fair and balanced.
  - Communications will be subject to review, filing with FINRA and recordkeeping requirements.
  - It will want to remind bankers of the firm’s social media policy.
- FINRA already is focused on Regulation D offerings and recently announced a sweep on social media issues.
FINRA Communication Rules (cont’d)

• The FINRA communication rules cover three categories of communications:
  • Institutional communications: Includes written (including electronic) communications that are distributed or made available only to institutional investors (does not include a firm’s internal communications).
  • Retail communications: Includes any written (including electronic) communications that are distributed or made available to more than 25 retail investors within any 30-calendar day period (retail investors include any persons other than institutional investors).
  • Correspondence: Includes any written (including electronic) communications that are distributed or made available to 35 or fewer retail investors within any 30-calendar day period.

• “Reason to believe” standard applied to communications.
• Principal pre-use approval requirements for retail communications.
FINRA and Due Diligence

• In the context of a Regulation D offering, FINRA Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non-accredited investors that will take into account the investors’ knowledge and experience.

• In order to ensure that it has fulfilled its suitability responsibilities, a broker-dealer in a Regulation D offering should, at a minimum, conduct a reasonable investigation regarding:
  • 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; and
  • the intended use of proceeds of the offering.
FINRA and Due Diligence (cont’d)

• The scope of the broker-dealer’s investigation also will depend upon a number of factors, including the broker-dealer’s affiliation with the issuer, its role in the transaction and other facts and circumstances of the offering, including whether the offerees are retail customers or more sophisticated institutional investors.

• In addition, a firm that engages in Regulation D offerings also must have supervisory procedures under NASD Rule 3010 that are reasonably designed to ensure that the firm’s personnel, including its registered representatives:
  • engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements;
  • perform the analysis required by NASD Rule 2310;
  • qualify their customers as eligible to purchase securities offered pursuant to Regulation D; and
  • do not violate the antifraud provisions of the federal securities laws or FINRA rules in connection with their preparation or distribution of offering documents or sales literature.
FINRA and Due Diligence (cont’d)

- In the course of a reasonable investigation, a broker-dealer must note and investigate further any information that it encounters that could be considered a “red flag” that would alert a prudent person to conduct further inquiry.
  - Such red flags might arise from information that is publicly available or information that is discovered during the course of the investigation.
- When presented with red flags, the broker-dealer also must do more than simply rely upon representations by the issuer’s management, the disclosure in an offering document or even a due diligence report of issuer’s counsel.
- In order to demonstrate that it has performed a reasonable investigation, a broker-dealer also should retain records documenting both the process and results of its investigation.
FINRA and Due Diligence (cont’d)

• Furthermore, a broker-dealer’s reasonable investigation must be tailored to each Regulation D offering.
  • A single checklist of possible practices for a broker-dealer engaged in a Regulation D offering will not be sufficient for every offering.
  • Mechanical reliance upon a single checklist may result in an inadequate investigation.
FINRA Enforcement Trends

• Earlier this year, FINRA announced that the policing of private placements would be its regulatory priority for 2013.
• However, FINRA enforcement actions relating to private placements have been dramatically increasing since 2010.
• With the adoption of FINRA Rule 5123, this trend of increased enforcement seems likely to continue.
FINRA Enforcement Trends (cont’d)

Source: Jennifer J. Johnson, “Private Placements: Will FINRA Sink in the Sea Change”
FINRA Enforcement Trends (cont’d)

• Recent FINRA enforcement actions suggest that FINRA is actively pursuing its 2013 regulatory priority and indicate the types of violations that are likely to draw FINRA’s attention, including:
  • Disclosing investment objectives that exceed or fail to accurately capture the objectives stated in the offering documents;
  • Making unsubstantiated or exaggerated claims, or statements that promise investment success;
  • Making unwarranted performance projections;
  • Failing to adequately disclose risk;
  • Providing materials with contradictory information;
  • Failing to provide a sound basis for evaluating the provided information; and
  • Violating applicable general solicitation rules.
Medical Capital Holdings VI Offering

- MedCap was a medical receivables financing company.
- 2001 through 2009, MedCap raised approximately $2.2 billion from over 20,000 investors through nine private placements of promissory notes.
- MedCap made interest and principal payments on its promissory notes until July 2008, when it began experiencing liquidity problems and stopped making payments on notes sold in two of its earlier offerings.
- MedCap nevertheless offered Medical Provider Funding Corporation VI through an August 2008 PPM.
- In July 2009, the SEC obtained preliminary injunction to stop all MedCap sales.
- FINRA imposed sanctions against broker-dealer firms and individuals for failing to conduct a reasonable investigation or for failing to enforce procedures with respect to the sale of private placements.
FINRA Enforcement – Seminal Cases (cont’d)

Provident Royalties Offerings
• Sept 2006 through Jan 2009, Provident Asset Management, LLC, sold preferred stock and limited partnership interests in 23 private placements offered by an affiliated issuer, Provident Royalties.
• Offerings sold through more than 50 retail broker-dealers nationwide and raised approximately $485 million from over 7,700 investors.
• Some of the proceeds of the offerings were used for the acquisition and development of oil and gas exploration and development activities.
• But most of the investors’ funds were transferred from the later offerings’ bank accounts to the Provident operating account in the form of undisclosed and undocumented loans, and were used to pay dividends and returns of capital to investors in the earlier offerings, without informing investors of that fact.
• In July 2009, the SEC obtained a temporary restraining order, an emergency asset freeze and appointment of a receiver.
FINRA Enforcement – Other Cases

• Other recent cases discuss:
  • Oil and gas offerings
  • Failure to perform adequate due diligence, including:
    • Third party verification
    • Documentation of due diligence
  • Red flags
  • Inadequate procedures, including:
    • Procedures related to conflicts of interest
FINRA Enforcement – Oil and Gas

Nobles and Richards, Inc. (October 2012)

- Offerings of speculative oil and gas programs.
- In due diligence, BD failed to reasonably determine the viability of the investments.
- BD never compared its internal viability projections with actual well performance. If it did, it would have discovered that its viability projections were inaccurate, and none of the wells met its projections.

The Tidal Group, Inc. (November 2012)

- The PPMs for the two prospects included maps that identified the proposed drilling location, as well as the surrounding wells.
- While the maps contained legends that included a symbol for plugged and abandoned wells, the maps failed to reflect that those wells were plugged and abandoned.
FINRA Enforcement – Due Diligence

Capital Financial Services (August 2011)
• The firm never obtained financial information about Provident and its offerings from independent sources, such as audited financial statements.
• Only reviewed the PPMs.
• Did not visit Provident’s headquarters to conduct any due diligence on these.

Synergy Investment Group (December 2011)
• BD’s compliance director reviewed only the PPM.
• Failed to review company financials, or third party reports. Took no steps to confirm the statement in the PPM that the MedCap affiliates had never delayed payments on their debt obligations.
• Review required by Synergy’s written supervisory procedures for new products never took place, and the due diligence checklist required by the procedures was never completed by Synergy.
• Firm failed to detect any of the late payments or defaults.
FINRA Enforcement – Due Diligence (cont’d)

Brookstone Securities, Inc. and David D. Locy (July 2012)
- Only due diligence conducted for the offerings consisted of a review of the PPMs.
- Did not request due diligence books, even though PPMs prominently stated that they were available upon request.
- Did not request report of a third party due diligence provider which had conducted due diligence reviews of the offerings.
- Failed to review another third-party due diligence report it had received, which would have informed them of a number of red flags with respect to the offerings.

Arete Wealth Management, LLC (July 2012)
- BD relied too heavily on the representations made by the issuer within the PPM.
- Failed to contact the law firm that purportedly created the PPM to verify its involvement, and failed to contact the accounting firm that was involved in preparing financial reports to confirm its involvement. BD ultimately learned that one individual involved with the fund had misrepresented his educational credentials, and the law firm and accounting firm supposedly involved with the fund had not in fact performed services for the fund.
Basis Financial LLC (September 2012)
• BD relied almost entirely on unsubstantiated statements touting the company as “the next Google,” and indicating that the company was planning an IPO.

Nobles and Richards, Inc. (October 2012)
• Due diligence was limited to collecting information about the offerings from the issuer.
• BD failed to conduct an independent investigation of the issuer’s representation and claims.
FINRA Enforcement – Third Party Verification

Investors Capital Corp. (November 2011)
• BD did not verify through third-party sources the representations made to the firm by issuer.
• BD did not take steps to scrutinize the offerings’ promised high rates of return to ensure that they were legitimate, and not payable from the proceeds of later offerings.
FINRA Enforcement – Red Flags

Capital Financial Services (August 2011)

- Two days after offering started, MedCap told BD that it was experiencing liquidity issues, and had not repaid principal to some clients but expected to correct the problem in 30 days.
- BD suspended sales of the securities, but allowed them to resume after a visit to the MedCap facility, discussions with MedCap representatives, and review of financial information provided by MedCap.
- Other red flags:
  - One of CFS’s custodial firms refused to hold MedCap notes, deeming them worthless;
  - CFS’s clearing firm valued MedCap notes at zero on its customers’ account statements;
  - CFS received two third-party due diligence reports highlighting MedCap’s failed payments and warned of further potential problems; and
  - CFS received communications from another third-party due diligence provider who indicated that MedCap was not allowing access to all of its records, thereby making it impossible to conduct any credible due diligence.
FINRA Enforcement – Red Flags (cont’d)

Brookstone Securities, Inc. and David D. Locy (July 2012)

• Net operating losses.
• Usage of the full amount of the credit line.
• Operating funds would need to come from a higher level of production revenues or future divestiture of lease/mineral assets.
• Areas relied upon to generate income were in the early development stages and their potential to generate profit was largely unknown.
• The fact that certain offerings were advancing funds to, or buying assets from, other offerings.
• Lack of transparency in financial statements.
• The lack of formal auditing or accounting firm confirmation for the financial statements associated with the offerings.
• High rates of return associated with the offerings.
FINRA Enforcement – Red Flags (cont’d)

KMS Financial Services, Inc. (November 2012)

• The investment company refused to provide any financial statements, audited or unaudited, or any other information that would confirm the fund’s assets and performance.

• There was no verification from any custodian that it held assets of the funds.

• The fund’s accountants did not prepare or review financial statements and relied upon the investment company to state the value of the fund’s assets.

• The fund manager changed accounting firms without explanation.

• The founder and portfolio manager of the fund had a disciplinary history (sanctioned by a NYSE hearing panel).
FINRA Enforcement – Documentation

Investors Capital Corp. (November 2011)
• BD did not create any documents or records of materials reviewed, or prepare any memoranda outlining the steps taken or why it was decided to sign a selling agreement for any particular offering.
• No documentary evidence that firm had performed any reasonable due diligence beyond maintaining and reviewing a copy of the PPM and any third-party due diligence.

Arete Wealth Management, LLC (July 2012)
• BD failed to sufficiently document its due diligence.
• Due diligence file only consisted of a PPM, some email correspondence between Arete and the issuer, and a written timeline of meetings and phone calls.
Synergy Investment Group, LLC (January 2012)

- BOM asked Director of Compliance to approve non-disclosure agreement used in connection with private placements. Director of Compliance told BOM that the branch could not use the form because it was not approved to sell any private placements.
- This was a red flag indicating that the branch had either already engaged in private securities transactions without firm approval, or was contemplating engaging in private securities transactions in the future.
- Despite red-flag, BD failed to follow up or increase its scrutiny of the branch.
- Would have learned that over 70% of the incoming and outgoing emails dealt with unapproved private placements.
FINRA Enforcement – Conflicts of Interest

Wendy Janeen Worcester (June 2013)

• Chief compliance officer (CCO) had dual affiliation with the broker dealer and its parent, which sponsored the offerings.
• CCO failed to conduct thorough and independent due diligence, and thus failed to resolve conflicts of interest.
• CCO failed to establish, maintain and enforce a system and procedures reasonably designed to resolve conflicts of interest between the broker dealer, the issuer and its parent company, in conducting due diligence of promissory notes, real estate investment trust and a profit participation program offerings.
• See laundry list of failings.
Recent FINRA Enforcement Action

• On July 17, 2013, FINRA approved a Letter of Acceptance, Waiver and Consent submitted by Sunset Financial Services, Inc. in connection with alleged violations of NASD Rules 3010(a) and 2110 and FINRA Rule 2010.

• This matter involved private placements for two funds, one a bridge loan lender of short-term mortgages secured by real property and the other an acquirer of discounted debt from distressed banks and other leveraged financial institutions.

• FINRA cited an increased default rate for the loan portfolio of the first fund of approximately 20% (which was a red flag given the relevance of default risk to the fund’s business) and the broker-dealer’s failure to follow-up or re-evaluate the appropriateness of retaining the fund on its approved list, even in light of subsequent suspended redemptions and monthly distributions.
Recent FINRA Enforcement Action (cont’d)

- FINRA pointed out that the broker-dealer also did not wait for the completion of a third party due diligence report on the second fund before placing the fund on its approved list, nor did it perform enhanced due diligence even though the second fund had the same management as the first fund.
- FINRA also highlighted that the broker-dealer delegated nearly all responsibilities relating to private placements to a single person, its vice president in charge of products and sales, who was responsible for conducting due diligence on private placements, determining which private placements to approve for sale by registered representatives, formulating recommendations for private placements and monitoring suitability, as well as the absence of written supervisory procedures other than a generic checklist.
Recent FINRA Enforcement Action (cont’d)

• Finally, FINRA emphasized the broker-dealer’s lack of adequate supervisory policies and procedures to review and monitor:
  • due diligence on approved private placements,
  • suitability of the securities for customers,
  • sales material provided to customers, and
  • internal use materials provided to registered representatives.
What Cases Say About Due Diligence

• Obtain information about offering from independent sources.
• Obtain audited financials (not essential).
• Visit company headquarters.
• Look at actual viability of existing business, such as oil and gas wells, and compare it to projections.
• Confirm material statements in PPM (e.g., “company has never delayed dividend payments”).
• If due diligence materials are made available, request them.
• If report of a third party due diligence provider is available, request it.
• Do not rely too heavily on issuer’s statements; verify with third parties, such as law firms and accounting firms.
What Cases Say Are Red Flags

• Information that the issuer is having liquidity issues, or problems paying dividends.
• High rate of return – suggests higher risk.
• Use of full line of credit.
• Movement of funds among different offerings.
• Requested audited financials not provided.
• Lack of revenues.
• No third party custodian verification regarding existence of assets.
• Change in accounting firms without explanation.
• Disciplinary history of individuals important to company.
• Financial problems with related company.
What Cases Say Are Deficient Procedures

- Failure to specify who is responsible for performing due diligence.
- Failure to specify what activities are required to satisfy due diligence requirements.
- Failure to specify how due diligence should be documented.
  - What documents should be obtained?
  - What financial information should be considered?
  - Should the issuer’s executives be consulted?
- Failure to identify who is responsible for approving due diligence and authorizing sales of securities.
- Failure to identify who is to perform ongoing supervision of offerings, once solicitations commenced.
- Failure to specify that information should be sought from sources other than the issuer.
- Reliance on a single individual to sign selling agreements.
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