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FINRA'S REGULATORY NOTICE 10-22 BROKER-DEALERS BEWARE

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Regulatory Notice 10-22, released by the Financial Industry Regulatory Authority (FINRA) on April 20, 2010 (the "Notice"), may ultimately have little impact on how most broker-dealers currently conduct their PIPEs and other private placements; however it may signal a trend toward imposing greater responsibilities on broker-dealers in such offerings.

Since PIPEs and other private placements are exempt from registration under the Securities Act of 1933, as amended (the "Act"), broker-dealers who market those deals are subject only to the antifraud provisions of the Act and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and, in particular, Rule 10b-5 thereunder. Rule 10b-5(b) renders it unlawful "[t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of any security."

The Notice reminds broker-dealers marketing PIPEs and other private placements of their responsibilities under the antifraud provisions of federal securities laws, as well as NASD Rule 2310 (regarding suitability). The guidance focuses on two areas in particular: (i) broker-dealers' regulatory responsibilities to engage in a reasonable investigation of a Regulation D offering and (ii) practices that broker-dealers should adopt, if they have not already, to help them discharge their reasonable investigation obligations.

The Notice takes the position that in order to discharge its obligations under FINRA rules, including the suitability rule, a broker-dealer has to engage in a reasonable investigation before recommending privately placed securities to customers. The Notice states that whether an investigation is deemed "reasonable" depends on the facts and circumstances of the offering. The Notice notes that "courts have found that 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." Importantly, in the context of a PIPE, the Notice indicates that the broker-dealer is entitled to rely on the issuer's Exchange Act filings absent "red flags."

The Notice indicates that broker-dealers should, at a minimum, conduct a reasonable investigation of the following matters:

- 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.

The Notice states that broker-dealers that prepare offering memoranda may have a greater duty to investigate than a broker-dealer that merely forwards offering materials to prospective investors. In addition, the Notice states that firms that engage in Regulation D offerings must have supervisory procedures that are reasonably designed to ensure that the firm's personnel engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements.

Many broker-dealers involved in PIPE offerings and other private placements

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already have procedures in place, such as investment committee approval processes, that are designed to assure that the broker-dealers have performed a reasonable investigation of an issuer's management and affairs before agreeing to market a deal. Because of the potential adverse reputational and legal issues that can arise as a result of being involved in an inappropriate offering, many of these firms already perform investigations that either meet or exceed the standards referenced in the Notice.

Nonetheless, the Notice should serve as a reminder to member firms that, at least in the eyes of FINRA, they have responsibilities to "know the issuer" as well as "know the customer." In particular, broker-dealers that don't have rigorous committee approval processes or that engage in "quick hit" overnight offerings, may have to review their business practices for vetting issuers.

Furthermore, the Notice should be read in light of recent unsuccessful attempts by the Securities and Exchange Commission (the "SEC") to impose liability on broker-dealers in this context. For example, in the recent case of SEC v. Tambone, No. 07-1384 (1st Cir. March 10, 2010) (en banc), the United States Court of Appeals for the First Circuit rejected the SEC's claim that a broker-dealer had liability under Rule 10b-5 because it provided customers with a prospectus that contained false and misleading statements. In doing so, the Court noted that Rule 10b-5(b) only prohibited the "making" of a false statement, rather than the "use" of a false statement and declined to broaden the plain meaning of the word "make" to encompass the provision of materials containing false statements prepared by the issuer. In part, the Notice may be seen as an attempt by FINRA to impose greater responsibility on broker-dealers in situations where the SEC has been unable to convince the courts to do so.

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