Form 51

Reasonable Investigations in Regulation D Offerings

As discussed in chapter 28, in April 2010 FINRA published Regulatory Notice 10-22, Regulation D Offerings—Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings. The following excerpt from the FINRA notice should serve as a basis for a broker-dealer’s diligence inquiries in connection with Regulation D offerings:

III. Reasonable Investigation Practices

A BD’s [broker-dealer] reasonable investigation must be tailored to each Regulation D offering in a manner that best ensures that it meets its regulatory responsibilities. Accordingly, a single checklist of possible practices for a BD engaged in a Regulation D offering will not suffice for every offering, and mechanical reliance upon a single checklist may result in an inadequate investigation. Nevertheless, we are providing a list of practices that some firms have adopted to help them adequately discharge their responsibilities. Many of the practices described below are designed to satisfy BDs’ regulatory requirements. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Securities Exchange Act. Industry participants that we surveyed described the following as practices that help ensure they meet their reasonable investigation obligations.

A. Issuer and Management

Reasonable investigations of the issuer and its management concerning the issuer’s history and management’s background and qualifications to conduct the business might include:

➢ Examining the issuer’s governing documents, including any charter, bylaws and partnership agreement, noting particularly the amount of its authorized stock and any restriction on its activities. If the issuer is a corporation, a BD might determine whether it has perpetual existence.

➢ Examining historical financial statements of the issuer and its affiliates, with particular focus, if available, on financial statements that have been audited by an independent certified public accountant and auditor letters to management.

➢ Looking for any trends indicated by the financial statements.

➢ Inquiring about the business of affiliates of the issuer and the extent to which any cash needs or other expectations for the affiliate might affect the business prospects of the issuer.

➢ Inquiring about internal audit controls of the issuer.

➢ Contacting customers and suppliers regarding their dealing with the issuer.

➢ Reviewing the issuer’s contracts, leases, mortgages, financing arrangements, contractual arrangements between the issuer and its management, employment agreements and stock option plans.

➢ Making reasonable inquiries concerning the issuer’s management. A BD might inquire about such issues as the expertise of management for the issuer’s business and the extent to which management has changed or is expected to change. For example, a BD might inquire about any regulatory or disciplinary history on the part of management and any loans or other transactions between the issuer or its affiliates and members of management that might be inappropriate or might otherwise affect the issuer’s business.

➢ Inquiring about the forms and amount of management compensation, who determines the compensation and the extent to which the forms of compensation could present serious conflicts of interest. A BD might make similar inquiries concerning the qualifications and integrity of any board of directors or similar body of the issuer.

➢ Inquiring about the length of time that the issuer has been in business and whether the focus of its business is expected to change.

B. Issuer’s Business Prospects

Reasonable investigations of the issuer’s business prospects, and the relationship of those prospects to the proposed price of the securities being offered, might include:

➢ Inquiring about the viability of any patent or other intellectual property rights held by the issuer.

➢ Inquiring about the industry in which the issuer conducts its business, the prospects for that industry, any existing or potential regulatory restrictions on that business and the competitive position of the issuer.

➢ Requesting any business plan, business model or other description of the business intentions of the issuer and its management and their expectations for the business, and analyzing management’s assumptions upon which any business forecast is based. A BD might test models with information from representative assets to validate projected returns, break-even points and similar information provided to investors.

➢ Requesting financial models used to generate projections or targeted returns.

➢ Maintaining in the BD’s files a summary of the analysis that was performed on financial models provided by the issuer that detail the results of any stress tests performed on the issuer’s assumptions and projections.

C. Issuer’s Assets

Reasonable investigations of the quality of the assets and facilities of the issuer might include:

➢ Visiting and inspecting a sample of the issuer’s assets and facilities to determine whether the value of assets reflected in the financial statements is reasonable and that management’s assertions concerning the condition of the issuer’s physical plants and the adequacy of its equipment are accurate.

➢ Carefully examining any geological, land use, engineering or other reports by third-party experts that may raise red flags.

➢ Obtaining, with respect to energy development and exploration programs, expert opinions from engineers, geologists and others as necessary as a basis for determining the suitability of the investment prior to recommending the security to investors.