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WHERE WE STAND

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EXPERT'S CORNER
About NCIs[1], Reg. D, and Suitability

Frederick Rosenberg

Regulation D[2] offerings are private placements exempt from the registration requirements and stringent auditing and reporting requirements of publicly offered securities under the Securities Act of 1933 (hereinafter referred to as the "'33 Act").[3] Regulation D (hereinafter referred to as "Reg. D") is a "safe harbor" provision of the '33 Act, meaning it is not a rule that can be violated and therefore, there are no penalty provisions for failure to comply. It was adopted in 1982 and constructed around the case histories of exemptions from registration.[4] Compliance with its provisions creates the legal presumption that the offering is not public; non-compliance with Reg. D however, still permits other routes to the exemption under Section 4(2) of the '33 Act. NCI Sponsors are the Issuers of the security. They are expected to document controls over the distribution of private placement memoranda as well as investor documentation such as subscription agreements and questionnaires.

Importantly, there is no prohibition against Non-Accredited Investors, "Purchasers,"[5] investing in Reg. D private placements, but the rules limit the number of "Purchasers" in any offering to 35[6] before it becomes a public offering, requiring complete disclosure and reporting. Most important to understand is that most Sponsors restrict their offerings solely to Accredited Investors, **not because of suitability issues**, *but because under Rule 502(b)2[7] of Reg. D, non-accredited investors are entitled to full disclosure*

1. "NCI" is an abbreviation for "Non-Conventional Investment." NCIs are typically private or public offerings of private equity investments including oil and gas, real estate, venture capital. These are further discussed in FINRA NOTICE TO MEMBERS 10-22 (2010), referencing NASD NOTICE TO MEMBERS 03-71 (2003) and 05-18 (2005) among others.

2. 17 C.F.R. § 230.501 (2013).

3. Securities Act of 1933, 15 U.S.C. § 77a (2014).

4. 17 C.F.R.§ 230.501 (2013).

5. 17 C.F.R. § 230.506 (2013).

6. 17 C.F.R. § 230.501(e) (2013).

7. 17 C.F.R. § 230.502(b)2 (2013).

comparable to small public offerings! Compliance with those heightened disclosure requirements is too costly, too risky, and far too restrictive to be practical for most Sponsors of private placements.

With appropriate disclosure even Non-Accredited Investors are permitted to invest if they are "Sophisticated" or have a "Purchaser Representative.".[8,9] The key is the required disclosure they are entitled to receive under Rule 502(b) 2. Reg. D requires that any information given to Non-Accredited Investors also be given to accredited investors, making compliance problematic.[10] In short, *Sponsors limit their private offerings to Accredited Investors specifically to avoid the disclosure and reporting requirements of Rule 502(b)2, and not for customer protection!* "Accredited Investor" status is definitely not a suitability condition.

Importantly, read and "plead" notes a, b, c, and d.[11] The four notes make clear that Reg. D applies only to the "transaction" and not to the "security."

8. 17 C.F.R. § 230.506 (2013).

9. 17 C.F.R. § 230.501(e) (2013).

10. See, 17 C.F.R. § 230.502(b)1 and (b)2 (2013).

11. 17 C.F.R. § 230.500 (a) Regulation D relates to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 (the Act) (15 U.S.C.77a *et seq.,* as amended). Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers are reminded of their obligation to provide such further material information, if any, as may be necessary to make the information required under Regulation D, in light of the circumstances under which it is furnished, not misleading.

(b) Nothing in Regulation D obviates the need to comply with any applicable state law relating to the offer and sale of securities. Regulation D is intended to be a basic element in a uniform system of federal-state limited offering exemptions consistent with the provisions of sections 18 and 19(c) of the Act (15 U.S.C. 77r and 77(s)(c)). In those states that have adopted Regulation D, or any version of Regulation D, special attention should be directed to the applicable state laws and regulations, including those relating to registration of persons who receive remuneration in connection with the offer and sale of securities, to disqualification of issuers and other persons associated with offerings based on state administrative orders or judgments, and to requirements for filings of notices of sales.

(c) Attempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of rule 506 (§ *230.506*) shall not raise any presumption that the exemption provided by section 4(2) of the Act *(15 U.S.C. 77d(2)*) is not available.

Arbitration claims are typically about the security and the basis for the recommendation under the customer protection provisions of the 1934 Securities Exchange Act (hereinafter referred to as "'34 Act"),[12] and not about the failure of the Sponsor to register the offering.

In arbitration claims involving NCIs, pleadings and hearings must avoid the problems of conflating the '33 Act and Reg. D's control over the "Transaction," with the '34 Act's broker- dealer liability in dealings with the public. A Sponsor is rarely a party to Arbitration and most Statements of Claim neither allege violations of the '33 Act's registration requirements nor claim the Broker wrote the Private Placement Memorandum ("PPM"). Instead, most causes of action focus on 1) a Broker-Dealers' negligent failure to conduct due diligence sufficient for reasonable basis suitability, and 2) recommendations unsuited to the customer's financial circumstances and needs – customer basis suitability.

Most large Sponsors rely on Section 506 of Reg. D for exemptions.[13] *Section 506 has no disclosure requirements for Accredited Investors*,[14] although Sponsors are not entitled through omissions to commit a fraud. Therefore, there demonstrably is an affirmative obligation to disclose relevant information that in its absence would be misleading.[15] That is a very limited restriction permitting much leeway. Whether via a public prospectus or a private placement memorandum, no amount of disclosure makes an unsuitable recommendation suitable. All recommendations must be appropriate for an investor's financial condition and needs, regardless of the contents of a PPM. A suitability determination is a condition of making an offer under FINRA conduct rules.

Furthermore, nothing that a client says, does, or signs carries any authority to alter or waive a broker's compliance or obligation to comply with FINRA rules. Neither does an investor's accepting a PPM inoculate the

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(d) Regulation D is available only to the issuer of the securities and not to any affiliate of that issuer or to any other person for resales of the issuer's securities. *Regulation D provides an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves.*

12. Securities and Exchange Act of 1934, 15 U.S.C. § 78a (2014).

13. 17 C.F.R. § 230.506 (2013). "(a) *Exemption.* Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act".

14. See, 17 C.F.R. § 230.502(b)1 and (b)2 (2013).

15. Use of Regulation D, 17 C.F.R. § 230.500(a) (2013).

Broker against any liability for making an unsuitable recommendation to that customer. Finally, if the broker is alleged to have violated his duties, you can often find those same duties memorialized in the Placement Agreement between the selling Broker-Dealer and the Sponsor, including representations and warranties, breach conditions, hold harmless, and remedies. Your client is a third party beneficiary to that agreement.

Disclosure is not Due Diligence! Remember, NCI cases mainly target due diligence failures, unsuitable recommendations, inducement frauds, and conflicts of interest – *not disclosure*. If the investment is unsuitable or without reasonable basis, the mere act of offering the PPM is the point where the violation occurs. Ultimately, customers are entitled to rely in good faith on a Broker-Dealer's compliance with the FINRA customer protection rules and this means recommendations based upon a competent Reasonable Basis analysis of the offering (know your investment), and a thorough evaluation of the customer's financial situation and needs prior to delivering a public prospectus or private placement memorandum.

Ironically, so-called prospectus defenses based upon PPM disclosures, executed subscription agreements, and investor questionnaires frequently amount to an admission of an unsuitable recommendation with foreseeable consequences, hence, "loss causation." The irony of such a defense is a broker making unsuitable recommendations defending on the grounds that the client executed the documents he induced him to sign, or that he failed to read a PPM delivered in violation of FINRA's Conduct Rules.