CLIENT ALERT

FINRA Provides Guidance on Private Placement Marketing and Sales Materials

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The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued Regulatory Notice 20-21 to provide guidance to its member firms regarding the marketing and sales materials they use in connection with private placement offerings.[1] As described below, the guidance focuses on five areas as they relate to retail communications and private placement offerings:[2]

[1] Regulatory Notice 20-21 (July 1, 2020). The Notice summarizes FINRA's views on the requirements for FINRA member firms under FINRA Rule 2210 for retail communications used in private placement offerings. FINRA notes that the term "private placements" refers to unregistered, non-public securities offerings that rely on either Section 3 or Section 4 of the Securities Act of 1933, most of which are sold pursuant to one of the "safe harbors" under Regulation D ("Reg D"). FINRA also observes that, as a result of the adoption of Rule 506(c) under Reg D, which allows for general solicitation of accredited investors, "firms have become increasingly involved in the distribution of private placement securities through online platforms and other widely disseminated communications such as digital advertisements."

[2] FINRA Rule 2210(a)(5) defines a "retail communication" as "any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period." Although FINRA notes that FINRA Rules 5122 and 5123 require FINRA member firms to file offering documents with FINRA for certain private placement offerings they participate in (generally, those offered to individual investors), the Notice applies to marketing and sales materials meeting the definition of "retail communication" that are used by FINRA members with any private placement offering. Due to the many exemptions in Rules 5122(c) and 5123(b), those rules apply for the most part to private placements sold to individual investors. *See* Willkie Client Memorandum, *SEC Approves FINRA Rule to Require Filings for Certain Private Placements Sold by Broker-Dealers*, here.

- Third-party prepared materials;
- Balanced presentation of risks and investment benefits;
- Forecasts of issuer operating metrics;
- Distribution rates; and
- Internal rate of return.

FINRA Rule 2210

FINRA member firms' communications with the public are primarily governed by FINRA Rule 2210 which includes filing requirements, supervisory obligations,[3] and content standards for those communications. In general, Rule 2210(d)(1) requires that a communication be fair, balanced, and not misleading and that it provide a "sound basis for evaluating the facts" regarding any products or services discussed in the communication. The rule also prohibits false, exaggerated, unwarranted, promissory, or misleading statements or claims in any communication and the publication, circulation, or distribution of any communication that a firm knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading. Although these general content standards apply to all communications, not only retail communications, the specific guidance provided in Regulatory Notice 20-21 focuses on retail communications used in connection with private placements.

Third-Party Prepared Materials

Citing Regulatory Notice 10-22, FINRA reiterates that "[a member firm] that assists in the preparation of a private placement memorandum or other offering document should expect that it will be considered a communication with the public by that [member firm] for purposes of … Rule 2210," and that the requirements of Rule 2210 apply to any communication distributed or made available by the FINRA member firm. Therefore, firms are responsible for communications they use or distribute, even if developed by a third party without the member firm's assistance, and not only those they have themselves prepared. Moreover, FINRA views it as irrelevant whether the communication is provided separately or as part of a package that includes other materials such as offering documents.[4]

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3 For example, Rule 2210(b)(1) with a few exceptions requires that an appropriately registered principal of the member firm approve each retail communication prior to its use or filing with the FINRA Advertising Regulation Department.

4 *See* Regulatory Notice 20-21, at 3. Additionally, Regulatory Notice 10-22 (Apr. 2010) states that "sales literature concerning a private placement that a [firm] distributes will generally be deemed to constitute a communication by that [firm] with the public, whether or not the [firm] assisted in its preparation."

Presentations of Risks and Investment Benefits Must Be Balanced

FINRA Rule 2210(d)(1) requires that communications appropriately balance any discussion of the benefits of an investment with its risks.[5] In the Notice, FINRA includes three specific examples related to the risks of investments in private placements that should be disclosed: (i) the potential for them to lose value, (ii) their lack of liquidity, and (iii) their speculative nature. Importantly, FINRA states that "[p]roviding risk disclosure in a separate document, such as a [private placement memorandum], or in a different section of a website does not substitute for disclosure contained in or integrated with retail communications governed by Rule 2210." Consequently, FINRA will look at the four corners of a communication to determine whether the communication has met the requirement that any discussion of potential investment benefits or the positive portrayal of an issuer be balanced with an appropriate discussion of the risks involved.[6]

Forecasts of Operating Metrics not Projections of Performance

With some exceptions,[7] FINRA Rule 2210(d)(1)(F) generally prohibits communications from predicting or projecting performance, implying that past performance will recur, or making any exaggerated or unwarranted claim, opinion, or forecast. FINRA makes clear in the Notice that, based on this provision, "retail communications concerning private placements may not project or predict returns to investors such as yields, income, dividends, capital appreciation percentages or any other future investment performance."

In the Notice, FINRA clarifies that this prohibition would not apply to reasonable forecasts of operating metrics (e.g., sales, revenue, number of customers). However, the presentation of this information must still comply with the content standards of Rule 2210(d), including that it be presented in a way to provide a "sound basis" for evaluating the facts. This may include, for example, "clear explanations of the key assumptions underlying the forecasted issuer operating metrics and the key risks that may impede the issuer's achievement of the forecasted metrics."

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5 Specifically, paragraph (d)(1)(B) of Rule 2210 requires communications to provide a "balanced treatment of risks and potential benefits."

6 The Notice provides specific examples of risks that may need to be disclosed when the issuer is a new company: "For example, when the issuer is a startup company, the risks may include a limited track record; more experienced or larger competitors; overreliance on financing; reliance on a single supplier, customer or employee; or lack of management experience." *See* Regulatory Notice 20-21, at 4. More generally, firms should also consider FINRA's recent guidance on disclosure innovations. *See* Regulatory Notice 19-31 (Sept. 19, 2019) ("FINRA rules require that communications be fair and balanced, but don't require them to be exhaustive lists of all possible risks and warnings associated with a product or service. Information about risks, costs or drawbacks is more effective when it is related to the benefits that the communication promotes.").

7 The three exceptions in FINRA Rule 2210(d)(1)(F) generally are: (i) hypothetical illustrations of mathematical principles; (ii) investment analysis tools and reports generated by such tools; and (iii) a price target contained in a research report. Each of these exceptions is subject to particular requirements.

FINRA provides four specific considerations for firms to evaluate for retail communications that include forecasts of issuer operating metrics. First, firms should assess the time period over which the forecast is made. In general, FINRA considers a time period of over five years to be unreasonable. Second, firms should consider “whether growth rate assumptions are commensurate with the nature and scale of the business.” Third, if gross margin is forecasted, the forecast should be appropriate in relation to industry averages.[8] Finally, firms should assess whether sales or customer forecasts are reasonable in light of the overall market for the issuer’s products or services. FINRA also warns against the use or distribution of retail communications that describe or characterize specific revenue or cash flow as “guaranteed or certain” or that use data from permitted operational forecasts to “project or depict specific investment returns.” Consequently, firms may not simply rely on forecasts of operational metrics when they are included in retail communications without determining their reasonableness.[9]

Distribution Rates

In 2013, FINRA issued Regulatory Notice 13-18 to provide guidance to firms regarding communications with the public involving both registered and unregistered real estate investment programs. In Regulatory Notice 20-21, FINRA explicitly extends that guidance to retail communications for private placements that are designed to provide investors with distributions. Noting that Rule 2210(d)(1)(B) prohibits false, exaggerated, unwarranted, promissory, or misleading claims, FINRA notes that retail communications cannot misrepresent the amount or composition of such distributions, imply that a distribution rate is a “yield” or “current yield,” or indicate that investment in the program is comparable to a fixed income investment. The Notice reiterates the list of distribution-related disclosures from Notice 13-18 that FINRA considers to be in accordance with Rule 2210, specifically:

- disclosure that distribution payments are not guaranteed and may be modified at the program’s discretion;
- if the distribution rate consists of return of principal (including offering proceeds) or borrowings, the communication should include a breakdown of the components of the distribution rate showing what portion of the quoted percentage represents cash flows from the program’s investments or operations, return of principal, and borrowings;

[8] The Notice provides that “[g]ross margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company.” Regulatory Notice 20-21, at n.14.

[9] More generally, FINRA has stressed that firms are under an obligation to conduct a reasonable investigation of the issuer and the securities they recommend as part of a Reg D offering, and FINRA has noted that firms “may not rely blindly upon the issuer for information concerning a company.” Regulatory Notice 10-22 (quoting *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969)).

- disclosure of the time period during which the distributions have been funded from return of principal (including offering proceeds), borrowings, or any sources other than cash flows from investment or operations;
- if the distributions include a return of principal, disclosure that by returning principal to investors, the program will have less money to invest, which may lower its overall return; and
- if the distributions include borrowed funds, disclosure that since borrowed funds were used to pay distributions, the distribution rate may not be sustainable.

The Notice also makes clear that FINRA's position in Notice 13-18 that it is "inconsistent with Rule 2210(d)(1) for retail communications to include an annualized distribution rate until the program has paid distributions that are, on an annualized basis, at a minimum equal to that rate for at least two consecutive full quarterly periods," also applies to retail communications concerning private placements that make distributions.

Internal Rate of Return

The final topic addressed in Notice 20-21 relates to internal rate of return ("IRR"), which is also known as "money-weighted returns." As FINRA explains, IRR "shows a return earned by investors over a particular period, calculated on the basis of cash flows to and from investors (i.e., the percentage rate earned on each dollar invested for each period the dollar was invested)."[10] Citing certain inherent drawbacks in calculating IRR (e.g., assuming investors will be able to reinvest any distributions from the investment at the IRR rate and needing to estimate the value of unsold assets), FINRA states that it views "[t]he use of IRR in retail communications concerning privately placed new investment programs that have no operations or that operate as a blind pool [to] be inconsistent with the prohibition on unwarranted forecasts or projections in Rule 2210(d)(1)(F)." Importantly, however, the use of IRR in retail communications would be permissible in two scenarios: (i) completed investment programs; and (ii) IRR for a specific investment in a portfolio if the IRR represents the actual performance of that holding.

Finally, the Notice provides that if the program has ongoing operations, it would be consistent with Rule 2210 for a retail communication to include IRR that is calculated consistently with the Global Investment Performance Standards (GIPS) adopted by the CFA Institute and that includes additional GIPS-required metrics such as paid-in capital, committed capital and distributions paid to investors.

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[10] *See* Regulatory Notice 20-21, at 6. FINRA notes that IRR is used typically in private placements involving real estate, private equity, and venture capital. FINRA contrasts IRR with time-weighted return (i.e., the compounded growth rate of $1 over a particular time period). *Id.* at n17. As explained by FINRA, "[t]ime-weighted returns ignore the size and timing of investment cash flows and therefore provide a measure of manager or strategy performance, while IRR measures how a specific portfolio performed in absolute terms." *Id.*

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