

## Communications With the Public

### FINRA Provides Guidance on Retail Communications Concerning Private Placement Offerings

#### Summary

This *Notice* provides guidance to help member firms comply with FINRA Rule 2210, Communications with the Public, when creating, reviewing, approving, distributing, or using retail communications concerning private placement offerings.

Questions concerning this *Notice* should be directed to:

- ▶ Amy C. Sochard, Vice President, Advertising Regulation, at (240) 386-4508; or
- ▶ Ira D. Gluck, Director, Advertising Regulation, at (240) 386-4614.

#### Background and Discussion

##### Private Placement Offerings

Private placements are unregistered, non-public securities offerings that rely on an available exemption from registration with the Securities and Exchange Commission (SEC) under either Sections 3 or 4 of the Securities Act of 1933 (Securities Act).<sup>1</sup> Most private offerings, however, are sold pursuant to one of three “safe harbors” under Rules 504, 506(b), and 506(c) of Securities Act Regulation D (Reg D).<sup>2</sup>

Reg D requires companies and funds to file a Form D through the SEC’s EDGAR system when selling unregistered securities based on a claimed Reg D exemption. The most recent Reg D data published by the SEC’s Division of Economic and Risk Analysis indicates that issuers make approximately 20,000 new offering Reg D filings with the SEC each year.<sup>3</sup> Of this total, approximately 4,000 new offerings identify an “intermediary,” such as a broker or finder, as participating in an offering.

Private placements sold by FINRA member firms to individuals generally must be filed with FINRA. In this regard, FINRA Rules 5122 and 5123 require a member firm to file offering documents regarding specified private placements in which the member firm participates.<sup>4</sup> FINRA receives

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#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Corporate Financing
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management

#### Key Topics

- ▶ Communications with the Public
- ▶ Private Placements
- ▶ Retail Communications

#### Referenced Rules

- ▶ FINRA Rule 2210
- ▶ Regulation D
- ▶ Regulatory Notice 10-22
- ▶ Regulatory Notice 13-18
- ▶ Regulatory Notice 19-31

approximately 2,000 new offering filings from its member firms each year,<sup>5</sup> and uses analytics and trained analysts to conduct a risk-based review of each filing. The number of annual filings with FINRA indicates that approximately half of the Reg D filings identifying intermediaries are for offerings by entities that are not subject to FINRA rules or offerings by member firms that are not required to file under Rules 5122 or 5123.

The offerings that are sold directly by issuers or through the efforts of intermediaries that are not FINRA member firms are not subject to the regulatory requirements applicable under FINRA rules and are not subject to FINRA's examination and review programs. Although FINRA does not have jurisdiction over Reg D private placements that are sold directly to investors or through non-member firm intermediaries, it is committed to promoting investor protection through meaningful regulation and oversight of member firms participating in these offerings.

The remainder of this *Notice* addresses the subset of private placements conducted by member firms.

### **Private Placement Retail Communications**

Many private placement offerings to retail investors include marketing or sales communications that meet the definition of retail communication in Rule 2210(a)(5).<sup>6</sup> For example, FINRA has observed that more than 40 percent of the offerings filed pursuant to FINRA Rule 5123 include retail communications. In addition, the adoption of Rule 506(c) under Reg D eliminated the prohibition against general solicitation and advertising for private placement offerings where all purchasers of the securities are verified accredited investors. Consequently, member firms have become increasingly involved in the distribution of private placement securities through online platforms and other widely disseminated communications such as digital advertisements.<sup>7</sup>

FINRA Rule 2210(d)(1) requires that all member firm communications be fair, balanced and not misleading. Communications that promote the potential rewards of an investment also must disclose the associated risks in a balanced manner.<sup>8</sup> In addition, communications must be accurate and provide a sound basis to evaluate the facts with respect to the products or services discussed. Rule 2210(d)(1) also prohibits false, misleading or promissory statements or claims, and prohibits the publication, circulation or distribution of a communication that a member firm knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading. With few exceptions, Rule 2210(b)(1) requires that an appropriately registered principal approve each retail communication before the earlier of its use or filing with FINRA's Advertising Regulation Department.<sup>9</sup>

Recent FINRA reviews of retail communications concerning private placements have revealed deficiencies. For instance, most if not all investments in private placements are illiquid, and many such investments are speculative in nature. Some retail communications do not balance claims of these investments' benefits by disclosing these risks. Others have contained false, misleading, or promissory statements or claims such as assertions about the likelihood of a future public offering of the issuer, claims about the future success of the issuer's new or untried business model, inaccurate or misleading assertions concerning the regulation or relative risk of the offering, or predictions or projections of investment performance prohibited by FINRA Rule 2210(d)(1)(F).

FINRA is providing the following guidance to assist member firms in their creation, review, approval, distribution or use of retail communications concerning private placement securities.

### Third-Party Prepared Materials

Rule 2210(a)(5) defines "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."<sup>10</sup> FINRA disciplinary actions demonstrate that member firms can be liable for violations of Rule 2210 when distributing or using noncompliant retail communications prepared by a third party.<sup>11</sup>

[Regulatory Notice 10-22](#) states 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, FINRA's advertising rule. If a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, then the [member firm] that assisted in its preparation may be deemed to have violated ... Rule 2210." *Notice 10-22* also provides that "sales literature concerning a private placement that a [member firm] distributes will generally be deemed to constitute a communication by that [member firm] with the public, whether or not the [member firm] assisted in its preparation."

In addition, FINRA has observed that some issuer-prepared private placement memoranda (PPMs) are bound or presented as one electronic file with retail communications, such as cover pages or exhibits. Such retail communications are distinguishable by their marketing or promotional content from the factual descriptions and financial information about the issuer generally disclosed in the PPMs. Regardless of whether a member firm distributes a retail communication that is attached to a PPM or as a standalone document, it constitutes a communication of the member firm subject to Rule 2210.

### Balanced Presentation of Risks and Investment Benefits

Rule 2210 requires communications that discuss the benefits of an investment also to include a discussion of its risks.<sup>12</sup> As indicated above, retail communications that discuss the potential benefits of investing in private placements should balance this discussion with disclosure of their risks, such as the potential for private placement investments to lose value, their lack of liquidity and their speculative nature. Providing risk disclosure in a separate document, such as a PPM, or in a different section of a website does not substitute for disclosure contained in or integrated with retail communications governed by Rule 2210.

Retail communications often highlight the business of the issuer and discuss the value proposition of a potential investment. In such cases, the key risks associated with an investment in the issuer are necessary in order to balance the positive portrayal of the investment. 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.

### Reasonable Forecasts of Issuer Operating Metrics

Rule 2210(d)(1)(F) generally prohibits the use of any prediction or projection of performance, as well as any exaggerated or unwarranted claim, opinion or forecast.<sup>13</sup> Accordingly, 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.

However, FINRA would not consider reasonable forecasts of *issuer operating metrics* (e.g., forecasted sales, revenues or customer acquisition numbers) that may convey important information regarding the issuer's plans and financial position to be inconsistent with the rule. Presentations of reasonable forecasts of issuer operating metrics should provide a sound basis for evaluating the facts as required by Rule 2210(d)(1)(A). For example, such presentations should include 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.

When creating, reviewing, approving, distributing or using forecasts of issuer operating metrics in retail communications, member firms should consider:

- I. the time period forecasted (generally a time period in excess of five years would be unreasonable);
- II. whether growth rate assumptions are commensurate with the nature and scale of the business;
- III. whether forecasted gross margins<sup>14</sup> are commensurate with industry averages; and
- IV. whether sales and customer acquisition forecasts are reasonable in relation to the overall market for the issuer's products or services.

While sources of contractual revenue such as royalty or master lease agreements may inform or provide a basis for reasonable forecasts of issuer operating metrics, it would be inconsistent with Rule 2210(d)(1)(B) to characterize specific revenue or cash flow as guaranteed or certain. Moreover, Rule 2210(d)(1)(F) precludes member firms from using the data from forecasts of issuer operating metrics to project or depict specific investment returns to an investor.

### Distribution Rates

[\*Regulatory Notice 13-18\*](#) provided guidance to member firms regarding communications with the public for registered and unregistered real estate investment programs. Given that some non-real estate private placement investments employ similar structures, the principles relating to distribution rates contained in that *Notice* are applicable to retail communications regarding private placement investments designed to provide distributions to investors and are reiterated below.

Some issuers fund a portion of their distributions through return of principal or loan proceeds. For example, a portion of a newer program's distributions might include a return of principal until its assets are generating significant cash flows from operations. Consistent with Rule 2210(d)(1)(B)'s prohibition of false, exaggerated, unwarranted, promissory or misleading claim, member firms must not misrepresent the amount or composition of such distributions. Nor may member firms state or imply that a distribution rate is a "yield" or "current yield" or that investment in the program is comparable to a fixed income investment such as a bond or note. Presentations of distribution rates consistent with Rule 2210 would disclose:

- ▶ 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, 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, what portion represents return of principal, and what portion represents borrowings;
- ▶ 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, 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, that since borrowed funds were used to pay distributions, the distribution rate may not be sustainable.<sup>15</sup>

FINRA believes 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.<sup>16</sup>

### Internal Rate of Return

Internal Rate of Return (IRR) is a measure of performance commonly used in connection with marketing private placements of real estate, private equity and venture capital. 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). IRR is calculated as the discount rate that makes the net present value of all cash flows from an investment equal to zero.<sup>17</sup>

A drawback of IRR calculations is their inherent assumption that investors will be able to reinvest any distributions from the investment at the IRR rate. In practice, it is unlikely that this would occur. Another drawback is that in order to calculate IRR for a portfolio that includes holdings that have not yet been sold (or otherwise liquidated or matured), a valuation of those remaining assets must be estimated. Depending on the nature of the asset, these estimated values may be based on subjective factors and assumptions.

The use of IRR in retail communications concerning privately placed new investment programs that have no operations or that operate as a blind pool would be inconsistent with the prohibition on unwarranted forecasts or projections in Rule 2210(d)(1)(F).

Nevertheless, FINRA interprets Rule 2210 to permit retail communications to include IRR for completed investment programs (*e.g.*, the holding matured or all holdings in the pool have been sold). In addition, FINRA does not view as inconsistent with the rule retail communications that provide an IRR for a specific investment in a portfolio if the IRR represents the actual performance of that holding.

Investment programs such as private equity funds and REITs may have a combination of realized investments and unrealized holdings in their portfolios. Where the program has ongoing operations, FINRA interprets Rule 2210 to permit the inclusion of IRR if it is calculated in a manner consistent with the Global Investment Performance Standards (GIPS) adopted by the CFA Institute and includes additional GIPS-required metrics such as paid-in capital, committed capital and distributions paid to investors.<sup>18</sup>

## Endnotes

1. See 15 U.S.C. 77c and 77d.
2. See 17 CFR 230.504, 230.506(b) and 230.506(c).
3. *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*: [https://www.sec.gov/dera/staff-papers/white-papers/dera\\_white\\_paper\\_regulation\\_d\\_082018](https://www.sec.gov/dera/staff-papers/white-papers/dera_white_paper_regulation_d_082018).
4. Rules 5122 and 5123 provide exemptions from the filing requirement when certain types of securities are sold or securities are sold to certain types of investors. For example, member firms are not required to file offerings made pursuant to Securities Act Rule 144A or Regulation S, or offerings sold solely to institutional accounts as defined in FINRA Rule 4512(c). See Rules 5122(c) and 5123(b). As a result of these exemptions, both rules apply predominately to retail private placements.
5. The total for “new offering filings” excludes duplicate filings for the same offering by different member firms.
6. “Retail communication” means any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period.
7. See FINRA’s [2019 Annual Risk Monitoring and Examinations Priorities Letter](#) (January 2019). The letter discusses factors FINRA may consider in reviewing online distribution platforms.
8. See [Regulatory Notice 19-31](#) (September 19, 2019), Question 3 (“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.”).
9. For example, pursuant to Rule 2210(b)(1)(C), if a member firm has already filed a retail communication with FINRA’s Advertising Regulation Department and received a letter indicating that such communication appears to be consistent with applicable standards, another member firm may use that communication without having a principal approve it, provided the communication is not materially altered or used in a manner that is inconsistent with the department’s letter.
10. Emphasis added. Rule 2210’s definitions of correspondence and institutional communications also refer to communications that are “distributed or made available” to particular investors. See FINRA Rules 2210(a)(2) and (a)(3).
11. See e.g., *Phillipe N. Keyes*, 89 S.E.C. 792, 800 (2006), *Sheen Financial Resources, Inc.*, Exchange Act Release No. 35477, 52 SEC 185, SEC LEXIS 613 (1995), *Fidelity Brokerage Services LLC*, Letter of Acceptance, Waiver and Consent No. 2008013056101 (2011) or *HSBC Securities (USA) Inc.*, Letter of Acceptance Waiver and Consent No 008013863801 (2010).
12. See FINRA Rule 2210(d)(1)(D).
13. Rule 2210(d)(1)(F) contains three exceptions from this prohibition, subject to specified conditions: (1) hypothetical illustrations of mathematical principles; (2) investment analysis tools and reports generated by such tools; and (3) a price target contained in a research report.
14. Gross 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. See *Jay Michael Fertman*, 51 SEC 943,950 (1994) and *Excel Fin., Inc.*, 53 SEC 303, 311-12 (1997).

15. See [Regulatory Notice 13-18](#) (May 2013).
16. *Id.* “In order to be fair and balanced, firm communications concerning a real estate program may not 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.”
17. IRR is also known as money-weighted returns. This can be contrasted to a time-weighted return, which is the compounded growth rate of \$1 over the time period. Average annual total returns used by mutual funds pursuant to SEC Rule 482 are an example of time-weighted returns. Time-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.
18. The CFA Institute is a global association of investment professionals. See *generally* [CFA Institute Global Investment Performance Standards](#).