

## **Alert** | Financial Regulatory & Compliance



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### **FINRA Releases Guidance on Retail Communications Concerning Private Placement Offerings**

On July 1, 2020, FINRA issued **guidance** on the application of FINRA Rule 2210, Communications with the Public, when creating, reviewing, approving, distributing, or using retail communications concerning certain private placement offerings. The guidance is intended to address the subset of private offerings that are sold directly by FINRA member firms to individuals and filed with FINRA pursuant to FINRA Rules 5122 and 5123.

#### **Private Placement Retail Communications**

The guidance notes that in recent reviews of retail communications concerning private placement offerings, FINRA identified certain deficiencies relating to such offerings including the failure of member firms to balance claims of potential investment benefits with the disclosure of risks. Other deficiencies identified by FINRA during its reviews included 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, therefore, reiterated FINRA's Rule 2210(d)(1) requirement "that all member firm communications be fair, balanced and not misleading." FINRA also added that FINRA Rule 2210(d)(1) 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.

### **Third-Party Prepared Materials**

The guidance also makes clear that member firms can be held liable for violations of FINRA Rule 2210 when distributing or using noncompliant retail communications prepared by a third party. FINRA noted in its guidance that it 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. However, regardless of whether a member firm distributes a retail communication that is attached to a PPM or as a standalone document, FINRA stated that the material would still constitute a communication of the member firm subject to Rule 2210. FINRA also highlighted [Regulatory Notice 10-22](#), which 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.” 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.”

### **Balanced Presentation of Risks and Investment Benefits**

With regard to the use of retail communications that aim to highlight the potential benefits of a private placement investment, FINRA notes that FINRA Rule 2210 requires retail communications that discuss the benefits of an investment to also include a discussion of its risks. Additionally, FINRA further notes that providing the risk disclosure in a separate document, such as a PPM, or in a different section of a website, does not substitute for a disclosure contained in or integrated with retail communications governed by Rule 2210.

### **Reasonable Forecasts of Issuer Operating Metrics**

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. According to FINRA, 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. However, FINRA noted that it 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. When creating, reviewing, approving, distributing, or using forecasts of issuer operating metrics in retail communications, FINRA expects member firms to consider:

- the time period forecasted (generally a time period in excess of five years may be unreasonable);
- whether growth rate assumptions are commensurate with the nature and scale of the business;
- whether forecasted gross margins are commensurate with industry averages; and
- whether sales and customer acquisition forecasts are reasonable in relation to the overall market for the issuer’s products or services.

## Distribution Rates

FINRA's [Regulatory Notice 13-18](#) previously provided guidance to member firms regarding communications with the public for registered and unregistered real estate investment programs. 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. In this regard, FINRA notes in its guidance that Rule 2210(d)(1)(B) prohibits member firms from misrepresenting 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 that would be 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.

## Internal Rate of Return

Finally, FINRA's guidance also addressed the use of the internal rate of return (IRR) measure in retail communications concerning privately placed investment programs. The IRR is a measure that 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)." FINRA cautioned in its guidance that the use of such measure 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). However, FINRA noted that Rule 2210 would permit retail communications to include IRR for completed investment programs (e.g., the holding matured or all holdings in the pool have been sold). Furthermore, FINRA added that it would not view as inconsistent with Rule 2210 retail communications that provide an IRR for a specific investment in a portfolio if the IRR represents the actual performance of that holding.

## Authors

This GT Alert was prepared by:

- [Steven M. Felsenstein](#) | +1 215.988.7837 | [felsensteins@gtlaw.com](mailto:felsensteins@gtlaw.com)
- [Robert Long](#) | +1 214.665.3659 | [longr@gtlaw.com](mailto:longr@gtlaw.com)
- [William B. Mack](#) | +1 212.801.2230 | [mackw@gtlaw.com](mailto:mackw@gtlaw.com)
- [Jennifer D. Newton](#) | +1 305.579.0584 | [newtonj@gtlaw.com](mailto:newtonj@gtlaw.com)

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