FINRA Regulation of Private Offerings

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Regardless of the trends with respect to the fines levied by The Financial Industry Regulatory Authority (FINRA), it still has considerable power and compliance with its rules is crucial is essential to the operation of its member brokerage firms and exchange markets.

FINRA (and its predecessor, the National Association Securities Dealers, the "NASD," for convenience jointly referred to here as FINRA) for many years avoided meaningful regulation of the substance of private offerings. Examiners would periodically look at private placement memoranda ("PPM's") but lacked the training or understanding both of the legal requirements and what is expected for substance in private offerings and appropriate due diligence. Further, the concept of highly sophisticated offerings with active due diligence and bargaining by the buyer was far beyond their ken. Accordingly, FINRA has been ill-equipped to comprehend both the general market for these securities and the numerous variations and shapes that private offerings take.

Most private offerings are sold directly by issuers rather than through registered broker-dealers. Many are sold illegally by unregistered broker-dealers (*See e.g., In the Matter of Alex Halimi, Dec. 17, 2013* - Sec. Ex Act Rel. 34-71097). Those sold through registered brokerage firms experience a wide range of shapes and forms. They range from small private offerings involving a couple of million dollars up to hundreds of millions raised by hedge funds, and include mergers and acquisitions involving equities in which there is often a single buyer who engages in both exhaustive due diligence and extensive bargaining over the terms.

During this time, there were FINRA cases involving broker-dealers who had sold junk disguised as private placements, but these cases reflected straight-forward fraud and not any level of understanding of the nuances of the world of legitimate private placements. The *Investment News* reported on July 13, 2012 that the two co-founders of Provident Royalties, LLC were indicted in connection with the $485 million investment fraud involving 7,700 investors. Virtually all of these were sold through brokerage firms. This however pales in comparison to Medical Capital Holdings that destroyed dozens of brokerage firms and wiped out almost $1 billion of investors funds. These cases are just the tip of a large iceberg, and every year new frauds arise. In setting new standards, FINRA is reacting to the reality of a major crisis.

Early efforts at attempting to develop standards for due diligence in private offerings met with an industry outcry and the first proposal (NTM 75-33) died on the vine. Except for the most obvious and extreme cases of fraud, allegations of failure of due diligence did not occur.

Over the past few years, there has been a substantial shift in approach by FINRA. The initial motivator was the sale of securities of broker-dealers themselves or of the holding companies for these firms. A small flood of FINRA proceedings against firms engaged in self-underwriting illustrated both the absence of adequate disclosure in the offerings and a paucity of due diligence to create the offering documents. Attorneys for such firms lacked knowledge of the laws, regulations, procedures and customs of the brokerage industry so too often glaring disclosure inadequacies characterized these offerings.

One area that FINRA did attack over the years was the suitability of these offerings for investors, looking at both the suitability of individual offerings, and the aggregate amount of private offerings sold into investors' portfolios. The level of risk inherent in the type of offering was also a significant factor in this evaluation, as was the ability of the investor to sustain risk. Early fraudulent and schlocky tax shelter private placements triggered investigation and proceedings from all regulatory sources.

Congress has been generous enough to provide FINRA with new challenges that will overlap into the private offering world, as the Jumpstart Our Business Act ("JOBS Act") dumps into FINRA's lap the responsibility for regulating portals which will be the mechanism for crowdfunding sales. FINRA has issued Regulatory Notice 13-34 proposed regulation of Portals. Comment Period expired February 3, 2014. Further, the expansion of Regulation D, Rule 506(c) to permit general advertising and solicitations may create a Pandora's box of problems, especially for brokerage firms selling to potential new customers who are reached by the new, innovative and probably aggressive forms of advertising.

SUITABILITY • FINRA issued two Regulatory Notices (11-02 and 11-25) in 2011 implementing new suitability and know your customer rules. Rule 2090 regarding "know your customer" is discussed below.

FINRA Rule 2111 requires that a firm and its representatives have a reasonable basis to believe that a recommended transaction or investment strategy involving securities is suitable for the customer, based on information obtained through reasonable diligence of the member or representative to ascertain the customer's investment profile.

A touchy matter for too many brokerage firms is the accuracy and currency of customers' data, which too often are not kept current, even with the mandate to update customer information every three years from FINRA. Firms will not want to face inspections where the data in the investor questionnaire does not square with the customer information at the firm. This will be especially true in the 506(c) offerings.

With the SEC expansion of Regulation D, Rule 506 to permit general advertising and solicitation of private offering investments from accredited investors, FINRA will undoubtedly be examining customer data to determine whether the firm's records confirm the accredited investor status of those solicited. It will be essential that the responses in investor questionnaires square with the information in customer files and risk preferences.

In reviewing private offerings FINRA will focus on the three fundamentals of suitability under its new rule—liquidity needs, risk tolerance, and time horizon. In the days of yore, it was not unusual for firms with questionable ethics to overload investor portfolios with illiquid private placements. With the growth of hedge funds, venture funds, and pools of many different kinds of assets, FINRA will be taking a closer look at the mix and exposure. Prolonged lock-up requirements will be subject to increased scrutiny, especially for older investors. Some states have adopted rules imposing more stringent sanctions on those who engage in abusive conduct relating to seniors.

Risk tolerance is defined as the ability and willingness to lose some or all of the original investment in exchange for greater returns. Many PPMs contain a caveat that potential investors should not invest in an offering unless they are willing to lose all or substantially all of their funds. While this is an excellent warning to insert, it is not a perfect defense if sales personnel are pitching the safety or certainty of the offering, or if disclosures fail to adequately disclose or warn of either risks or substantive problems.

The issue of time horizon is raised in the contexts. First in investor expectations and then again at the time of inspection when regulators determine whether the brokerage firm or issuer created unrealistic expectations of time frames for fruition of the project or creation of exit strategies. Having seen a few hundred projections full of pipe dreams about how quickly profitability and potential IPO or corporate sale will occur, one becomes skeptical of future promises and expectations from promoters, especially when the assumptions underlying forward looking information are unrealistic or even non-existent. This is an essential element of due diligence, and my general advice is don't put in forward-looking information unless vital to the offering, and then only put it in for short periods of time, never beyond three years. The basis for the assumptions must be clearly disclosed and be reasonable.

The new rule covers not only recommendations of specific securities but of strategies, which is broadly defined under the rule. Hold recommendations are included along with buy and sell advice. As secondary markets emerge for previously nonliquid investments in private offerings, this expansion becomes very relevant.

Firms must have a reasonable basis for approving a product for sale. The approval process will be based on its due diligence. In the past many firms have failed abysmally in the due diligence process and accepted products which have turned out to be Ponzi schemes (in several instances on a massive scale) or opportunities for promoters to skim the investments for personal benefit. Many of those brokerage firms have now gone out of business. Almost 200 brokerage firms have shut their doors over 2010 and 2011 alone. Most closures were related to regulatory action and to civil litigation, emanating from due diligence failures.

Finally, the reasonable basis requirement extends not only to firms but to registered representatives. It is not enough that a firm approves a product, as established in an AWC from FINRA *In the Matter of George Baselous, Respondent* (AWC 2008011743302, February 3, 2012). Rather information, even office conversation, in possession of the representative must be given fair weight. In that case FINRA alleged that Baselous failed to disclose that the issuer of the private offering had not generated any profits, had not repaid debts, had not broken ground on construction as promised, and sought now to raise capital to meet its everyday expenses. Other representatives had visited the site and reported on these problems.

Firms should be aware of FINRA's investor alert of September 17, 2013, on *Private Placements, Evaluate the Risks Before Placing Them in Your Portfolio*. The alert lists areas of due diligence that an investor should expect to find in a PPM and suggests a number of defensive steps that potential investors should take.

Institutional investors are given more latitude from a suitability perspective. Rule 2111(b) provides an exemption for recommendations made to qualifying institutional investors when the institution has at least $50 million in total assets, and it is affirmatively exercising independent judgment. I suggest that this is not enough. Not all institutions are equally competent, and there is merit in dividing institutions into those that are truly sophisticated and capable of complex evaluation of risks, strategies, the markets where transactions will occur, and the product, including hedging and derivate strategies as well as the level and use of margin. The next group should be those that while not possessing this level of expertise, will access qualified professionals to assist. This does NOT include the sales personnel trying to market to the institution, or even their affiliates. The third group is the unsophisticated institution, whether it be religious, education, municipal, or other non-profit which neither has the expertise or retains it, but rather blindly trusts the salesman. The aftermath of the financial crash includes many cases by institutions against wirehouses who created and distributed products designed to make money for themselves and their firms, but not for investors.

KNOW YOUR CUSTOMERS • FINRA Rule 2090 is the "Know Your Customer Rule," which FINRA adopted following its amalgamation with the enforcement operations of the New York Stock Exchange in July of 2007. NYSE did not have a suitability rule and instead relied upon a know-your-customer standard. The rule has four objectives:

- Effectively servicing customer accounts;
- Acting in accordance with instructions from the customer;
- Understanding the authority of those acting for a customer; and
- Complying with applicable rules and regulations.

The rule requires that firms engage in reasonable due diligence to know and record unspecified "essential facts" concerning every customer. The term customer is defined in Rule 0160(b)(3) to include any person, other than a broker-dealer, with whom the firm engages in securities business. FINRA Regulatory Notice 12-25 *Suitability Rule Guidance Q&A* defines customer in answer #6 to include any individual or entity with which a FINRA member has even an informal business relationship. In a FAQ (undated but released on December 12, 2012), the term "customer" is further explained, as a person who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives, or will receive, directly or indirectly compensation, even through the security is held at an issuer, the issuer's affiliate or a custodial agent (e.g. private placement) or using a similar arrangement. Obviously payment to a representative is deemed to be payment to the firm, and in fact it is a violation of FINRA rules to directly pay a representative. All compensation must pass through the firm!

Essential guidance in interpreting this rule is found in Regulatory Notice 11-02, *Know Your Customer and Suitability* which provides a detailed history of the rule going back to the time of the NYSE Rule 405(1). In July of 2012, Regulatory Notice 11-25 was published, which expanded on and provided additional guidance relating to suitability and know your customer. It contained a series of questions and answers to guide compliance.

In the world of private placements, regulators and litigators look to whether the firm and its representative have engaged in reasonable due diligence and whether from that due diligence the offering warranted a recommendation to appropriate customers, and requires consideration, of among other things which are not specified: age, other investments, financial situation and needs, tax status, risk tolerance, and other customer disclosed information. The suitability requirements discussed above are part of this analysis.

DUE DILIGENCE • Regulatory Notice 10-22 highlights potential red flags and supervisory requirements. It also suggests good practices for adequate due diligence. FINRA examinations are now looking at due diligence efforts in private placement offerings during inspections, and recent proceedings have cited brokerage firms for the lack of due diligence, primarily in instances where the firm has participated in a patently fraudulent offering.

FINRA expects firms and their counsel involved in private placements to be alert to "red flags" and then act to follow up on any information which could result in material disclosures in offering documents, need for corrective action, or even a decision not to have further involvement with the offering.

Due diligence cannot be competently performed at one's desk in a brokerage firm. On-site visits are essential to detect problems and almost invariably will produce questions and information which can't be gleaned just from looking at documents. Further, cursory visits are often meaningless. Detailed on-site interviews, inspections and verifications are the key to competent due diligence.

In 2010 FINRA brought three enforcement actions involving private placement offering violations. They include a complaint charging McGinn, Smith & Co. of Albany and its president with securities fraud in the sales of tens of millions of dollars in unregistered securities; the expulsion of Dallas-based Provident Asset Management for marketing a series of fraudulent private placements offered by an affiliate in a massive Ponzi scheme; and, fines totaling $750,000 against Pacific Cornerstone Capital, Inc. of Irvine, CA, and its former CEO for failing to include complete information in private placement offering documents and marketing material, as well as for advertising violations and supervisory failures.

In 2013, FINRA fined M.D. Sass Securities, L.L.C., $100,000 because the firms marketing materials for private placements were misleading and failed to accurately capture stated objectives in the applicable PPM. FINRA found that the materials contained unwarranted performance projections and failed to provide material disclosure regarding the risks of investing in the funds. Moreover, FINRA found that the risk disclosures contained in the communications were not clear and transparent. *In the Matter of M.D. Sass Securities, L.L.C.,Respondent*, (AWC 2009018187701, March 21, 2013).

On July 7, 2013, FINRA reaffirmed member firms' obligations to maintain adequate procedures for conducting due diligence on private placements, including the review of sales materials, and systems for monitoring suitability. Sunset Financial Services, Inc. ("Sunset") sold private placements of investment funds as an unaffiliated broker-dealer under Regulation D of the Securities Act ("Reg D"). The firm assigned responsibility for conducting due diligence on private placements, and for approving private placements for sale, to a vice president who was also responsible for reviewing third-party due diligence reports, formulating recommendations for private placements and monitoring the suitability of purchases of such private placements.

The vice president failed in his duties when he approved the private placement of an investment fund that was operated by the son of one of Sunset's registered representatives. For several years the firm continually ignored red flags regarding the fund's holdings and never reconsidered whether the fund should be on the firm's approved list. FINRA also found that the vice-president had never reviewed third-party reports regarding the fund. Accordingly, FINRA found that the firm had inadequate procedures for due diligence on private placements and that checks and balances on the vice president's activities were also inadequate since he was simultaneously recommending private placements and reviewing the suitability of those recommendations. The firm was fined $200,000. *In the Matter of Sunset Financial Services, Inc., Respondent*, (AWC 2011026915701, July 17, 2013).

Also, Joseph Hodby Ireland was found responsible for having made misleading and inaccurate representations pertaining to the private placement of oil-and-gas securities pursuant to Regulation D. Mr. Ireland was held personally responsible for the misstatements because he was the control person of his member firm and its affiliated entities. FINRA found that the materials overstated the number of wells being drilled and incorrectly stated that financial statements would be available at the partnership's yearly meeting. *In the Matter of Joseph Hobdy Ireland, Respondent*, (AWC 2011030790301, March 19, 2013).

In *NEPPEX,* FINRA held that a firm was responsible for conducting due diligence in private placement offerings when the firm was not just acting as an introducer. FINRA found that the firm had directly contacted selected customers regarding transactions and was, therefore, required to conduct due diligence. *In the matter of NYPPEX, LLC, Respondent* (AWC 2011025563801, March 18, 2013). In 2013, FINRA reminded broker-dealer firms that its examiners will focus on "due diligence policies and procedures, valuation processes, placing special emphasis on the integrity and independence of third-party valuation services, and the timely disclosure of material risks" in an effort to improve the sale and marketing of private placement securities. This comes as a result of the "relative scarcity of independent financial information and uncertainty surrounding the market and credit-risk exposure" with these private placements. FINRA advised firms to focus due diligence on: (i) the issuer's creditworthiness; (ii) the validity and integrity of their business model; and (iii) the plausibility of expected rates of return as compared to industry benchmarks. FINRA, *2013 Examination Priorities* (Jan 11, 2013).

Again in 2014, FINRA specifically reminded the broker-dealer firm of its "responsibility to conduct adequate due diligence on its offerings to ensure any recommendations to purchase securities in a private placement are suitable." The notice stated that this responsibility was in no way diminished by *Regulatory Notice 10-22*. FINRA, *2014 Examination Priorities* (Jan 2, 2014).

DEALING WITH NON-MEMBERS • Several pitfalls exist for firms in dealing with non-members. Statistically the worst of the issuers, often created by con men, who persuade representatives of the firm that a product is not a security and that they need not report sales activity in the product to their firm. The Supreme Court's ETS Payphone decision is an excellent illustration of this risk on a massive scale. It is amazing how stupid and greedy some representatives can be, and how a con man can convince them that they can make massive commissions but not have to tell anyone or comply with the law.

Another problem is the use of boiler room tactics to sell private offerings through massive advertising. This is particularly a problem in the oil and gas business, as illustrated by many proceedings against single-product captive firms.

A controversial area has been the use of "finders" to help sell securities. Firms encounter problems here in multiple ways. In some instances, the issuer has sold securities through finders before the offering is provided to a brokerage firm. At that time there is a substantial likelihood of integration of the prior and present offering which may lead to regulatory and civil proceedings against the firm and its representatives, as well as to a requirement for a rescission offer by an issuer who has already spent the money. Since the brokerage firm is the only target left standing with funds, the firm becomes at serious risk even under those circumstances.

The other "finder" problem occurs when individuals or entities want to get paid for referring potential purchasers to the brokerage firm. The SEC believes that such individuals or entities are in reality unregistered broker-dealers and that such payments cannot be made. FINRA permits payments to other brokerage firms under those circumstances, if disclosed, but not to unregistered persons.

For guidance, look to NASD Rule 2420, *Dealing with Non-Members,* the related IM-2420-1 *Transactions Between Members and Non-Members,* and NASD Rule 1060, *Persons Exempt from Registration.* For foreign transactions, one looks to NASD NTMs 95-37, 01-81, and FINRA Regulatory Notice 09-69 (*Payments to Unregistered Persons).*

PRIVATE PLACEMENTS • Private placement can present some serious problems, so FINRA has rules governing self-offerings, required filings and potential consequences, exemptions from filing, and subordinated lending.

Self-offerings

This has been a hot topic for FINRA as the result of serious deficiencies found in a number of self-offerings done as private placements. In a nutshell, the principal problem is that firms don't want to disclose to customers and competitors much of their essential information. On the other hand, they wish (or even desperately need) to raise capital either in the form of equity or subordinated debt.

FINRA Rule 5122 governs private placements of securities issued by members and was adopted concurrently with Rule 5123.

In an investor alert on June 14, 2004 FINRA issued a warning entitled "Brokerage Firm Private Securities Offerings: Buying Your Brokerage" where it cautioned about past cases of fraud in the use of proceeds by firms, high pressure sales techniques aimed at senior citizens, and the general risks of the brokerage business. The lack of future liquidity, potential conflicts of interest, and regulatory requirements relating to capital rules are also stressed. A few basic questions are suggested to potential investors, but these are incredibly limited and unsophisticated. Further guidance is provided in RN09-27.

In inspections, FINRA focuses first on protecting customers, including suitability, supervision and advertising, as well as antifraud concerns. A major issue for FINRA is whether the firm has participated in an offering of unregistered and non-exempt securities.

Required Filing and Potential Consequences

Regulatory Notice 12-40 states that new FINRA Rule 5123 requires each member firm that sells an issuer's securities in a private placement, subject to certain exemptions, to file with FINRA a copy of any private placement memorandum, term sheet or other offering document the firm used. It must be filed within fifteen calendar days of the date of the first sale, or the firm must indicate that it did not use any offering document. The rule became effective on December 3, 2012 and applies to private offerings that commenced on or after that date.

FINRA wants to feel comfortable that firms know what they are selling and have determined that legal risks and reputation risks have been adequately considered.

This rule is frightening! While in its notice of adoption, FINRA disclaims this potential result, logic and experience suggests that this is not so. When the filing is made, FINRA examines it, and does so not just for statistical purposes as the SEC has done for many years with Form D. Some PPMs are examined. When that occurs, despite disclaimers from FINRA, the matter will be referred for an inspection (possibly for cause) or the ensuing comments from FINRA will cause the halt of the offering to allow amendments or reframing of the offering. Alternatively, the firm and the issuer will now have a ticking bomb suggesting that the offering documents were deficient, misleading or fraudulent. FINRA is also focused on ensuring that documents provided to investors are written in plain English, whatever that means. The SEC has failed at that objective for many years. Criticism for lack of clarity could also raise antifraud issues. FINRA will not, and indeed cannot, receive these private placement documents and then ignore problems which are revealed. FINRA disclaims this concern by stating that a requirement to make a notice filing after the offering has commenced and sales have occurred would not impose an unnecessary burden on members or capital formation and would be appropriate in light of the intended regulatory benefits for investors that would flow from enhanced oversight of, among other things, member's compliance with their suitability obligations. When a problem is identified presumably FINRA will not just sit on its duff and not react. Madoff and Sanford certainly sent a clear message that when problems are identified, action is essential. Therefore either a direct contact identifying the problems should occur, or a deficiency letter, discoverable in litigation, will be issued in conjunction with an inspection. Finally, if the matter is serious enough there will be an investigation and potential proceeding.

By way of justification for the rule, Footnotes 18-24 in the January 19, 2012 letter to the SEC with FINRA's response to public comments contain a helpful compendium of recent cases involving private offerings.

FINRA is expanding its financial reporting requirements in the FOCUS report to require additional information from firms that derive more than ten percent of their total revenues during a reporting period from participation in unregistered offering. An Operational Page will be required for each such unregistered offering. (RN 12-11).

In June of 2013 FINRA expanded its required filing form for private placements. The original form was authorized in Rule 5123, and adopted with Regulatory Notice 12-40. The amended form adds six new areas of questions:

1. Is the offering a contingency offering?

2. Are independently audited financial statements available for the issuer's most recently complete fiscal year?

3. Whether the issuer is able to use offering proceeds to make or repay loans to, or purchase assets from, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor or any of the issuer's affiliates?

4. Does the issuer have a board of directors comprised of a majority of independent directors or a general partner that is unaffiliated with the brokerage firm?

5. Have the issuers have engaged, or does the member anticipate that the issuer will engage in

general solicitation in connection with the offering or sale of securities?

6. Has the issuer, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor, or any of the issuer's affiliates been the subject of SEC, FINRA or state disciplinary actions or proceedings or criminal complaints in the last ten years?

These questions are asked in the context that FINRA intends to do something with the answers, and the actions taken by FINRA may directly affect an offering in process. Further, the disciplinary history questions go far beyond the "bad person" disqualified person tests established by the SEC. At the very least, FINRA will expect member firms to ensure disclosure of these disciplinary matters in the PPM.

Exemptions from Filing

FINRA carved out exemptions from the filing requirement. Private placements to institutional accounts (as defined in Rule 4512(c) are exempt [see Rule 5123(B)(1)(A)]). However, sales made to any natural person, including officers, directors, general partners, managers of LLCs, etc. who are accredited investors triggers the filing requirement. Accredited investors who are listed in Regulation D, Rule 501(a)(1), (2), (3) or (7) do not trigger a filing, because of their actual or quasi-institutional status. Brokerage firms acting only in a finder capacity may be required to file as well. However, FINRA will not require crowdfunding transactions to be reported.

Offerings made pursuant to Rule 144A or Regulation A do not trigger a filing. Short term notes meeting the requirements of 3(a)(3) of the 1933 Act are exempt. Subordinated debt loan offerings do not require a filing here, since they are otherwise subject to inquiry by FINRA.

There is a list of 14 exemptions from filing listed in the rule which should be consulted prior to filing. Unfortunately, few offerings will fit these exemptions.

Subordinated Lending

When in need of capital for a sustained period, firms often turn to private offerings of subordinated debt. For investors this can present traps for the unwary. FINRA has issued a release on *Subordination Agreements—Understand the Risks* which spells out the difficulties that can arise when funds are loaned through these agreements. The principal concern is that even if the loan document has a firm date for payout, no funds can be paid without compliance with complex terms and conditions which are mandatory in subordinated loan agreements, including FINRA approval in some instances. Further, the financial condition of the firm at the time the debt is due can also preclude payout.

Since subordinated debt raises are private offerings done under 1934 Act Rule 15c3-1 and FINRA NTM 02-32, they must comply with disclosure requirements and with the antifraud provisions of federal and state securities laws. Even wealthy lenders must receive essential information, and during inspections or in some instances even prior to approval of the loan, FINRA may ask for that documentation.

RN 10-15 sets for further detail on FINRA requirements for subordination and sets out the availability of new standard forms for subordination agreements.

FINRA's skepticism of these transactions heightens when the lender is also a customer, particularly one without experience in the brokerage business and with business in general. Such investors may be rejected by FINRA.

ESCROWS • SEC 1934 Act Rule 15c-4 mandates the use and establishment of escrow accounts in conjunction with certain private offerings. FINRA regularly examines compliance with SEC requirements, as well as its requirements that all proceeds received from a private placement be transmitted directly and promptly to the escrow agent. Among common proceedings are those relating to failure to promptly transmit, breaking escrow prior to the time that "good funds" have been established through clearing, making undisclosed last minute investments by the firm in order to meet the minimum (and earn commissions), continuing the offering past the time the escrow is required to terminate and funds be returned, and making undisclosed loans to others to reach the minimum offering target.

CONFIRMATIONS • Private placements are subject to FINRA confirmation requirements, just as if a traditional stock or debt security purchase had occurred. SEC Rule 10b-10, FINRA Rule 2232 and RN 10-62 set forth the requirements.

BROKER-CHECK • FINRA maintains a data base of the regulatory history of all registered representatives (as reported for the firm of the U-4 for the representative, and the U-5 upon termination). That is available to the public, which FINRA encourages to use it. It is also a helpful device for spotting unregistered broker-dealers and agents or those with regulatory or litigation histories. Go to http://www.finra.org/Investors?ToolsCalculators/BrokerCheck/index.htm.

CROWDFUNDING • To the undoubted delight of FINRA, Congress dumped part of the regulatory responsibilities for regulation and oversight of the portal portion of crowdfunding onto FINRA. While hardly a perfect match under existing regulatory structures, the responsibility is there and must be dealt with. The SEC's Division of Trading and Markets and FINRA cooperated in shaping the proposal for a regulatory structure. Presently we don't know what a portal will look like. What can it do? What can't it do? Can it screen companies and engage in limited due diligence? What role does it play in quality of disclosure? Will anyone be free to use any portal or will the portal be able to control who may participate at its site? Can the portal attempt to control quality? If so, to what degree can this be accomplished? What are the regulatory, civil, and even criminal liability risks to this activity? No one knows yet. We await the comments and review of those comments on the SEC and FINRA rule proposals to begin real analysis. Congress however limited FINRA's control over crowdfunding to "rules written specifically for funding portals" precluding general application of FINRA rules, which doesn't make a lot of sense for crowdfunding sold through existing brokerage firms. FINRA's proposed Rule 13-34 cutoff date for comments was February 3, 2014. Substantial comments were received by both the SEC and FINRA on their proposals.

In Notice to Members 12-34 in July 2012 FINRA requested comments on the crowdfunding mandate, but no public guidance has been offered yet as the result of any comments received. The SEC and NASAA have warned against any crowdfunding activity before the SEC and FINRA rules are final.

On January 10, 2013, FINRA issued a voluntary Interim Form for Funding Portals that seeks information about the intended business models, ownership, funding and management. This initial filing is to be kept confidential.

Existing brokerage firms may also engage in crowdfunding activities and probably will be able to do so under existing structures with only very limited restriction beyond SEC crowdfunding rule compliance.

An overriding concern of regulators in this process is the fear of large scale fraudulent activity in the world of crowdfunding. Rules will undoubtedly target that potential, and consequently will be more burdensome that crowdfunding entrepreneurs would prefer.

"**GARBAGE COLLECTION" •** FINRA periodically issues warnings to the public about abuses in securities offerings. Recent warnings have related to:

- Oil and gas frauds, including those relating to alleged clean-up activities after oil spills;
- Gold mine stocks;
- China stocks;
- Neutraceutical stocks;
- Marijuana stock scams;
- Pump-and-dump email scams; and
- High Yield Investment Programs

These warnings are posted on the FINRA site, and when combined with the alerts that go from the SEC and NASAA on popular frauds get some press coverage and help to prevent or detect scams.