

REGULATION BEST INTEREST AND PLACEMENT AGENTS

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U.S. Investment Management Alert

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Placement agents in private securities offerings may have new obligations under SEC Regulation Best Interest ("Reg BI") when dealing with natural persons. Although placement agents are retained by issuers, and generally limit their marketing activities to institutions and high-net-worth individuals, they are required to meet certain standards of care when making recommendations to customers. Reg BI may raise the standard of care for placement agents engaged in the sale of securities to individual investors, including trusts and certain family offices who are currently treated as "institutional customers."

The adoption of Reg BI [1] represents a significant change to the regulation of broker-dealer standards of conduct. [2] Reg BI is intended to be broadly applicable: It will apply to any securities broker-dealer, and to any individual associated with a broker-dealer, who recommends a securities transaction to a "retail customer." This deceptively simple wording captures a broad array of broker-dealers and imposes a standard of conduct beyond that currently in place related to the suitability of investments.

Our prior client alerts describing the new regulation (available on the [K&L Gates Financial Professional Standards Hub Page](#)) summarize general aspects of Reg BI and related reforms. This client alert focuses on the implications of Reg BI for broker-dealers serving as placement agents in private placement transactions. For the reasons discussed below, depending on the placement agent's business, the types of investors placement agents contact could trigger Reg BI obligations.

The new rule goes into effect in June 2020. K&L Gates will continue to provide commentary as market practices and regulatory guidance develop.

ACTIVITIES OF PLACEMENT AGENTS

Issuers, such as small operating companies or private investment funds (e.g., hedge funds, private equity funds, and venture capital funds), frequently retain third-party placement or marketing agents to market and sell their securities in privately offered transactions. Placement agents generally provide a number of services to issuers, including locating potential investors, arranging for and attending meetings between prospective investors and issuers and/or fund sponsors, assisting issuers and/or fund sponsors in the preparation of due diligence packages as may be requested by prospective investors, delivering offering materials to prospective investors, and working with issuers to document the private placements to prospective investors. These services are provided in exchange for fees pursuant to a written placement agreement between the broker-dealer and the issuer.

SUITABILITY OBLIGATIONS OF PLACEMENT AGENTS

Although the contractual privity in specific private placement transactions generally runs solely between the issuer and placement agent for each offering, issuers typically engage placement agents because the placement agents will have business relationships and contacts to whom the placement agent may recommend the purchase of the securities being offered, even if there are no express customer or "brokerage" accounts maintained at the placement agent or written customer agreements with these investors.

When a placement agent recommends the purchase of a specific security, it must consider suitability requirements under the antifraud provisions of state and federal securities laws and the rules of the Financial Industry Regulatory Authority, Inc. ("FINRA"). Broadly speaking, suitability applies to "customers" of a broker-dealer, without specific requirements that a contractual or account relationship exist. FINRA Rule 2111 requires a broker-dealer (or an associated person) to have a reasonable basis to believe that a recommended transaction or strategy is suitable for the customer (this has been described as a "know your customer/know your product" standard). [3] FINRA Rule 0160(4) unhelpfully defines the term "customer" as not including a broker-dealer. However, case law regarding jurisdiction in FINRA arbitration has defined a broker-dealer "customer" as including any person (other than another broker-dealer) who has an account with the broker-dealer or purchases a good or service from the broker-dealer. [4] FINRA has clarified that suitability applies to a placement agent just as it does to any other type of broker-dealer. [5]

A placement agent's suitability obligations are somewhat reduced in dealings with certain investors. Specifically, a placement agent who makes recommendations to "institutional accounts," including the accounts of certain high-net-worth individuals, may satisfy its suitability obligations if it has a reasonable basis to believe that the customer is capable of evaluating investment risks independently, and the customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendation. [6] Further, suitability may not apply if the placement agent is dealing with another intermediary or a "purchaser representative," such as an investment adviser, that, in turn, determines whether the recommendation is suitable for the investor. However, suitability obligations may extend to the placement agent if it is dealing directly with its contacts when it recommends the purchase of a privately offered security.

NEW STANDARD OF REG BI

Reg BI establishes a new standard of conduct that requires broker-dealers and their associated persons to act in the "best interests" of retail customers when recommending securities and investment strategies. It includes a broad definition of the term "retail customer" that extends to natural persons who may have previously been treated as institutional for suitability purposes under FINRA rules. A "retail customer" for Reg BI purposes is:

- a natural person, or the legal representative of such natural person, who:
 - Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and
 - Uses the recommendation primarily for personal, family, or household purposes.

When it adopted Reg BI, the SEC stated its interpretation that a customer "uses" a recommendation when, as a result of the recommendation:

- The customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation;
- The customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation, or
- The broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm. [7]

Notably, Reg BI does not exempt from the definition of "retail customer" high-net-worth natural persons who would be eligible to participate in a private offering. Reg BI also extends to trusts and family offices directed by a nonregulated person and who are currently treated as "institutional customers" for purposes of FINRA's suitability rule.

Thus, retail customer status, and all of the associated requirements of Reg BI, will depend on whether the person receives a "recommendation." Whether a broker-dealer has made a "recommendation" depends on the facts and circumstances, such as whether the communication may be viewed as a "call to action" or reasonably would influence an investor to engage in a particular transaction or strategy. [8]

The fact that the placement agent is engaged by the issuer (and not the customer) is not determinative of whether an investor is a customer for purposes of Reg BI. Rather, the application of Reg BI depends on the *activities* of the broker-dealer. Soliciting natural persons and discussing the terms of an investment appears to fall within the definition of a "recommendation" to retail customers under Reg BI and would trigger Reg BI obligations for placement agents who perform such activities. In contrast, there are other types of broker-dealers who are engaged by an issuer and who would not ordinarily have Reg BI obligations due to the limited nature of their businesses and interaction with those investors. For example, the principal underwriter of a mutual fund generally deals with other broker-dealers or financial institutions and does not interact with retail customers. [9] Other broker-dealers may limit their interactions with retail customers by only providing information regarding offerings to institutions. However, a placement agent engaging with retail customers may find that its traditional functions and activities will implicate the new "best interest" standards of Reg BI.

IMPLICATIONS FOR PRIVATE OFFERINGS

The new investor protection standard established in Reg BI will have multiple implications for the private placement offerings, including:

- Placement agents should carefully consider the nature of their relationships in light of the new definition of "retail customer" and specifically relationships with high-net-worth natural persons, trusts, and family offices.
- Firms that conduct private placements should consider establishing new or revised compliance programs addressing investors who are "retail customers" under Reg BI. These new or revised compliance programs should address, among other things, management of conflicts of interest, disclosures (including Form CRS), and training of personnel.

- Legal and compliance officers should be alert to any future statements by the SEC. The SEC is actively seeking questions from the industry regarding implementation of Reg BI and related regulatory changes, and it has indicated that it will seek to issue guidance where necessary or appropriate. The role of the placement agent under Reg BI is ripe for such interpretive guidance, and broker-dealers may wish to engage with the SEC in order to provide perspectives based on their experience.
- Broker-dealers and associated persons should be mindful of the compliance deadline for Reg BI: June 30, 2020. As of the date of this Alert, there remain only eight months to implement significant disclosure, compliance systems, and training programs.

The implications of Reg BI are far-reaching. Broker-dealers serving as placement agents for private securities offerings who may recommend the purchase of securities in such offerings by natural persons should consider whether they are making recommendations to retail customers that would trigger Reg BI obligations. Reviewing operations and customer bases for this purpose will promote effective planning and risk management. In a separate Alert, entitled "Triggering Regulation Best Interest: What Are 'Retail Customers' and 'Recommendations?'" found [here](#), we discuss in more detail the meaning of key trigger points for applying Reg BI.

For more analysis of Reg BI and related developments, please visit the [K&L Gates Financial Professional Standards Hub Page](#).

NOTES

[1] 17 C.F.R. § 240.15l-1(b)(1).

[2] The Securities and Exchange Commission ("SEC") adopted Reg BI on June 5, 2019. Our prior advisories, webcast archives, and other materials describing the new rule and related SEC actions are available at the [K&L Gates Financial Professional Standards Hub Page](#).

[3] FINRA Rule 2111. See *also* Hanly v. SEC, 415 F.2d 589, 595–96 (2d Cir. 1969); SEC v. Great Lake Equities Co., 1990 U.S. Dist. LEXIS 19819 at *16–17 (E.D. Mich. 1990); SEC v. N. Am. Research and Dev. Corp., 424 F.2d 63, 84 (2d Cir. 1970); SEC v. Current Fin. Servs., Inc., 100 F. Supp. 2d 1, 14–15 (D.D.C. 2000); Dist. Bus. Conduct Comm. for Dist. No. 4 v. Everest Sec., Inc., 1994 NASD Discip. Lexis 188 (Sept. 2, 1994), *aff'd*, 52 S.E.C. 958, 962–63 (Aug. 26, 1996), *aff'd*, 116 F. 3d 1235 (8th Cir. 1997); Securities Act Release No. 4445, 27 Fed. Reg. 1415 (Feb. 2, 1962).

[4] Citigroup Glob. Mkts., Inc. v. Abbar, No. 13-2172, 2014 WL 3765867 (2nd Cir. Aug. 1, 2014).

[5] FINRA Notice to Members 12-55, at 2 (Dec. 2012); Regulation D Offerings, FINRA Notice to Members 10-22 (April 2010). See *also* [FINRA Rule 2111 \(Suitability\) FAQ](#), Q2.1. *What constitutes a "customer" for purposes of the suitability rule?*

[6] FINRA Rule 2111(b). An "institutional account," for these purposes, is the account of: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC or a state; or (3) any other person (whether a natural or legal person) with total assets of at least \$50 million. FINRA Rules 2111(b), 4512(c). If the institutional customer delegates investment authority to an

agent, then the agent must fall into one of these categories and the broker-dealer must apply these standards to that agent.

[7] Regulation Best Interest: The Broker-Dealer Standard of Conduct, SEC Rel. No. 34- 86031, 84 Fed. Reg. 33,318, 33,344 (Jul. 12, 2019).

[8] *Id.* at 33,335.

[9] See the SEC's discussion of the operations of a mutual fund's principal underwriter in its order approving new Form CRS (SEC Rel. No. 34-86032, 84 Fed. Reg. 33,492, 33,551 (Jul. 12, 2019) ("Additionally, we would not consider a broker-dealer that is serving solely as a principal underwriter to a mutual fund ... to be offering services to a retail investor for purposes of [Form CRS requirements], when acting in such capacity. [B]roker-dealers serving solely as principal underwriters do not typically establish the kind of relationship with retail investors that Form CRS has been designed to address.")).

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