DUE DILIGENCE: SECURITIES APPLICATIONS AND REGULATORY REQUIREMENTS, 2011

Douglas J. Schulz[1]

INTRODUCTION

This article is to inform and assist the individual or entity who is claiming that their securities professional and firm failed in their duty to conduct thorough, proper investigation and research, commonly known as "due diligence". Investment professionals, regulators and lawyers often inappropriately use the term due diligence, which causes confusion in both the implementation of "due diligence" work and later in the attempt to ferret out the regulatory requirements under the rules relating to due diligence. The term "due diligence" has applications in numerous investment products and services. It is of the utmost importance that all practitioners fully understand their obligations and liabilities as it relates to this investigative research guideline and rule.

DEFINITIONS

What are the accepted or appropriate definitions of the term "due diligence"? As in almost all regulatory or litigation situations, it depends on which side of the fence you are on. If you are on the defense side and you are being accused by either a regulator or an investor/claimant that you failed

1. Douglas J. Schulz has worked in the securities industry for over 30 years. He is a Certified Regulatory Compliance Professional (CRCP) and worked as a registered representative for such firms as Bear Stearns and Merrill Lynch. He has held numerous securities licenses and certifications such as the Series 24, 6, 7, and 3, and he has also worked as a Registered Investment Advisor (RIA). Since 1989, Mr. Schulz has been a securities expert witness through his company Invest Securities Consulting Inc. (Invest). Mr. Schulz has worked closely with regulators and was an arbitrator for both the NYSE and NASD/FINRA. He co-authored the book, BROKERAGE FRAUD: WHAT WALL STREET DOESN'T WANT YOU TO KNOW with Tracy Pride Stoneman, a nationally known securities attorney. He has been a prolific author of articles on securities regulation, securities arbitration, online trading and unauthorized trading. Mr. Schulz can be reached at Invest Securities Consulting, Inc., 301 Snowcrest, Westcliffe, Colorado 81252, 719-783-3230, Schulz@securitiesexpert.com, www.securitiesexpert.com.

to perform proper due diligence, your definition may be amorphous and narrow. You might claim the term is synonymous with such words as inquiry, investigation, research or review. On the other hand, if you are the investor/claimant, your definition will be more encompassing and will include such words as systematic, methodical, meticulous, scrupulous, detailed, and comprehensive. Let's begin by dissecting the term, "due diligence." Definitions of the word "due" include the following:

> [Middle English, from Old French deu, past participle of devoir, *to owe*, from Latin]; In accord with right, convention, or courtesy: appropriate: due esteem; all due respect; Meeting special requirements; sufficient: We have due cause to honor them; … (noun) Something owed or deserved: You finally received your due;[2]
>
> Justly claimed as a right or property; suitable: becoming; appropriate; fit;
>
> Such as (a thing) ought to be; fulfilling obligation; proper; lawful; regular; appointed; sufficient; exact; as, due process of law; due service; in due time;
>
> That which is owed: debt; that which one contracts to pay, or do, to for another; that which belongs or may be claimed as a right; whatever custom, law, morality requires to be done; a fee, a toll.[3]

Definitions of the word "diligence" include the following:

> Diligence: 1. the quality of being diligent: 2. steady application to business of any kind: constant effort to accomplish what is undertaken; perseverance;[4]
>
> (n) diligence (conscientiousness in paying proper attention to a task; giving the degree of care required in a given situation): diligence, industriousness, industry (persevering determination to perform a task) *"his diligence won him quick promotions";…* application, diligence (a diligent effort) *"it is a job requiring serious application"*[5]
>
> Diligence is a zealous and careful nature in one's actions and work, exemplified by a decisive work ethic, budgeting of one's time, monitoring one's own activities to guard against laziness, and putting forth full concentration in one's work. Diligence is usually promoted in work places. It is one of the seven heavenly virtues in Catholic catechism. … Diligence is the act of doing all things efficiently and

2. Freedictionary.com, http://www.thefreedictionary.com/due.
3. Ardictionary.com, http://ardictionary.com/Due/10091.
4. WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY (1996).
5. *Diligence Definition*, Wordnet Search 3.0, http://wordnetweb.princeton.edu.

> relentlessly to the best of one's ability in order to achieve success in every endeavor.[6]
>
> Vigilant activity; attentiveness; or care, of which there are infinite shades, from the slightest momentary thought to the most vigilant anxiety. Attentive and persistent in doing a thing; steadily applied; active; sedulous; laborious; unremitting; untiring. The attention and care required of a person in a given situation; the opposite of Negligence.[7]
>
> Synonyms: active, constant, earnest, industrious, laborious, painstaking, persistent, pertinacious, sedulous, steadfast, studious, tireless, unflagging, unrelenting.

There are other key words to consider, such as synonyms for the word "thorough": full, systematic, detailed, exhaustive, in-depth, comprehensive and methodical. And when you cross reference the synonyms for these words you get: careful, thorough, contentious, systematic, methodical, painstaking, meticulous, scrupulous, detailed, comprehensive, wide ranging, broad, all-inclusive, and full.

Those firms claiming that their investigation and due diligence fulfilled their obligations will claim their research was adequate or sufficient, ample, enough, plenty, passable, satisfactory, and tolerable. Or they may claim their research was reasonable - sensible, rational, logical, practical and realistic. It doesn't take a wordsmith to deduce that the words "adequate" and "reasonable" connote a much lower standard than "thorough" or "diligence."

The term "due" clearly connotes an obligation, something that is owed or that something is done appropriately. One of the more obvious definitions of the word "diligence" is the quality of being diligent. If you take these two words and combine them without first looking at various definitions of the term "due diligence", it is easy to determine that the phrase means an obligation to another to perform an act and that this obligation is only fulfilled when the act is done in a vigilant, thorough, and detailed manner. Ultimately, this definition applies to the term "due diligence". The term additionally means that the act to be performed will be in the nature of investigation, research and evaluation.

Definitions of the term "due diligence" include the following:

- Due diligence is the process of investigation and evaluation, performed by investors, into the details of a potential investment,

---

6. http://en.wikipedia.org/wiki/Diligence.

7. WEST'S ENCYCLOPEDIA OF AMERICAN LAW (2nd Ed. 2005), *available at* http://www.answers.com/topic/diligence.

such as an examination of operations and management and the verification of the material facts.[8]

- The investigation and evaluation of management team's characteristics, investment philosophy, and terms and conditions prior to committing capital to the fund.[9]
- 1. General: Measure of prudence, responsibility, and diligence that is expected from, and ordinarily exercised by, a reasonable and prudent person under the circumstances. 2. Business: Duty of a firm's directors and officers to act prudently in evaluating associated risks in all transactions. 3. Investing: Duty of the investor to gather necessary information on actual or potential risks involved in an investment. 4. Negotiating: Duty of each party to confirm each other's expectations and understandings, and to independently verify the abilities of the other to fulfill the conditions and requirements of the agreement.[10]

THE INVESTOR'S UNDERSTANDING

Though defining terms can be tedious, in litigation the debate as to whether one party did or did not conduct its proper due diligence is often engulfed in the extent of the thoroughness or appropriateness of the research that was conducted. As a regulatory expert, it is my practice to go to the websites of both the SEC and FINRA to aid my research into how the regulators interpret terms and obligations such as "due diligence." But separately, it is important to consider the term "due diligence" without interpretations by others, but rather how an average investor would interpret the words. Securities professionals and regulators have a horrible habit of assuming that the investing public is as familiar with all the investment clichés, acronyms, and phrases that we professionals use on a regular and day-to-day basis.

But this could not be further from the truth. The non-regulatory definitions of the term are important because these are the ones an average investor and even many sophisticated investors rely upon when making

8. Venture Capital Glossary, http://www.fundingpost.com/glossary/venture-glossary.asp.

9. VCAonline, http://vcaonline.com/resources/glossary/index.asp.

10. *Definition of Due Diligence*, http://www.businessdictionary.com/definition/due-diligence.html.

investment decisions. This reliance is often a key issue in litigation. For example, it’s not uncommon for a private placement memorandum (PPM) or prospectus to state that the general partner or investment advisor will conduct "due diligence" as to any investments made. An investor who buys into a limited partnership or private placement will not find a definition of the term "due diligence" in the document. Litigation then ensues over the thoroughness and appropriateness of the due diligence conducted. The investor clarifies his understanding of the obligations based on the definitions above. The defendants, on the other hand, may rely on much narrower, lighter definitions and might quote some case law that favorably defends their less than diligent “due diligence.”

It is inappropriate for an entity to use the term "due diligence" in its marketing or offering materials to lead an investor to believe that the research and investigation that will be conducted on its behalf will be vigilant, thorough, and detailed when the responsible entity feels no obligation to conduct their research in such a manner. And it becomes even more inappropriate when that same entity attempts to lessen its obligations by having its lawyers quote case law that blesses even the most cursory investigations. Stockbrokers, investment advisors, money managers, and hedge funds should confine themselves to using such words as investigation, research, and inquiry when their intent and performance is below the standards established by the term "due diligence".

In securities litigation who should determine what is or is not thorough, reasonable or appropriate? Should the issue of thoroughness, appropriateness, and reasonableness be left to lawyers, briefs, and experts? Not entirely. It is a rare investor, be they naïve, average, or even sophisticated, who would invest with a securities professional or entity if they believed the underlying investments that were going to be made on their behalf would not be thoroughly, diligently, and appropriately investigated. Thus, the investor’s understanding should be given great weight in any litigation.

WHY DO DUE DILIGENCE?

The answer can be as simple as "you're supposed to" or "it is the law". Or maybe the better answer is because it's to the investigating firm’s benefit. The marketing of a money management business is pretty simple - if you make above average returns for your clients, you'll maintain your client base and client assets will grow in value. You'll attract new business and make more money because you are charging a percentage of the assets. So how does conducting due diligence help the marketing department? There is no guarantee that even the most thorough due diligence translates into investment profitability. But just like any other sound business practice, adhering to regimented due diligence procedures generally should improve the soundness and success of the investments made.

> A managers' past is an excellent predictor of his future actions (results are always another story). Determining what those characteristics are, therefore will give you, the institution, the ability to recognize how the manager is likely to act in specific scenarios, and allow you to act before these actions turn disasters…People's behavioral tendencies tend to repeat, especially in times of stress…. Discovering past behavioral patterns greatly improves present decision-making by predicting and dealing with future problems, before they happen. [11]

But maybe the single most important reason to conduct due diligence is because fraud is still very much a risk in investing:

> Embezzlement, inflating profits to mask losses, lying about academic and professional credentials, stealing from retirees and then fleeing the country – these are just some examples of the types of criminal and blatantly fraudulent activities that were carried out by hedge fund managers who, for whatever reason, deluded themselves into thinking they were smarter than everyone else and above the law…. By examining the non-investment-related risk of hedge funds through such methods as background investigations and insuring independent oversight in areas such as pricing, investors can significantly reduce any exposure they may have to incidences of outright fraud….. Yes, those who are in blatant violation of certain laws can be banned from the industry and even face time in the white-collar prisons, but someone who is discovered as lying about his academic qualifications, for example, particularly if he is at a more junior level within an organization, tends to part company with the firm and move on to another one. This is particularly true within the closely knit hedge fund industry. Finally, those on the fringes of fraudulent activity, who were aware of the activity and perhaps even participated in some way but did not take the fall, are still employed throughout the industry.[12]

---

11. RANDY SHAIN, HEDGE FUND DUE DILIGENCE 11, 12, 29 (2008).
12. JASON A. SCHARFMAN, HEDGE FUND OPERATIONAL DUE DILIGENCE: UNDERSTANDING THE RISKS 51, 52 (2009).

The most thorough background investigation work and due diligence has its limitations and is not intended to address certain risk associated with investing such as: market risk, economic risk, credit risk, and interest rate risk which could be categorized as general investment risk. All the investigation and back ground checks in the world cannot protect an investor or fund from these general risks.

Hedge funds are discussed in two sections of this article because of the phenomenal growth, their lack of regulatory oversight, and the fact that they are still a relatively new unknown amorphous product. "In recent years, it seems that before the newsprint is even dry reading one [hedge fund] failure another takes its place and new names are added to the hedge fund graveyard."[13] Another author addresses the growth and dangers in hedge funds by stating the following: "The industry is rife with firms who have entered the hedge fund field for the same reason that legions of investment bankers morphed themselves into head fund managers at the turn-of-the-century… Low, to no barriers to entry, combined with perceived riches to be made in a short period of time."[14]

KNOW YOUR CUSTOMER – KNOW YOUR PRODUCT

Those die-hard securities lawyers and experts who have been at it for decades and who know song and verse the regulations and interpretations of FINRA's Rule 2090, the "Know Your Customer Rule", may be unfamiliar that this same rule requires the investment professional to "Know Your Product". As recently as January 2011, FINRA clarified this point:

> The new rule makes clear that a broker must have a firm understanding of both the product and the customer. It also makes clear that the lack of such an understanding itself violates the suitability rule [15]

FINRA Rule 2011 on suitability requires any registered representative who makes a recommendation to make sure that the recommendation is

13. *Id.* at 49.
14. SHAIN, *supra* note 11.
15. FINRA, KNOW YOUR CUSTOMER AND SUITABILITY: SEC APPROVES CONSOLIDATED FINRA RULES GOVERNING KNOW YOUR CUSTOMER AND SUITABILITY OBLIGATIONS, FINRA REGULATORY NOTICE 11-02, 4 (2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf. *See also* FINRA Manual, Rules 2111(a); 2111:04; 2111.5(a); 2111.04, 2111.05(a), http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607.

suitable for the investor. We are all too familiar with the laundry list of information that the investment advisor needs to know about the investor before he can make the recommendation - age, net worth, investment objective, risk tolerance, etc., but what about the other side of the equationThe suitability process can be summarized as an A B C process: A) the broker must know all aspects of the investor, B) the advisor must know all the aspects of the investment he is recommending, and C) the advisor must now utilize his knowledge of the investment to determine if it is suitable for the investor based upon his knowledge of the investor.

This process is the same for those brokers or registered investment advisors who manage money on a discretionary basis. The mere fact that the advisor no longer needs to consult with the investor prior to making the investment does not negate his obligation to ensure the purchases he makes on the investor's behalf are suitable. In fact, the advisor's obligations are heightened because of the fiduciary relationship created when money is managed on a discretionary basis. Either way, discretionary or nondiscretionary accounts require that due diligence be performed on each of the investments and strategies utilized in an investor's account.

On the subject of "knowing your customer," the original "know your customer" rule was NYSE Rule 405. The NYSE wrote about it:

> The emphasis here is upon due diligence and account approvals and their relationship and application to effective new account procedures. The first part of rule 405 requires the use of due diligence to learn the essential facts relative to every customer every order and every account. Its language leaves to the member organizations judgment to the determination of which facts are "essential" in the varying circumstances of each new account. Facts essential to the opening of one account, maybe insufficient or irrelevant to the opening of another.[16]

NYSE Rule 405 will be morphed into FINRA's "Know Your Customer" Rule 2090, effective October 7, 2011. The language has been altered to read "reasonable diligence" instead of "due diligence" as it relates to knowing your client. Whether the regulators intended to lessen the diligence required of advisors in knowing their clients is debatable, but the extent to which a product must be understood is not.

---

16. NEW YORK STOCK EXCHANGE, PATTERNS OF SUPERVISION (1982).

ON WHOM CAN YOU RELY TO PERFORM DUE DILIGENCE?

It is hard to finish the day without reading a story where someone is blaming another for their shortfalls. It is an American pastime that has found its way into our courts and arbitrations. Witnessing these attempts to lay the blame on others is often like watching a rerun of Abbott and Costello's "Who's on first base?" The investor is allowed under the law to rely upon his broker, money manager, or registered investment advisor who is handling his brokerage accounts, partnerships, private placements, or hedge funds to conduct due diligence. But who can these investment professionals rely upon to conduct their due diligence? We can begin to answer this question by determining who is qualified to conduct due diligence.

Brokerage firms have large staffs of highly paid and hopefully highly educated and qualified analysts. Large money management firms, mutual funds, and hedge funds have similarly qualified individuals. If the investments being made by these firms are mostly in listed publicly traded stocks, the kind of investigation, research and due diligence that is being conducted is dramatically different than if they are making investments in non-publicly traded companies such as private placements, venture capital, or in such unregistered investments as sub-funds or other hedge funds. It is inappropriate to take an individual whose training and experience has been limited to evaluating publicly traded companies and expect them to translate that knowledge into conducting due diligence on a completely different kind of investment.

A sad example of the type of person one should be able to rely upon for due diligence was highlighted in the SEC's 2002 finding against almost every major brokerage firm – for the debacle involving brokerage firm analysts.[17] Hardly an investment cycle goes by without these highly paid, in-house analysts at the major brokerage firms completely missing the boat on a particular stock, à la MCI, Tyco, WorldCom, Global Crossing, and Enron. Such analysts are as pitiful when rating and ranking their sister brokerage firms such as Lehman Brothers and Bear Stearns. It is an embarrassment to the analyst profession that so many brokerage firms were touting and recommending Enron almost to the bitter end, especially considering that some of the company's more questionable practices were right there in Enron's annual and quarterly financial statements. There is far too often a

17. SEC News Digest, Issue # 003-07 (April 28, 2003), http://www.sec.gov/news/digest /dig042303.txt. For an easier analysis read CHARLES GASPARINO, BLOOD ON THE STREET (2005).

dangerous "herd mentality" that has brokerage firm analysts working in lockstep.

Investment banker types and brokerage analysts have relatively inflated egos. You can't blame them; that is what happens when recent college graduates are paid over half a million dollars. But both they and their employers have a vision of the kind of research they do, and it does not involve snooping around. This probably bodes well for the investor, since these pin striped suited investment banker types probably don't have the credentials, experience, or the stomach for hard-nosed investigative work anyway. Investment firm employees' dislike for dealing with these "sticky" issues such as sensitive background searches is why often the investment firm will handle all the standard due diligence but leave the personal background investigation and verification to outside third party firms.

There is nothing worse than having somebody conduct due diligence for a firm who is not qualified; garbage in, garbage out. If someone does not know the right questions to ask, he is not going to get answers that are of any value.

Separate from qualifications is the issue of conflicts. The analyst debacle underscored that brokerage and investment banking firms that have an investment banking relationship with the very company they are underwriting for, have no incentive to tick off the client by asking a lot of delicate questions. Accordingly, it is a common practice of money management firms to hire outside companies that specialize in securities due diligence work.

OUTSIDE FIRMS THAT SPECIALIZE IN DUE DILIGENCE WORK

Today numerous firms offer investigative services, Kroll being one of the largest and oldest. All an individual needs to do is type into any search engine "due diligence firms" and a vast array of firms offering such services will be listed. They perform a myriad of investigative functions, sometimes incognito, such as:

- Conduct a site visit of various plants and warehouses to "kick the tires";
- Visit the operations of direct competitors;
- Conduct an exhaustive background check on key officers, managers, and participants;
- Verify college degrees, prior work and responsibilities, accolades, awards;
- Interview previous employers or employees;

- Track down and interview potentially disgruntled customers or vendors;
- Verify or discount rumors and stories, both positive and negative; and/or
- Act as a customer, consumer, vendor, or supplier and test the facilities and employees of both the target company and/or competitors.

Hiring outside firms to conduct due diligence is generally a good idea. But advisory firms considering outside investigative/due diligence firms must be cautioned: don't go cheap! In one securities arbitration case, a registered investment advisory firm hired an outside firm to conduct due diligence on a hedge fund. The consulting firm's report showed that they were unable to answer specific, important questions because of budgetary constraints and other limitations. Instead of what could have been a useful report supporting the contention that the advisory firm did proper due diligence, the report became a damaging document because the claimants showed that the due diligence was truncated and grossly inadequate.

To illustrate this predicament: a company hires an outside firm to fulfill its due diligence obligations and the firm is negligent in its investigation work. Who is responsible? The hiring firm would be guilty of not doing its "due diligence" on the very firm it hired to do its "due diligence". Leave it to the NASD to address this point in Notice to Members (NTM) 05-48:

> The procedures should include, without limitation, a due diligence analysis of all of its current or prospective third-party service providers to determine whether they are capable of performing the outsourced activities.[18]

NTM 05-48 goes as far to state that both NASD rules 3010 and 3012 require that there must be a written supervisory policy as to conducting this proper due diligence on outside service providers.

RUBBER STAMPING

A fairly apparent practice termed "rubberstamping" refers to the art of papering a file. When an entity, for example an underwriter, is putting together an IPO and hires a private company to conduct due diligence on some individual or entity, and the underwriter a) is pretty positive nothing

18. NASD, MEMBERS RESPONSIBILITIES WHEN OUTSOURCING ACTIVITY TO THIRD-PARTY SERVICE PROVIDERS, NASD NOTICE TO MEMBERS 05-48 (2005), *available at* http://www.finra.org/Industry/Regulation/Notices /2005/p014736.

negative will be found, b) is pretty positive they are going ahead with the deal regardless of what information is found, and c) their main reason for hiring an outside firm is so that if they are sued for not having done their due diligence, they can say they did it. This is rubber stamping. It is a dangerous practice, but it can also be effective. An investor who is contemplating suing an investment firm for a lack of due diligence, might think twice when she discovers that the defendant, not only has a large due diligence file, but in addition hired an outside service to conduct this due diligence.

But rubberstamping is a dangerous practice because it can get to be a bad habit, particularly if the investment advisor won't change its decision whether to invest or not invest based on what it discovers. Consequently, the outside firm will not do as a thorough or exhaustive an investigation as it might otherwise do. This lax style becomes habit-forming; it can be hard for the advisory firm to turn the switch off and on as whether to perform thorough due diligence, "light" investigation, or rubberstamping. And it's just a matter of time until both firms may get burned.

The following is an example of a callous and lax attitude that some firms might take toward due diligence.

> Due diligence: A process, typically undertaken by junior lawyers/paralegals, involving reviewing a company's legal and financial documents to flag up any issues that may cause problems during and/or after a transaction.[19]

Take note of two items: first, note that the work is being shoveled off to "junior" staff. Second, the work described is merely reviewing documents. This sounds like dangerous rubberstamping.

There is an additional problem with this "light" investigation work: who else may ultimately rely upon it? In large firms, does everybody understand that the investigation was a "wink, wink" transaction? Some might rely on the truncated/cursory investigation, believing that it was thorough and exhaustive due diligence that was performed. And think of the problems created in the cumulative effect of a "light" investigation: "We investigated them before and didn't find anything wrong." A subsequent firm might rely on the earlier inadequate investigation, and so on. This is one of the reasons that relying on another firm's due diligence work is so inappropriate: you simply do not know how thorough the other firm was.

19. LAWYER 2B, *Jargon Buster*, http://l2b.thelawyer.com/useful-resources/jargon-buster#D.

CONDUCTING DUE DILIGENCE

This article does not attempt to cover every nuance of how to conduct due diligence. Not only would that require a book-length article, there is no one standard format or complete questionnaire that can cover all the bases. Since hedge funds can invest in anything under the sun, it would be near impossible to create a questionnaire or list that can anticipate every fact that should be addressed prior to investing. It is more important for investors to concentrate on what they do not know, versus what they do know. Furthermore, claimants and attorneys, when preparing for litigation, should spend less time on the strengths of the case and instead concentrate on the weaknesses and negatives. This same mentality applies to the issue of due diligence. "As any good due diligence analyst will explain, performing due diligence can be equated to peeling away the layers of an onion. In order to get to the center investors must successfully peel away layer after layer with subsequent questions and inquiries."[20]

Far too often firms that conduct due diligence concern themselves more with the volume of their due diligence file than the quality of the materials contained within. Because it is just human nature, too often those conducting the investigation are happier filling the file with positives as opposed to negatives and warnings. Many investigators shy away from conducting really thorough due diligence, because they realize a due diligence file filled with negatives can do more harm than good should litigation ensue. This is only further complicated by the fact that most individuals, especially those people who consider themselves investment bankers or money managers and not super sleuths, would be uncomfortable and unfamiliar with asking embarrassing and probing questions such as:

Do you or any of your key employees at the firm:

- have a history of drug abuse, and if so can you furnish me with the medical records?
- have a history of mental problems, and if so can you furnish me with the medical records?
- ever been accused of child or spousal abuse and what was the outcome?
- been a claimant in either civil or criminal litigation, if so please provide detailed information, as to the specifics, dates, location, parties involved, and final resolution?

---

20. SCHARFMAN, *supra* note 12, at 53.

- ever a defendant or accused in either civil or criminal litigation, if so please provide detailed information as to the specifics, dates, location, parties involved, final resolution?
- ever declared bankruptcy, if so provide all written documentation?
- ever been accused of wrong doing by any securities regulatory body, if so provide all written documentation?
- please provide me with: full name and any aliases, date of birth, social security number , driver's license number, living addresses for the last 20 years, full maiden name for any spouses current or previous, full names and information provided above for all children over the age of 21?

The last bit of questioning is so that a physical or electronic background investigation can be conducted on the individuals. As a majority of people would feel uneasy asking these questions, therein lies the reason for hiring outside consulting firms who specialize in this business.

A bit of warning to those who conduct due diligence, uncover some negatives or red flags and then fail to share it with prospective or current investors. The following paragraph is from an SEC finding:

> Bell's recklessness became even more egregious after he learned, at least as early as June 2004, that Petters had previously been convicted of multiple crimes involving fraud and deception. These facts should have led Bell to question everything Petters was telling him. But instead, Bell deliberately concealed Petter's prior convictions from the Funds' investors and continued to invest the Funds' money in Petter's notes.[21]

Investment professionals should take note of the SEC's language. Point one: if you find something questionable in an individual's history, you should start second guessing and do a more exhaustive job of due diligence. Point two: if you find something negative, then disclose it; always err on the side of full disclosure and total transparency.

One last key piece of advice on conducting due diligence: when contemplating an investment in any firm or fund, negotiate on the front end that the target firm will provide a signed document or release authorizing the background investigation. In this age where identity theft is a real concern and new privacy restrictions are in place, conducting any meaningful

21. *United States Sec. & Exch. Comm'n v. Thomas J. Petters, Gregory M. Bell, & Lancelot Investment Management LLC*, No. 09SC1750 (D. Minn. July 7, 2009), *available at* http://www.sec.gov/litigation/complaints/2009 /comp21124.pdf; *see also,* SEC Litigation Release No. 21124 (July 10, 2009), http://www.sec.gov/ litigation/ litreleases / 2009/lr21124.htm.

background investigations without the target firm's written authorization is much more difficult. The authorization and release must be all-encompassing with no restrictions or limitations and is even that much more powerful when the signature is notarized. What if the party refuses? It makes your investment decision very easy. Walk away and never look back!

In assessing whether proper due diligence was conducted, be sure to discover all communication between the due diligence firm and the target firm, particularly any such authorizations/ releases. You might find that the target firm refused to sign but the investigation went forward nonetheless. This might reveal evidence of a hampered investigation.

SHOULD DUE DILIGENCE LISTS BE UTILIZED?

Before discussing the use of lists, there is a notable distinction between a list and a questionnaire and their uses in this field. A questionnaire, at least in the area of hedge fund due diligence, is used in two ways. Many hedge funds create a questionnaire to provide to potential investors, often in the form of a "Frequently Asked Questions" wherein the hedge fund asks and then answers the questions that they think an investor would want to know. The second use of questionnaires is when the firm conducting the due diligence provides to the potential target firm a fairly extensive group of questions that the target firm itself answers. A list is an internal set of questions, investigative methods and fact finding that needs to be completed in order to document the "due diligence" being performed.

Often, the first step in any due diligence process is the furnishing of a questionnaire to the target firm. That base information is often used to conduct due diligence, but there is a problem. If a firm in and of itself (or one of its officers) has something to hide or something they would rather not disclose, relying on a questionnaire can be a dangerous start. What is being sought in proper due diligence is something the company does not want to reveal, regardless of how detailed the questionnaire is. No doubt, a significant portion of investigative due diligence is the verification of known facts. But if the investigation stops there, in the vast majority of the fraud cases that have been perpetrated on investors over the last couple of decades, little of this fraud would have been discovered.

There is often a debate among investment firms and even firms that contractually do due diligence work as to the benefits of using "lists" in conducting their investigations. The number one benefit of having lists and requiring them to be utilized is that it forces individuals to cross their T's and dot their I's. Utilizing lists also can help guard against not being unduly influenced by any one person or piece of information. The other great thing that lists do is they allow management to delegate task to certain people. A thoroughly experienced individual who creates the list can now potentially rely on a less experienced person to conduct the due diligence, as long as that person is capable and qualified to do the work. A qualified individual should be one who understands the business that he is investigating.[22]

Yet, there are negatives that can come from the overuse of lists. Unlike many investments such as mutual funds, limited partnerships, and even ETFs, hedge funds are not regulated and are most often not limited in what they can invest in. Hedge fund investments might include a coffee plantation in Brazil; an oil shale in Canada, a recycling plant in California, and a sub-fund in Timbuktu. Can a due diligence list be created that can properly and adequately cover all of these variables and opportunities? No! Hence, herein lie the dangers with utilizing lists for conducting due diligence. In the hands of a less diligent experienced employee, the list might be conceived as all-encompassing: "If I get the answers to all of these questions, I've done my job." However, any list, no matter how thorough, should only be used as a base from which to expand the investigation.

The following is a partial list that covers several broad topics of due diligence work[23]:

- Organizational structure and control;
- Material contracts;
- Litigation;
- Regulatory compliance;
- On-site management interviews;
- Background investigations;
- Reference checks;
- Management and staff capability analysis;
- Review of policies and procedures;
- Financial statement review;
- Prior performance review;

---

22. JAMES P. JAILIL, UNDERWRITERS DUE DILIGENCE; WHAT IS IT AND HOW MUCH IS ENOUGH? (2004).

23. SNYDER & KEARNEY LLC., DUE DILIGENCE OF 1031 OFFERINGS (2007), http://www.snyderkearney.com / articles/1031 _Due_ Diligence_White_Paper_ (vfinal4_)%204.pdf; *see also*, MANAGED FUNDS ASSOCIATION, MODEL DUE DILIGENCE QUESTIONNAIRE FOR HEDGE FUND INVESTORS, http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf.

- Prior performance disclosure;
- Overall performance;
- Identification of problem properties; and
- Analysis of internal controls and procedures

The following are a few more items to add to a due diligence list:

Securities regulatory bodies
- ADV forms and IARD for investment advisors
- CRDs
- SEC and FINRA enforcement proceedings
- Regional offices for the SEC and FINRA
- NAASA
- Individual state securities boards and commissions
- NFA

Verification of:
- Licenses
- Schooling, colleges, diplomas, accolades
- work history, responsibilities, titles, accomplishments

Press, articles, news stories, publications
- Reuters
- LEXIS-NEXIS
- Westlaw
- Wall Street Journal.com (wsj.com)
- Bloomberg
- Dialogue
- Google
- Factiva (Dow Jones)
- All local newspapers where the individual has either worked or lived

Negatives set aside, all investment management firms and individuals should have articulately crafted lists to aid them in their due diligence work.

LIMITING DUE DILIGENCE

There will always be an explanation for a less than thorough due diligence when someone is accused of being lax in their investigation. Two of the common explanations that can also be pitfalls are 1) how current is the investigation and 2) over reliance on certain factors.

HOW CURRENT IS CURRENT?

Due diligence is not always static but, depending on the circumstances, may require ongoing monitoring. It is a mistake for a firm to perform due diligence and then think "Well, that's done; now we can go back to sleep." What if an advisory firm does a thorough background check on a sub-fund which results in an investment and then six months later the advisory firm contemplates making an additional investment in this same sub-fund? Does the firm need to do the same level of investigation/due diligence for the second investment? What if the first investment was one year earlier or two years earlier? The standard is the information must be current, but how current is current? A firm should update its due diligence annually, at the very least to determine whether or not any changes have taken place. For example, let's say that you have conducted thorough background checks on all the key officers and those with investment responsibilities at a hedge fund you are thinking of placing money with. But six months later, three new employees are added. It would probably be appropriate to conduct additional background checks, thus catching these new employees, as well as new occurrences in the backgrounds of the current employees, no less than once a year.

OVER RELIANCE

Another danger is allowing one piece of information to sway the person conducting the due diligence. Commonly, it is a personal recommendation from someone you highly regard: "If Bob says he can be trusted, that's good enough for me." Thorough, exhaustive, proper due diligence is exactly that: the person/firm conducting the due diligence should never be swayed or overly influenced by any one item or group of items no matter how positive. Far too often the following items have unduly influenced advisor's decisions to invest with a particular firm or in a particular investment:

- Above average annual rates of return (maybe the most classic mistake);
- Accolades of key individuals (an MBA from Harvard guarantees attracting money is easy, and everyone assumes you are brilliant);
- Praise from other professionals (little value, just a circle of professional courtesy)
- References that are glowing (pretty worthless - who gives negative references?)
- Size (bigger is not better, you only need to review the capitalization of Bear Stearns and Lehman Brothers before they went under);

- Impressive list of major investors (these same investors invested with Bear Stearns, Lehman Brothers, Bernie Madoff and Long-Term Capital Management.);
- Hot new product area (want to buy some tulips or subprime mortgage debt?)

DUE DILIGENCE – SECTION 11 DEFENSE TO PROSPECTUS FRAUD

Section 17 of the Securities Act of 1933 contains the anti-fraud provisions that relate to false statements or omissions of material facts that occur in a securities offering, be it registered or unregistered. Section 11 spells out defenses for those officers, underwriters, and other individuals who might be held responsible for any false, misleading, or material omissions in the offering prospectus or memorandum. [24] One such defense is that these individuals were not aware of the falsehoods or material facts that were not disclosed. It requires the defendants to prove that prior to the offering materials they undertook "reasonable investigation" to discover any potential falsehoods or other material facts that needed to be disclosed.

Neither the history books nor legal research reveals how the term "due diligence" first came to be used in conjunction with this Section 11 defense.[25] Nowhere in the '33 Act or accompanying code provisions is the term "due diligence" used. But most practitioners in this field are familiar with this particular Section 11 defense being called the "Due Diligence Defense ". One of the better articles written is titled, "The Section 11 Due Diligence Defense for Director Defendants" [26]

Where a securities professional is being accused of inappropriate or inadequate investigation into the securities purchased on an investor's behalf, raising this "due diligence defense" is common, even when the claims have nothing to do with a violation of section 17 of the Securities Act of 1933. Immediately the question becomes, why is this practice so common? A more thorough reading of Section 11 clears up the question almost immediately:

24. Securities Act of 1933, §11 (b)(3)(A), 15 U.S.C. §77K.
25. For some history and on the issue of reasonableness, see JALIL, *supra* note 22.
26. Tonay Rodriquez, Karen Petroski, *The Section 11 Due Diligence Defense for Director Defendants*, 2007 A.B.A. LIT. SEC., SECURITIES LITIG. JOURNAL (Summer, 2007); see also William K. Sjostrom Jr., *The Due Diligence Defense under Section 11 of the Securities Act of 1933*, 4 BRANDEIS L. J. 549 (2006), *available at* http://papers.ssrn.com/sol3/papers. cfm?abstract_id=864584.

> As regards any part of the registration statement not purporting to be a made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading;
>
> Standard of Reasonableness
>
> In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.[27]

The reader only need to go back and read the definitions as to the term "due diligence" and they will quickly recognize why this tactic of using this Section 11 "due diligence defense" is utilized by defense attorneys. Note that the measuring stick for the adequacy of the due diligence is only that of being "reasonable". At least there is some attempt to measure what is "reasonable" by referring to the "prudent man rule". Securities practitioners are infinitely familiar with the "prudent man rule" in connection with the overall management of investment portfolios, especially those governed by ERISA or discretionary agreements. I will not burden this article with a dissection of the "Prudent Man Rule", but will only say that it is a somewhat lesser standard than is called for under "due diligence". This is why so many defense attorneys find solace in the Section 11 "due diligence defense."

When opposing counsel tries to inappropriately inject a Section 11 defense, one reference an attorney can use is a footnote from NASD NTM 03-71:

> NASD's use of the term "due diligence" is not intended to equate the responsibilities of a member for its sales conduct obligations with the requirements of an underwriter under Section 11 of the Securities Act of 1933 and Securities Act Rule 176.[28]

---

27. Securities Act of 1933, §11(b)(3)(A), 15 U.S.C. §77K.

28. NASD, NON-CONVENTIONAL INVESTMENTS, NASD NOTICE TO MEMBERS 03-71 (2003), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003070.pdf.

DUE DILIGENCE-APPLICATIONS AND REQUIREMENTS

Having debunked the notion that the "due diligence" requirements of money managers is somehow tied to Section 11 of the Securities Act of 1933, let's take a look at specific applications of the term "due diligence" to various securities professionals.

FIDUCIARY RELATIONSHIPS

Federal and state securities regulations, as well as the courts, are pretty consistent in declaring that any securities professional who is managing money for an investor on a discretionary basis has a fiduciary relationship with that investor. And it is fairly axiomatic that a fiduciary duty is a higher duty than a non-fiduciary relationship. "Fiduciaries should bear more responsibility for doing due diligence and pay a high price for neglecting this fundamental duty."[29] It is for this reason that most brokerage firms are very nervous about this issue and try to keep their stockbrokers from becoming fiduciaries. The major brokerage firms fought very hard in the last decade to keep the legislature from enacting regulations which would have made all stockbrokers fiduciaries.

STOCKBROKERS

As noted in BROKERAGE FRAUD: WHAT WALL STREET DOESN'T WANT YOU TO KNOW,[30] stockbrokers are salesmen. The technical name for stockbrokers is Registered Representatives. This is because these individuals must be both licensed and registered with a licensed and registered broker dealer. The broker dealer is licensed and registered with various self-regulatory organizations such as FINRA, MSRB etc. The most common practice of stockbrokers when working for large brokerage firms is for the broker to rely on the research conducted by the firm's in-house analyst. The typical stockbroker merely parrots these recommendations to his retail

29. Stephen Brown, Anthony Lynch & Antti Petajisto, *Hedge Funds after Dodd-Frank*, REGULATING WALL STREET, NYU Leonard N. Stern School of Business (July 19, 2010), http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html.

30. DOUGLAS SCHULZ & TRACY STONEMAN, BROKERAGE FRAUD-WHAT WALL STREET DOESN'T WANT YOU TO KNOW (2002).

clients. Of course, he must first determine that these recommendations are suitable (see the “Know Your Customer-Know Your Product” section of this article).

In the last two decades more and more brokerage firms have encouraged their stockbrokers to become "money gatherers" and less traders or stock jockeys. The marketing and management concept is to gather as much money as possible and charge a fixed annual fee, averaging between 1% and 2%. In many instances the brokers will get a power of attorney for client to manage their account on a discretionary basis. And there is the more traditional way where the broker turns over the client’s funds to the brokerage firm’s in-house money managers or places the money in the in-house mutual funds. In both these instances, the money is managed on a discretionary basis. As stated earlier, if the stockbroker himself or any other individual at the brokerage firm is managing the investors’ money on a discretionary basis there is an automatic fiduciary relationship.

CAN A STOCKBROKER RELY ON HIS FIRM’S DUE DILIGENCE?

In 1980, I was a new stockbroker (registered representative) for Merrill Lynch in Dallas, Texas. Every day on the "squawk-box,” a stream of Merrill analysts pontificated about the new, hot recommendation of the day. I was young and naïve, and worse yet, trusting. I took the stock option recommendations and recommended them to my trading clients; who then lost their money before the ink was even dry on the tickets. When I tried to question the analyst about the previous day's disastrous recommendations, I was told, “We don't look backward.” I recommended Merrill Lynch's proprietary underwriting “The Ginnie Mae Fund,” which on the cover of the prospectus said that the fund was “Government Guaranteed.” My clients quickly lost both principal and interest. Additionally, Merrill Lynch sponsored and recommended a number of insurance company’s annuity products, and they were touted as very safe. Very shortly thereafter two of these very same insurance companies went down the tubes.

Throughout the late 80s, thousands of Prudential’s stockbrokers recommended numerous limited partnerships which were being heavily touted by Prudential Securities. I assisted the SEC with investigating Prudential. The SEC found that numerous senior executives at Prudential had not only misled investors about these limited partnerships, but that Prudential had also misled their brokers. Many of these partnerships were riddled with conflicts of interest and were very risky, yet they were marketed and sold as safe.

So to ask the question again: under the regulations, is a broker allowed to rely on his sponsoring firm to investigate and perform due diligence for him and his clients? I can give you from firsthand knowledge Merrill Lynch's opinion at the time I worked for the firm. We were trained as salesman. Merrill wanted us to concentrate our efforts on selling. Merrill Lynch had a cadre, of highly paid, highly rated analysts and we were to rely on their recommendations.

However, brokers who rely too heavily on their firms' due diligence need to take note of the following finding by the National Adjudication Council.

> BEFORE THE NATIONAL ADJUDICATORY COUNCIL NASD
> Faber argues that he did not act recklessly because he relied on the due diligence conducted by his employer. Faber does not provide any legal support for this contention; rather, he asserts that if his position is incorrect, every individual representative will be required to investigate for him or herself the accuracy of every report, opinion, analysis, or recommendation made by a firm. Faber overstates his argument and we disregard it. First, our finding is that. —given the red flags that confronted him. —Faber acted recklessly in representing that the Interbet transaction was an IPO. Our finding is consistent with applicable case law. See Richard H. Morrow, 53 S.E.C. 772, 779 n. 10 (1998); see also Hasho, 784 F. Supp. at 1107 ("Registered representatives have certain duties that they cannot avoid by reliance on either their employer or an issuer"); Donald T. Sheldon, 51 S.E.C. 59, 71 (1992) aff'd, 45 F.3d 1515 (11th Cir. 1995) (material misstatements and omissions by registered representatives are not excused by a representative's reliance on information from his broker or dealer); William G. Berge, 46 S.E.C. 690, 694 (1976) ("Compliance with the antifraud provisions cannot be shifted entirely to a salesman's supervisor"), aff'd sub nom, Feeney v. SEC, 564 F.2d 260 (8th Cir. 1977). Second, Faber did not show that the Firm's due diligence concluded that the Interbet transaction was an IPO. We therefore reject Faber's argument that he relied on Smith Culver's due diligence.[31]

This question of "reliance" raises its head often when the issue of due diligence is discussed in the securities field. When conducting investigations, research, and due diligence often someone ends up relying or

---

31. *Department of Enforcement v. Dane S. Faber*, NASD Regulation, Inc. Office of Hearing Officers Complaint No. CAF010009 (May 7, 2003), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/ohodecisions/p006568.pdf.

trusting the words or reports of others. But there is a very special relationship between the stockbroker/registered representatives and his broker-dealer. The broker is not only registered and licensed with his parent firm, he is an employee (regardless of whether is characterized as an independent contractor for tax purposes). In theory they should be a cohesive team that is working in the best interest of their clients (of course, this theory does not always hold true because of the conflicts of interest within the brokerage industry resulting in thousands of lawsuits filed annually by investors). There is no doubt that a broker "should" be able to rely on his brokerage firm's product recommendations. Clearly, because of the massive staff of lawyers, economists, and analyst employed by the brokerage firm, the firm is in a better position than the individual stockbroker to dissect, analyze, and conduct due diligence on each and every product/investment that it markets through its individual brokers.

That being said, the individual broker is still not left off the hook. Each stockbroker/registered representative is an individually licensed person. He/she will have a series 7 and series 63 and maybe many other licenses. These licenses require the broker as an individual to follow a myriad of securities regulations dictated by FINRA, the SEC and other federal and state statutes and regulations. The broker must "know his customer" and "know his product." No one argues the point that it is the individual stockbroker who has the primary duty to "know his customer"; but what about the product? And more specifically, what about the product that is being specifically recommended and touted by the brokerage firm at which the individual broker is employed?

The norms of the securities industry do not require the broker to perform a redundant set of due diligence obligations on the products that are being recommended by its firm. What is required is that the broker be reasonable at taking at face value the recommendations of his firm. Let's take two examples to illustrate this point.

I earlier mentioned the incident where Prudential Securities sold hundreds of millions of dollars of illiquid, risky, conflict-laden limited partnerships to investors and touted them as anything but. Were these brokers at Prudential fulfilling their regulatory requirements under their individual licenses by taking Prudential's word and marketing materials at face value, and merely acting as a conduit and salesman to the investing public? No! These limited partnerships did not satisfy the "smell test" from the get-go. Each and every one of these limited partnerships had a prospectus. A broker selling one of these prospectus products would not be fulfilling his obligation to "know his product" by merely using the suggested sales scripts by Prudential. He/she would be required to read the prospectus. And any licensed and properly qualified registered representative who had read one of these prospectuses would have immediately realized that the prospectus language did not jive with the sales scripts that Prudential was handing to its brokers. At this point, it is no longer reasonable or appropriate for the broker to merely "rely" on his firm and its due diligence. He is now *on notice* of a problem, or as we sometimes call it in the industry, a “red flag”. Blindly recommending these limited partnerships to their clients from that point forward would be a securities violation.

A second example is those stockbrokers who found themselves working for the "bucket shops" and other sleazy, cold calling and microcap brokerage firms that so permeated the industry in the 70s and 80s. The movie Boiler Room so perfectly portrayed this type of operation. Many of these firms were a complete mockery of securities regulation. Almost each and every day it would be easier to delineate the few regulations that were followed, rather than trying to list all of the regulations that were violated. Any licensed registered representative who was working at one of these firms who might claim he was unaware of the infractions and inherent unethical business model would clearly be guilty of unreasonably and unprofessionally relying on the recommendations of his brokerage firm. One might even go so far as to accuse such a person of being brain-dead or totally blind.

These examples highlight the point that licensed stockbrokers cannot blindly rely on their parent brokerage firms when it comes to such issues as due diligence, product knowledge and suitability.

BROKER DEALERS’ DUE DILIGENCE OBLIGATIONS

The “Know Your Product” obligation is a dual responsibility both on the stockbroker/registered representative and the broker-dealer itself. There are numerous places throughout the regulations that specifically use the term due diligence. The following are a couple of examples.

BROKER DEALERS RECOMMENDING MICROCAP AND OTC SECURITIES

NASD Rule 2315 is intended to address abuses in transactions involving ("microcap") securities. The rule mandates that a member conduct a due diligence review of an issuer's current financial and business information before recommending that issuers microcap securities.[32] NASD rule 2315 was amended and the rule was changed to FINRA Rule 2114. In addition, the rule covers OTC securities and requires that the individual at the broker-dealer conducting the due diligence be either a series 24 General Principle or a series 8 General Securities Sales Supervisor. [33]

BROKER DEALERS RECOMMENDING HEDGE FUNDS

Broker-dealers who are marketing hedge funds also have specific due diligence requirements. NASD Notice to Members (NTM) 03-71 is right on point:

> **Reasonable-Basis Suitability** Under reasonable-basis suitability, a member that recommends hedge funds, directly or indirectly, must have a belief that the product is suitable for any investor. Members discharge this requirement by conducting due diligence with respect to the hedge fund, or in the case of a fund of hedge funds, with respect to the underlying hedge funds. Due diligence is especially important for hedge funds because, as noted above, many hedge funds are not registered as investment companies and are offered though unregistered private placements. Members therefore have a ***heightened*** responsibility to investigate the hedge funds and funds of hedge funds that they recommend to customers. Members must perform ***substantial due diligence*** into a hedge fund before making any recommendation to a customer, including, but not limited to: an investigation of the background of the hedge fund manager, reviewing the offering memorandum, reviewing the subscription agreements, examining references, and examining the relative performance of the fund.[34]

The words "heightened" and "substantial due diligence" are emphasized, because it is important for the licensed securities professional to recognize

---

32. NASD, SEC APPROVES NASD RULE 2315: RECOMMENDATIONS TO CUSTOMERS IN OTC EQUITY SECURITIES, NTM 02-66 (October 2002), *available at* http://www.finra.org /Industry /Regulation/Notices/2002/p003454.
33. FINRA, SEC APPROVES NEW CONSOLIDATED FINRA RULES, REGULATORY NOTICE 09–20 (April 2009), *available at* http://www.finra.org/web/groups/ industry/@ip/@reg/@notice/documents/notices/p118483.pdf.
34. NASD, NASD REMINDS MEMBERS OF OBLIGATIONS WHEN SELLING HEDGE FUNDS, NTM 03-07 (February 2003)(emphasis added), *available at* http://www.finra.org/Industry /Regulation/Notices/2003/p003356.

that the regulators are insisting on a higher level of investigation when it comes to more complex, risky products. This follows decades of regulatory guidelines when it comes to less liquid, more complex, higher risk products. For the longest time, the NASD only had two sections of its manual devoted to specific products: stock options and limited partnerships. Both are more complex, higher risk, and at least as to the latter, less liquid.[35]

Because of the incredible growth in hedge funds, there has been a commoditization of research on various hedge funds. This background investigation is creating libraries of information which is aiding those conducting due diligence on hedge funds.[36]

BROKER-DEALER RECOMMENDING NONCONVENTIONAL SECURITIES

NASD Notice to Members 03-71 reminds members offering nonconventional investments (NCI's) of their obligations to conduct adequate due diligence to understand the features of the product:…[37]

> Due Diligence/Reasonable-Basis Suitability
>
> As NASD noted most recently in Notice to Members 03-07 (pertaining to hedge fund sales to customers), performing appropriate due diligence is crucial to a member's obligation to undertake the required reasonable-basis suitability analysis. A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination, discussed below, which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product. Moreover, the fact that a member intends to offer an NCI only to institutional investors does not relieve the member of its responsibility to conduct due diligence and a reasonable-basis suitability analysis.

---

35. The FINRA Manual now has a section on annuities, another complex, illiquid, commission laden product. See, e.g., FINRA Manual, Rule 2330, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=12069&element_id=8824&highlight=annuities#r12069.

36. SCHARFMAN, *supra* note 12, at 271.

37. NASD NOTICE TO MEMBERS 03-71, *supra* note 28.

> The type of due diligence investigation that is appropriate will vary from product to product. Members should examine these and other appropriate factors when conducting due diligence. A member may in good faith rely on representations concerning an NCI contained in a prospectus or disclosure document. However, reliance on such materials alone may not be sufficient for a member to satisfy its due diligence requirements where the content of the prospectus or disclosure document does not provide the member with sufficient information to fully evaluate the risk of the product or to educate and train its registered persons for sales purposes. In such case, the member must seek additional information about the NCI or conclude that the product is not appropriate for sale to the public. In addition, members should ensure that the persons responsible for conducting due diligence have appropriate training and skill to evaluate the terms of the investment as well as the potential risks and benefits. Members must ensure that their written procedures for supervisory and compliance personnel require that (1) the appropriate due diligence/reasonable-basis suitability is completed before products are offered for sale.[38]

In Notice to Members 05-18, the NASD once again addressed the issue of conducting due diligence as it relates to even another product area. The repeated theme of the NASD (now FINRA) is that due diligence is product specific. In NTM 05-18, the NASD states:

> NTM 03-71 reminds members that the type of due diligence that is appropriate will vary from product to product. NASD staff believes that it is not appropriate for members that recommend a TIC transaction simply to rely on representations made by the sponsor in an offering document. [39]

In NTM 05-18 the NASD stated that because of the complicated tax structure surrounding tenants-in-common ("TIC") transactions, the broker-dealer and broker can only fulfill their due diligence obligations by fully understanding all the tax ramifications surrounding the recommended transaction.

---

38. NASD, NOTICE TO MEMBERS 03-71, *supra* note 28; see also, NASD, NASD PROVIDES GUIDANCE CONCERNING THE SALE OF STRUCTURED PRODUCTS, NOTICE TO MEMBERS 05-59, (September 2005) *available at* http://www.finra.org/ Industry/Regulation/ Notices/2005/p014998 (similar to NTM 03-71, requiring due diligence into structured products before selling them to the public).

39. NASD, NASD ISSUES GUIDANCE ON SECTION 1031 TAX-DEFERRED EXCHANGES OF REAL ESTATE PROPERTY, NOTICE TO MEMBERS 05-18 (March 2005), *available at* http://www.finra.org/Industry/Regulation/Notices/2005/p013456.

MONEY MANAGERS & REGISTERED INVESTMENT ADVISORS

When discussing money management firms, it is best to divide them up: mutual funds and registered investment advisory firms (RIAs). There is a long laundry list of distinctions between the two but here only the relevant differences will be discussed. For the most part, the regulations that govern the mutual fund industry are under the Investment Company Act of 1940; for RIAs, it is the Investment Advisers Act of 1940.

In addition to following the securities regulations of the SEC, FINRA, etc., the overriding document that dictates the activities in a mutual fund is the fund prospectus. Herein lies the specifics of what a particular fund can and cannot do when selecting investments of the fund. Notably, the mutual fund industry attracts the least amount of lawsuits. Many people find that surprising when mutual funds almost by definition are sold to the masses in the billions of dollars. More people, more lawsuits. But because mutual funds are offered to the general public, they are generally structured to be suitable for the general public. The classic way to make a mutual fund suitable for most people is to: a) keep it conservative; b) keep it simple; and c) have fairly restrictive covenants on what the fund can invest in. It is the latter that will be discussed here.

Most mutual funds are considered diversified. To be classified as a "Diversified Investment Company" under the Investment Company Act of 1940, the fund can have no more than 5% invested in any one security with respect to 75% of its portfolio, and can own no more than 10% of the voting rights of any one company. In addition to this restriction of the amount the fund can put in any one security, the vast majority of all mutual funds are investing in publicly traded securities, be they common stocks, preferred stocks, options, corporate bonds, government bonds, municipal bonds and the like. Mutual fund management teams are often wrong and sometimes can even be stupid but it is typically not a problem related to due diligence. The mutual fund industry did have a string of funds in the last decade that had disastrous returns for investors which was mostly a result of their concentrated positions in subprime debt. The successful regulatory actions and investor lawsuits against these funds were based more on the funds not following the requirements of the prospectuses, as opposed to a lack of due diligence.

The story is somewhat the same for the vast majority of registered investment advisory firms (RIAs). The reason is because, like the mutual fund industry, most RIAs trade in publicly traded securities. It is not that trading in publicly traded securities is any guarantee of success; but the securities requirements of reporting and public disclosure are so high on publicly traded companies, conducting research is a relatively easy task.

That being said, there is one glaring example that turns this on its head: Enron! Enron was not only publicly traded; it was a very widely held common stock and a favorite of institutions. Before its demise, there were approximately 14 analysts covering the company. Almost all of these analysts were fairly bullish on the stock almost to the bitter end. This article cannot attempt to retell the entire Enron story, but most everyone in the securities industry is fully aware of the debacle. The main point to consider here is the failure of due diligence. But what makes the failure of due diligence on the part of the analyst that were covering Enron so grevious is that the very earnings information that ultimately resulted in the downfall and implosion of Enron was reported in at least one of the company's 10-K's significantly before the implosion. A footnote in one of the 10-K's laid out that the vast majority of Enron's earnings came from a remote offshore "special-purpose entity". No credible analyst will admit that they did not review Enron's 10-K's, so what went wrong? The analyst either ignored or did not give the proper weight to this key information about Enron's earnings. The reason for this failure on the part of the analyst has filled volumes of books, which also resulted in numerous fines by the SEC against almost every major brokerage firm.

Would a claim of lack of due diligence be appropriate in this instance, when every analyst had a copy of the 10-K's in their due diligence file? Yes, but the claim may be as much gross negligence as it is a lack of due diligence. Arguably, the footnote in the 10-K's in and of itself might not have been enough information to cause the analysts to alter their bullish recommendation. But the footnote put the analysts on notice that there was a serious "red flag" as it relates to the quality of the earnings of Enron. The majority of these analysts did not investigate and conduct proper due diligence as it related to this footnote. Net result: a loss of roughly $11 billion for shareholders.

HEDGE FUNDS & REGULATION D OFFERINGS

Why group hedge funds and Regulation D offerings together? The answer is quite simple: there is no specific definition for a hedge fund except for the fact that it is unregistered. Decades ago, when there was a mere handful of hedge funds as opposed to the plethora of thousands that exist today, most hedge funds actually hedged. Today, most new hedge funds use the term simply because investors are flocking to hedge funds at unprecedented rates. The majority of these new hedge funds do not actually hedge; one need only read the offering materials to discover this fact. Therein lies one of the major advantages of hedge funds versus other registered and more regulated securities: hedge funds can typically do almost anything they want. It is for that reason that there is no specific definition for hedge fund; it is hard to put a title on such an amorphous product.

So how do the due diligence requirements relate to hedge funds and Reg-D offerings? The answer to that question depends on the securities regulations that apply to these two investment vehicles. First, there is the issue of who is offering or selling the underlying investment. If a brokerage firm is marketing either a Reg-D offering or hedge fund, federal and state statutes and FINRA regulations still apply. If the firm making the offering is not a brokerage firm but instead a registered investment advisory firm (RIA), once again almost all the same rules and regulations apply. By definition, a Reg-D offering is unregistered much the same as hedge funds. What many people on both sides of the fence often mistake is that unregistered does not mean unregulated. Even in the case of a hedge fund where the officers and managers are not registered or licensed with the securities industry, those individuals are not exempted from securities regulations.

For example, in the course of conducting its due diligence, a hedge fund manager discovers that the CEO and president of one of the companies that it is making a major investment in is a convicted felon. At no point does the hedge fund make this disclosure to its investors. The fact that this CEO is a convicted felon is clearly a "material fact." Under the Securities Act of 1933 section 17, it is a fraudulent act to omit a material fact to an investor. Of course, under the new Dodd-Frank Wall Street Reform and Consumer Protection Act, hedge funds are finally gaining more scrutiny.

In Regulatory Notice 10-22, Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings,[40] FINRA specifically addresses the obligation relating to due diligence and reasonable investigation into securities that brokerage firms recommend.

> 3. The Presence of Red Flags
>
> In the course of a reasonable investigation, a BD must note any information that it encounters that could be considered a “red flag” that would alert a prudent person to conduct further inquiry. Red

40. FINRA, REGULATION D OFFERINGS: OBLIGATIONS OF BROKER-DEALERS TO CONDUCT REASONABLE INVESTIGATIONS, FINRA REGULATORY NOTICE 10-22 (April, 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.

> flags might arise from information that is publicly available or information that is discovered during the course of the investigation. A BD's reasonable investigation responsibilities would obligate it to follow up on any red flags that it encounters during its inquiry as well as to investigate any substantial adverse information about the issuer.
>
> When presented with red flags, the BD must do more than simply rely upon representations by issuer's management, the disclosure in an offering document or even a due diligence report of issuer's counsel. In *Kunz and Cline*, the SEC found that the broker could not justifiably rely on financial statements in private placement memoranda that had been audited and certified by an accountant when numerous "red flags" indicated that the financial statements were inaccurate. The broker had a duty, which it failed to discharge, to conduct a further, independent investigation of the financial condition of the issuer under the circumstances.[41]

RED FLAGS

The body of securities regulations, regulatory releases, articles, and case law addressing the issue of "red flags" is a book in and of itself, but will nevertheless be briefly addressed. One of the inappropriate defenses as to why a firm did not conduct proper due diligence is: "We didn't see any reason for further investigation," "We felt comfortable with all of the information we had," and "We had an ongoing relationship and felt we could trust the key individuals." In other words, "We didn't see any "red flags" that indicated we should conduct a more thorough investigation." These explanations are all excuses, attempted justifications, and mere backpedaling. They are inappropriate and unacceptable as legal defenses against the claim of lack of due diligence.

Red flags are exactly what the due diligence process is supposed to discover in the first place! A red flag is a danger signal, a warning, a concern, an unknown risk, a conflict of interest, an alarming fact, an unanswered question or just something that doesn't add up. If a number of

---

41. *Id.* at 6 (footnotes omitted) (citing to, *inter alia*, *Everest Securities, Inc. v. Sec. & Exch. Comm'n*, 116 F.3d 1235, 1239 (8th Cir. 1997), stating that there the investigation that was performed was itself insufficient and that even a cursory investigation would have uncovered facts showing offering memorandum was materially misleading).

these red flags are known before any investigation or due diligence work is even commenced, why would an investor even consider making the investment in the first place? Not conducting proper due diligence is not only against the securities regulations; it is against the best interest of the investor. Going ahead with an investment without conducting exhaustive due diligence to completely dissect and unravel red flags is somewhere between a wanton disregard of money management standards and pure stupidity.

TWO EXAMPLES OF LACK OF DUE DILIGENCE

Following are two cases in which claimants/investors invested in a Reg-D offering (arguably a hedge fund), which in turn invested into two sub-funds which were hedge funds. Both sub-funds imploded, and a key issue in each case was a claim of lack of due diligence.

TOM PETTERS – PETTERS WORLDWIDE LLC – LANCELOT PARTNERS

Between 2002 and 2008 Gregory Bell raised approximately $2.6 billion by selling interests to both individual investors, investment funds and institutions in an unregistered securities offering called Lancelot Investment Management LLC. The business concept described in the PPM was that investors would make money from the sale of notes that would be used to finance what was called "purchase order inventory financing" or factoring, which would be conducted by a company called Petters Company. Thomas J. Petters who was roughly 50 years old and also resided in Minnesota, ran Petters Company in addition to running Petters Worldwide. Mr. Petters had a national reputation because of the aggressive growth of Petters Group Worldwide LLC; he made such acquisitions as Fingerhut Direct Marketing in 2002; Ubid in 2003; Polaroid Corporation in 2005, and Sun Country Airlines 2006. Petters Company's purchase order inventory financing operation turned out to be a complete Ponzi scheme and one of the larger ones in U.S. history.

Would proper due diligence conducted on the part of investors have prevented their losses? Absolutely!

Investors were aware that Tom Petters and his related companies (referred to as Petters Company) were receiving the vast bulk of the dollars that Lancelot was investing. Based on the knowledge that Petters was receiving the vast bulk of Lancelot's dollars, Petters was a key and instrumental individual in the entire Lancelot investment. An investment company could not properly fulfill its due diligence obligations and warranty to investors that it was conducting proper investigation and monitoring the investments made with Lancelot unless this included fully investigating Petters and his related entities. Per various regulatory releases, an investment company could not fulfill its due diligence obligations by just relying on Bell or the PPM of Lancelot, without verifying and confirming information. On this point the SEC stated in their complaint against Bell and Petters:

> Bell also took virtually no steps to verify the truth of the representations that Petters made to him. Instead, blinded by the huge fees he was receiving, Bell simply repeated Petters' story to investors and potential investors in the Funds. In doing so, Bell, and through him Lancelot Management, acted with a reckless disregard for the truth of their representations to investors and potential investors.[42]

The investment company should have taken whatever was told to them by Bell with a grain of salt because there was a natural built-in conflict of interest; Bell had a long-term relationship with Petters, and Lancelot was tied at the hip to Petters. Various articles which came out shortly after the Petters Ponzi scheme became national news pointed out that some relatively simple background checks would have discovered Petters criminal and questionable past.

Petters was charged in Colorado in 1989 with forgery, larceny and fraud. In February 1990 he was extradited from Minnesota to Colorado were he reported to prison on May 31, 1990 to serve a prison sentence for these charges. In 1990, a Minnesota state court charged Petters with two counts of theft by check in the amount of $500 – $2,500. Petters pleaded guilty to one count and the other was dismissed.[43] Greg Bell the general partner for Lancelot became aware of Petters prior criminal history in June of 2004, and the SEC faulted Bell for deliberately concealing Petters prior convictions from investors and prospective investors.

A few would-be investors stayed away. Randy Shain, who does background checks, says he researched Mr. Petters for clients around 2002 and was struck by the volume of litigation against him. "For 15 solid years, there were one to two lawsuits a year for not paying for something or not

42. Complaint in *Sec. & Exch. Comm'n v. Thomas J. Petters, et al*., *supra* note 21.
43. *Thomas J. Petters, supra* note 21.

paying for products purchased," says Mr. Shain, of First Advantage Investigative Services in New York. His clients steered clear.[44]

As it turns out, individuals like Randy Shain, who were hired to conduct due diligence work on Mr. Petters, uncovered even more than just his criminal records; they discovered that Mr. Petters had not been truthful about his college records, and that Petters had other business failures

.

WILLIAM GUNLICKS – STABLE VALUE – FOUNDERS PARTNERS

William Gunlicks was the president of Founders Partners, an investment advisory firm, which solicited investors in an unregistered offering called Founding Partners – Stable Value LLP. The investment strategy of Stable Value was the financing with securitized loans the purchase of discounted healthcare receivables by third-party entities or factoring. The Private Placement Memorandum (PPM) laid out all the specifics of how this healthcare financing/factoring would take place. After raising millions between 2004 and 2009, the fund imploded and the Securities Exchange Commission issued findings and a judgment against William Gunlicks for numerous securities violations and most predominantly section 17(a) of the Securities Act of 1933 and 10b violations of the Securities and Exchange Act of 1934.[45]

Investors in the Founders Partners – Stable Value hedge fund lost millions and were shocked and upset to find that the general partner William Gunlicks had violated numerous securities regulations. In addition to the regulations listed above, the SEC alleged that Gunlicks had represented that the investors' money would be loaned to a third party factoring company to be used purchase highly liquid, short-term commercial and healthcare receivables, when in fact the factoring company used the money to invest in longer-term, less liquid, and much riskier receivables, in addition to other impermissible uses which were not disclosed to investors.

Could individual investors and money management firms who invested millions with Mr. Gunlicks have prevented these losses if they had performed appropriate, thorough due diligence work? Absolutely!

---

44. *Roots of $3 Billion Fraud Case Lie in DVD Players, Not CDO's,* THE COMPLIANCE EXCHANGE (April 22, 2009), http://compliancex.typepad.com/compliancex/2009/04/roots-of-3-billion-fraud-case-lie-in-dvd-players-not-cdos.html.

45. William L. Gunlicks, Investment Advisors Act Release No. 3004, Admin. Proc. File 3-13820 (March 17, 2010), *available at* http://www.sec.gov/litigation/admin/2010/ia-3004.pdf.

As it turned out, the March 2010 SEC finding against Mr. Gunlicks was not his first run-in with the SEC. In December 2007, the SEC issued findings, sanctions and a cease and desist order against Mr. Gunlicks. Interestingly, the infractions that the SEC found that Mr. Gunlicks had perpetrated prior to 2007, were in many aspects similar to the same violations that the SEC found against him in 2010. Mr. Gunlicks was found to have withheld key information from investors, was self-dealing, and had violated some of the covenants and restrictions of the PPM.

Almost all of the institutions and hedge funds that invested with Gunlicks could have discovered this 2007 SEC finding with even cursory due diligence. The sad reality is some hedge funds invested millions with Mr. Gunlicks even when they had discovered his prior SEC problems. That goes beyond the issue of due diligence and enters the realm of negligence. Earlier, this article addressed the topic, "Why Conduct Due Diligence." The Gunlicks matter is a perfect example of one of the additional key necessities for conducting due diligence: bad actors have a tendency to repeat their previous bad acts.

DEFENSES TO LACK OF PROPER DUE DILIGENCE

A professional money management firm accused of not performing proper due diligence may raise the following defenses to that accusation.

PERCENTAGES TOO SMALL

The firm might state that either the dollars or the percentages being made in the investment were comparably small, and thus the necessity for more than a cursory investigation was unnecessary. For example, the money management firms may state that its total annualized investment returns were supposed to be 5% – 8%. The firm then invests 5% of available funds in a deal that goes bust. The annual results for the fund were calculated on a total return basis and the return that year was 6%, before taking into account the 5% capital or principal loss in the deal that went bust. When you take into account this 5% principal loss, the fund had a net total return of 1%. So entering year two, this fund starts with a capital base of 101% of the initial investment instead of 106%. Having less money to work with could and should affect the returns for that year and years into the future. So the argument that a 5% investment is not material is specious. Another point is how FINRA has focused on costs and how a few percentage points can be a material difference (in commissions and fees). And in this day and age of significantly reduced interest rates and yields, losing 5% means a lot more than it did 15 years ago.

WE RELIED ON SOMEONE ELSE'S DUE DILIGENCE

This tactic is reminiscent of a line from Forrest Gump – "Stupid is as stupid does". It's probably one of the single most ridiculous defenses and clearly one of the more dangerous practices. When you can barely pick up a paper without being shocked at the quality of name brand firms committing fraud and the experienced and knowledgeable people who have been defrauded, relying on someone else's due diligence should not even be a consideration. We still live in a society that believes that "bigger is better". We have actually witnessed sworn testimony where one hedge fund justified their lack of due diligence and placing of millions of dollars with another sub-advisor hedge fund by stating the following: "We called around and talked to some other highly respected money management firms and they told us they were investing with this sub advisor, that was good enough for us." Professional money managers including hedge fund managers, often make one of the worst mistakes by relying on the mere suggestion that because a very large well-known investment firm has placed money with a particular fund or manager (which is often referred to as a sub-advisor) that that is a "seal of approval" for other firms to do the same. Along with clichés like "bigger is better," let's not forget "the bigger they are the harder they fall" and "too big to fail." In many respects relying on the other "big boys" is one of the more dangerous practices a firm can utilize in performing its due diligence. There often tends to be an arrogance at these larger firms: "Of course we only invest with the best."

It is this crazy, unreliable, dangerous group mentality that has been the downfall of many investment sectors: the commercial real estate bubble of the late 80s, the telecom/tech bubble of the late 90s, and the sub-prime mortgage debt debacle in just the last decade. It is always the same mentality: "Everybody's doing it, so we should too." The story goes that investors were waiting in line and begging Bernie Madoff to take their money up until the bitter end. And that is just one of many examples. This practice is actually even used in marketing. Certain funds may list their largest investors, of course with permission. It has a multiplying effect – the bigger or more prestigious the companies that invest, the bigger and more prestigious companies that are willing to invest.

THE SEC DIDN'T CATCH THE FRAUD – SO HOW ARE WE SUPPOSED TO CATCH IT?

Many readers of this article will remember the comical antics of such groups as the Marx Brothers, the Three Stooges, and Abbott and Costello. One of the more routine movie plots was where one of these groups was hired for some major undertaking, and the audience is entertained by their bungling and this cast of characters falling all over themselves. In my experience with securities regulation, the SEC is almost always the last one to know of the wrongdoing of investment professionals. The SEC often only enters the scene after some private investor has uncovered much of the fraud, a state securities commissioner uncovers the fraud, or some employee/whistleblower steps forward and hands the SEC the case on a silver platter. [46]

It is excusable that a mere retail investor might be ignorant as to how well the securities regulators are or are not protecting their investment dollars, but it is grossly negligent for any licensed professional money management person to rely on the regulators when it comes to the investigation, due diligence, supervising, and monitoring of its investment dollars. It becomes even more comical when they use the regulators as a defense for their lack of due diligence.

SUPERVISION & COMPLIANCE AS TO HIRING AND RETENTION

The term "due diligence" in the securities industry is not limited to investigation of investments or companies. The term "due diligence" is also utilized in hiring and retaining registered representatives by broker-dealers. FINRA Rule 3010 is the "Supervision Rule." Section (e), "Qualifications Investigated" states:

> Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association.[47]

Various NASD/FINRA Regulatory Notices and Notices to Members (NTM) are more specific as to the brokerage firm's investigation into the background and qualifications of their registered representatives.

---

46. DOUGLAS SCHULZ, *supra* note 30.
47. FINRA Manual, NASD Rule 3010, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3717.

When conducting due diligence concerning a prospecting for new registered representative, the hiring firm should seek to learn the nature of the representative's business and the extent to which he or she offers investment products for which the hiring firm would need a dealer or servicing agreement in order for the representative to sell and provide service.[48]

CONCLUSION

It is a sad commentary on the investment management community that there is a need for articles such as this one, in addition to the other publications and books written on the subject of due diligence. Practicing appropriate due diligence before each and every investment is made seems as natural as hand washing before eating. Luckily for investors, they need not be content to rely on the good manners of the investment community; numerous securities regulations and interpretations make "due diligence" the law.

48. FINRA, SUPERVISION OF RECOMMENDATIONS AFTER A REGISTERED REPRESENTATIVE CHANGES FIRMS, FINRA REGULATORY NOTICE 07-36 (August 2007), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p036445.pdf; *see also* NASD, SPECIAL CONSIDERATIONS WHEN SUPERVISING RECOMMENDATIONS OF NEWLY ASSOCIATED REGISTERED REPRESENTATIVES, NASD NOTICE TO MEMBERS 07-06 (February 2007), *available at* http://www.finra.org/Industry/Regulation/Notices/2007/p018631.