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Takeaways From Broker-Dealers' Section 5 Inadequacies

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The staff of the U.S. Securities and Exchange Commission recently addressed broker-dealers' obligations when they engage in transactions in unregistered securities by issuing FAQs[1] and a risk alert[2] that reported the results of examinations of a number of broker-dealers' practices in handling unregistered securities.[3] The agency's core focus in these areas is curbing and preventing activities that undermine, or threaten to undermine, well-functioning markets, including fraud, manipulation and money laundering.[4]

Section 5's Requirements

Section 5 of the Securities Act of 1933 ("Securities Act") requires all offers and sales of securities in interstate commerce to be registered, unless an exemption from registration is available. Specifically, Sections 5(a) and 5(c) of the Securities Act prohibit any person, including broker-dealers, from using the mails or other interstate means to sell or offer to sell, either directly or indirectly, any security, unless a registration statement is in effect or has been filed with the SEC as to the offer and sale of such security, or an exemption from the registration provisions applies.[5]

A violation of Section 5 may be preliminarily established upon a showing that: (1) no registration statement was filed or in effect as to the offer and sale of the relevant securities; (2) a person, directly or indirectly, sold or offered to sell the securities; and (3) the sale or offer to sell was made through the use of the mail or other interstate facilities.[6] Unlike many other provisions that the SEC enforces, such as Section 10b-5's prohibition on securities fraud and insider trading, the SEC need not offer evidence of intent to prove a violation of Section 5(a) or 5(c).

An entity may claim an exemption from registration based on certain enumerated exemptions. Section 4(a)(1) of the Securities Act provides an exemption for the routine trading of already-issued securities, but does not exempt sales by an issuer, a control person of the issuer, or an underwriter or dealer. Section 4(a)(2) exempts sales made by an issuer not involving a public offering. Section 4(a)(3) exempts dealer transactions subject to certain conditions. And, as discussed further below, Section 4(a)(4) exempts "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders."[7]

A Broker-Dealer's Duty to Make "Reasonable Inquiry"

The FAQs issued by SEC staff clarify the obligations of broker-dealers that seek to rely on the exemption in Section 4(a)(4) to engage in unregistered transactions on behalf of their customers.[8]

"Reasonable Inquiry" Requirement

Reliance on the Section 4(a)(4) exemption requires a broker-dealer to conduct a "reasonable inquiry" into the facts surrounding a proposed unregistered sale of securities before selling the securities in order to form reasonable grounds for believing that a selling customer's part of the transaction is exempt from Section 5. The "reasonableness" of the inquiry depends on the facts and circumstances surrounding the transaction.

According to the FAQs, a broker-dealer may not simply accept "self-serving statements" of the sellers or counsel without reasonably exploring the accuracy of such statements. Moreover, where indicators, or "red flags," exist that the distribution of securities may be illegal, a broker-dealer will not escape liability merely because the relevant stock certificates lacked a restrictive legend, such as when they were transferred into the customer's account electronically, or the clearing firm or transfer agent — such as the Depository Trust Co. — did not object to the sales.

The SEC's classic formulation for the required inquiry states:

The amount of inquiry called for necessarily varies with the circumstances of particular cases. A dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for.[9]

What is a "Reasonable Inquiry"?

Consistent with SEC regulations,[10] the FAQs state that the SEC will consider the following factors, among others, in assessing the reasonableness of a broker-dealer's inquiry into an unregistered sale of securities, and thus its reliance on the exemption in Section 4(a)(4):

- the length of time the securities have been held by the broker-dealer's customer (including physical inspection of the securities, if practicable);

- the nature of the transaction in which the securities were acquired by the customer;

- the amount of securities of the same class sold during the previous three months by all persons whose sales are required to be taken into consideration in evaluating compliance with the volume limitations of Rule 144(e);[11]

- whether the customer intends to sell additional securities of the same class through any other means;

- whether the customer has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;

- whether the customer has made any payment to any other person in connection with the proposed sale of the securities; and

- the number of shares or other units of the class outstanding, or the relevant trading volume.

The FAQs further clarify that when a broker-dealer uncovers facts that may be indicative of a distribution or resale that goes beyond a typical secondary market transaction, additional inquiries may be warranted in order for the broker-dealer to rely on the Section 4(a)(4) exemption.

FINRA's Regulatory Notice 09-05 provides (at pages 6-8) a very useful high-level description of appropriate supervisory procedures and controls for unregistered resales of securities, based on its review of the procedures of firms of various sizes.

What is a "Red Flag"?

When a broker-dealer uncovers facts that may be indicative of a distribution or resale that goes beyond a typical secondary market transaction, additional inquiries may be warranted to allow the broker-dealer to rely on the Section 4(a)(4) exemption. Such "red flags" may include, but are not limited to:

- When a customer deposits a large block of recently issued shares of a little-known issuer into its account and then requests that the broker-dealer sell such shares without a registration statement in effect;

- When a customer sells securities soon after depositing them into the account;

- When a customer engages in repeat transactions in the shares of a little-known issuer;

- When an issuer of stock is a newly formed company, with little trading, operating or earnings history; or

- When a customer is engaged in stock promotion activities on behalf of the issuer.

FINRA's Regulatory Notice 09-05 includes a similar, but expanded, list that includes these additional red flags:

- When the issuer's SEC filings are not current, are incomplete or nonexistent; and

- When there is a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security.

According to the FAQs, in any of these or similar situations, a broker-dealer is "required to conduct a searching inquiry to assure itself that [its customer's] proposed sales [are] exempt from the registration requirements and not part of an unlawful distribution."[12]

Risk Alert

The risk alert summarizes the SEC staff's examinations of 22 broker-dealers identified as being frequently involved in the sale of the securities of microcap companies.[13] The examinations assessed the firms' compliance with obligations to (1) perform a "reasonable inquiry" in connection with customers' unregistered sales of securities when the firms relied on Section 4(a)(4)'s exemption (see discussion above) and (2) file suspicious activity reports (SARs), as required under the Bank Secrecy Act and the Securities Exchange Act of 1934 ("Exchange Act"), in response to "red flags" related to such sales.[14] Such obligations are viewed by the SEC as important safeguards against harmful market activity.

Examination Process

The examinations focused not only on the controls the broker-dealers had implemented, but also on whether those controls operated effectively. In particular, SEC staff scrutinized the broker-dealers' sales of large blocks of shares of microcap issuers that were also the subject of significant promotional efforts.

Examination Findings

As a result of the exams, OCIE issued letters of deficiency for material control weaknesses and/or potential violations of law to more than 80 percent of the 22 firms examined. OCIE also referred the vast majority of the firms examined to the Division of Enforcement or another regulatory agency for further consideration of whether violations of law occurred. Highlights of the findings follow.

Reasonable Inquiry Requirement. The majority of the 22 broker-dealers had adopted supervisory policies and procedures regarding conducting a "reasonable inquiry" when relying on Section 4(a)(4) of the

Securities Act. However, SEC staff identified certain deficiencies in their design and/or implementation, including:

- Insufficient detail in the firms' policies and procedures to assist relevant employees in identifying potential red flags;

- Reliance, without further inquiry, on the absence of restrictive legends on stock certificates to conclude that the securities could be resold in unregistered transactions; and

- Failure to collect information from customers on the origin of large blocks of shares in the customers' accounts.

SARs. Some firms failed to file SARs, in violation of the Bank Secrecy Act and the firms' own policies and procedures, when encountering unusual or suspicious activity in connection with customers' sales of microcap securities. The risk alert noted that indications of this activity had been identified by the examined broker-dealers, including:

- Unusual trading patterns in the issuers' securities, such as sudden spikes in trading price and volume;

- Patterns of trading activity shared by multiple customers, including sales of large quantities of the shares of multiple issuers by the customers;

- Notification of potentially suspicious activity by the broker-dealers' clearing firms;

- Requests from FINRA for information relating to issuers and the broker-dealers' customer accounts; and

- The presence of certain types of accounts in the sale of the shares of the microcap issuers, such as those that provide anonymity to the beneficial owners.

Takeaways

There is no question that the SEC and the Financial Industry Regulatory Authority currently are highly focused on Section 5 compliance and related issues of anti-money laundering compliance and microcap

manipulation. The issues appear repeatedly in their examinations. FINRA views supervisory failures in complying with Section 5 obligations as an opportunity to demand improvements in firms' controls, policies and procedures. And the SEC views Section 5 supervisory failures as a gateway to more serious violations that threaten the integrity of the markets.

Broker-dealers — particularly mid-sized and smaller firms — are continually confronted with the decision of whether the revenue from accepting and selling large quantities of lower-priced stocks is worth the costs of adequate compliance or the risks that the stocks that appear to be freely tradable will turn out to be the subject of an improper scheme. Given the current regulatory climate, firms should take the following steps:

- Review their supervisory procedures and make sure that they line up with the supervisory procedures and controls outlined in the FAQs and FINRA Regulatory Notice 09-05.

- Review the risk alert and consider whether their policies, procedures and practices have the same deficiencies.

- Provide training to all supervisory and compliance personnel as to the procedures to follow when considering whether to transact in large quantities of low-priced stocks. Such training should address, at a minimum:

    - Red flags;
    - Procedures for escalating a decision of whether to engage in a proposed transaction that implicates Section 5 issues;
    - The need to document all decisions involving such potential transactions; and
    - Suspicious-activity reporting.

- Consider conducting a "look-back" of transactions in low-priced securities over a previous period to determine whether the firm should have conducted any additional inquiry or reported them as suspicious activity.

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[1] SEC, Responses to Frequently Asked Questions About a Broker-Dealer's Duties When Relying on the Securities Act Section 4(a)(4) Exemption to Execute Customer Orders (Oct. 9, 2014), http://www.sec.gov/divisions/marketreg/faq-broker-dealer-duty-section4.htm.

[2] SEC, Office of Compliance Inspections and Examinations, National Exam Program Risk Alert: Broker-Dealer Controls Regarding Customer Sales of Microcap Securities, Vol. IV, Issue 3 (Oct. 9 2014), available at http://www.sec.gov/about/offices/ocie/broker-dealer-controls-microcap-securities.pdf.

[3] The SEC also announced an enforcement action and settlement under which two firms agreed to disgorge more than $1.5 million and pay a combined penalty of $1 million for allegedly improperly selling billions of shares of microcap, or "penny," stocks through such unregistered offerings.

[4] See id. ("Broker-dealers serve an important gatekeeping function that helps prevent microcap fraud by taking measures to ensure that unregistered shares don't reach the market if the registration rules aren't being followed.").

[5] 15 U.S.C. § 77e(a), (c). Violations of Section 5 of the Securities Act may also constitute violations of Financial Industry Regulatory Authority (FINRA) rules, including NASD Rules 2710 (Corporate Financing Rule — Underwriting Terms and Arrangements), 2720 (Distribution of Securities and Affiliates — Conflicts of Interest), and 2810 (Direct Participation Programs). Thus, while this article focuses on SEC regulatory and enforcement initiatives with respect to Section 5, broker-dealers should consider related FINRA rules in designing and implementing compliance programs.

[6] See SEC v. Cavanagh, 445 F.3d 105, 111 n.13 (2d. Cir. 2006).

[7] 15 U.S.C. § 77d(a)(1)-(4).

[8] In 2009, FINRA also issued a regulatory notice relating to unregistered resales of securities, including Section 4(a)(4). The notice identified situations in which firms should conduct a searching inquiry to comply with their regulatory obligations under the federal securities laws and FINRA rules. The notice also approvingly discussed procedures that various large, medium and small firms implemented to address compliance. FINRA, Regulatory Notice 09-05, "Unregistered Resales of Restricted Securities" (Jan. 2009), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117716.pdf.

[9] Securities Act Rel. No. 4445, 1962 SEC LEXIS 74 (Feb. 2, 1962) (cited in FINRA Regulatory Notice 09-05, at 4).

[10] 17 C.F.R. § 230.144(g)(4), Note (ii).

[11] Rule 144 generally provides a safe harbor for the sale of restricted or controls securities. See 17 C.F.R. § 144.

[12] In the Matter of Midas Securities LLC and Jay S. Lee, Exchange Act Release No. 66200, 14 (Jan. 20, 2012) (Commission opinion).

[13] The term "microcap" applies to companies with low or "micro" capitalizations, meaning the total value of the company's stock. See SEC, Microcap Stock: A Guide for Investors, http://www.sec.gov/investor/pubs/microcapstock.htm.

[14] Exchange Act Section 17(a) and Rule 17a-8 require broker-dealers to comply with the record-keeping, record retention and reporting obligations of the Bank Secrecy Act and the related regulations. Under these regulations, broker-dealers must file an SAR with the Financial Crimes Enforcement Network to report any transaction (or a pattern of transactions of which the transaction is a part) by, at, or through the broker-dealer involving or aggregating funds or other assets of at least $5,000 that it "knows, suspects, or has reason to suspect": (1) involves funds derived from illegal activity or is conducted to disguise funds derived from illegal activities; (2) is designed to evade any requirements of the Bank Secrecy Act; (3) has no business or apparent lawful purpose and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts; or (4) involves use of the broker-dealer to facilitate criminal activity. See 31 C.F.R. § 1023.320.