Legal Alert: What Does It Take to Make the SEC Happy? SEC Criticism of Broker-Dealers’ Due Diligence for Sales of Unregistered Securities Leaves More Questions Than Answers

October 23, 2014

To ensure that broker-dealers (BDs) do not inadvertentl \-
\-y facilitate an unlawful
distribution of securities, the Securities and Exchange Commission has long
required BDs to conduct a “reasonable inquiry” into the circumstances
surrounding their customers’ claimed registration exemptions for transactions
involving unregistered securities. However, the SEC recently injected confusion
into this area by reaching a $1 million settlement with two BDs whose due
diligence procedures appear, at times, to have been quite thorough.1

Although the settlement gives plenty of suggestions—but no answers—as to
where the Commission’s concerns lie, one thing is clear: to the extent the SEC
meant to criticize the BDs’ reactions to red flags identified during due diligence,
rather than the BDs’ efforts to detect red flags, the settlement’s vagueness
inevitably raises the suspicion that the Commission was guided more by 20-20
hindsight than by established law. The result is confusion; the Commission has
given BDs little guidance on what practices it considers sufficient to satisfy a
BD’s obligations under the Securities Act. Instead, BDs are now left to guess at
whether the Commission merely issued a muddled settlement that largely
reaffirms established law, or whether the Commission has utilized an
enforcement action, rather than rulemaking, to impose heightened obligations on
BDs that sell thinly traded securities.

I. The Securities Act’s Brokers’ Exemption and the Duty of Reasonable
Inquiry

Section 5 of the Securities Act of 1933 generally prohibits offers or sales of
unregistered securities unless one of several exemptions, listed in Section 4 of
the Securities Act, applies. Among those registration exemptions, Section
4(a)(4)’s so-called “brokers’ exemption” exempts from registration “brokers’
transactions executed upon customers’ orders on any exchange or in the over-
the-counter market but not the solicitation of such orders.” However, as its name
suggests, the brokers’ exemption applies only to a broker’s portion of a
securities transaction and is therefore “not available if the broker knows or has
reasonable grounds to believe that the selling customer’s part of the transaction
is not exempt from Section 5 of the Securities Act.”2 As a consequence,
“[b]rokers . . . have a duty of inquiry into the facts surrounding a proposed sale”
to ensure that the “customer’s part of the transaction” involving unregistered
securities is itself also exempt from Section 5.3 (This is most frequently an issue
when an individual, who might ordinarily be exempt from Section 5’s registration
requirement by Section 4(a)(1) of the Securities Act, engages in a “distribution”
of securities and is therefore deemed an “underwriter” under Section 2(a)(11) of
the Act.)

Contacts
If you have any questions about this Legal Alert, please feel free to contact
any of the attorneys listed or the Sutherland attorney with whom you
regularly work.

Bruce M. Bettigole
Partner
bruce.bettigole@sutherland.com
202.383.0165

Charlie M. Kruly
Associate
charles.kruly@sutherland.com
202.383.0952

Related People/Contributors
• Peter J. Anderson
• Eric A. Arnold
• Keith J. Barnett
• Bruce M. Bettigole
• Patricia A. Gorham
• Olga Greenberg
• Clifford E. Kirsch
• Michael B. Koffler
• Susan S. Krawczyk
• Neil S. Lang
• S. Lawrence Polk
• Brian L. Rubin
• Amelia Toy Rudolph
• Holly H. Smith
• W. Scott Sorrels
• John H. Walsh
• Bryan M. Ward
• Charlie M. Kruly
The SEC has long taken the position that the extent of a BD’s “duty of inquiry” under Section 4(a)(4)’s brokers’ exemption is informed largely by the number and the seriousness of the “red flags” that appear during the course of a transaction involving unregistered securities. As the SEC’s classic summary of a BD’s obligation states:

The amount of inquiry called for necessarily varies with the circumstances of the particular case. 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.4

In other words, the more red flags a BD observes during the course of a transaction, and the more serious those flags appear to be, the more in-depth the BD’s inquiry into the customer’s claimed Section 5 exemption must be. This is not to say, however, that a BD can, in most cases, simply act as a passive facilitator of a sale of unregistered securities; the SEC and FINRA have both suggested that before engaging in a transaction involving unregistered securities, a BD must make “certain routine inquiries of customers”—in other words, affirmative steps—designed to elicit information that might identify a possible unlawful distribution of securities.5 For example, the SEC has suggested that BDs ask customers:

- “[W]hether the customer has direct or indirect connections with any publicly owned company or with the issuer;
- “[W]hat his financial condition is (so that the broker-dealer may determine whether it is consistent with the value of the securities to be sold);
- “[W]hether the customer’s securities were acquired on the open market;
- “[W]hether he is the true beneficial owner of them; [and]
- “[W]hether he has non-public information about the issuer and whether he is currently selling or attempting to sell the same securities through other brokerage houses.”6

Similarly, FINRA has identified interpretative notes from SEC Rule 144 (which creates a safe harbor for sales of unregistered securities) as “a pragmatic
Legal Alert: What Does It Take to Make the SEC Happy?

SEC Criticism of Broker-Dealers’ Due Diligence for Sales of Unregistered Securities Leaves More Questions Than Answers

continued

guideline in determining what questions securities firms should ask their customers before engaging in an unregistered resale of securities.7 According to FINRA, these questions might include, among others:

• “How long has the customer held the security?

• Does the customer intend to sell additional shares of the same class of securities through other means?

• Has the customer solicited or made any arrangement for the solicitation of buy orders in connection with the proposed resale of unregistered securities?

• Has the customer made any payment to any other person in connection with the proposed resale of the securities? and

• How many shares or other units of the class are outstanding, and what is the relevant trading volume?8

A customer’s responses to any of these questions may trigger a “duty to make further inquiries and verify the information received.”9 Likewise, the SEC and FINRA have also noted that in addition to answers arising from these “routine inquiries,” a transaction involving unregistered securities might raise “[o]ther ‘red flags’” that are suggestive of an unlawful distribution and that might therefore trigger a duty of further inquiry.10 For example, among the classic red flags suggestive of an unlawful distribution, FINRA and the SEC have advised BDs to look for “customers liquidating stock shortly after deposit, the stock being thinly-traded, or the issuer being newly formed or recently experiencing a change in control.”11

II. The SEC’s Recent Focus on Broker-Dealers’ Due Diligence of Sales of Unregistered Securities

This law has been relatively well-settled for decades. However, the SEC has recently caused a stir by simultaneously issuing three releases: (1) an Office of Compliance Inspections and Examinations (OCIE) Risk Alert, Broker-Dealer Controls Regarding Customer Sales of Microcap Securities,12 summarizing the findings of a recent OCIE examination sweep; (2) answers to a list of frequently asked questions, which “remind[ed] broker-dealers of their obligation to conduct a reasonable inquiry” when using the Section 4(a)(4) brokers’ exemption to sell unregistered securities;13 and (3) a settled administrative proceeding imposing a $1 million fine and disgorgement on a large broker-dealer for deficient inquiries into sales of unregistered securities.14 The first two SEC releases add little to the state of the law under Section 4(a)(4); OCIE’s sweep is most notable because it resulted in “[t]he overwhelming majority of the firms examined [being] referred”
for potential enforcement action, while the Division of Trading and Market’s Frequently Asked Questions largely reaffirm the long-standing elements of a BD’s “reasonable inquiry” discussed above. However, the Division of Enforcement’s settled enforcement action muddies the waters. By failing to clearly state the deficiencies the Commission identified in the case, the enforcement action has, at best, caused unnecessary confusion as to what constitutes a “reasonable inquiry” under Section 4(a)(4) or, at worst, appears to be a quiet attempt to push the envelope beyond what current law requires, potentially increasing the burden on BDs to ensure that they are complying with Section 4(a)(4).

The SEC’s enforcement action, which involved two affiliated BDs, arose from three customers’ “routine[ ] deposit[s]” of “large quantities of newly issued penny stocks that they had acquired from little known, non-reporting issuers, through private transactions” over a four-year period. According to the SEC, “[s]hortly after the three customers deposited these securities, the customers placed orders for [the BDs] to sell these securities to the public . . . without any registration statements being in effect.” The Commission thus observed, consistent with past guidance, that these activities likely constituted red flags that should have triggered further inquiry into the transactions.

But the Commission then gave little consideration to substantial due diligence efforts by the BDs—efforts that increased over the two review periods the Commission identified. During the first period, lasting three years, the Commission noted that the BDs “initially did not ascertain the specific exemptions [from registration] on which the customers were relying” and “did not ask the customers to submit documentation, such as attorney opinion letters, that may have helped substantiate the availability of an exemption.” Further, the BDs “did not become aware of any other exemptions [from registration] potentially available to” two of the three customers at issue. However, during the first review period, the BDs did not allow its customers to sell unregistered securities without question; as the Commission noted, among other things, “prior to accepting [two customers] [the BDs] inquired as to the nature of [the customers’] intended trading activities” and “on multiple occasions, [the BDs] visited the offices of [two customers] in New York in an effort to gain comfort that they were responsible customers.” Further, the BDs “reviewed the trading history for securities that [two customers] had already resold, to assess whether those securities had been subject to market manipulation.”

During the second review period, the BDs “expanded their review of pending security deposits by [two customers] under a process [the BDs] referred to as the Enhanced Due Diligence review.” Under the “enhanced” review process, the customers submitted “[w]ith each pending security deposit” an attorney opinion letter that the BDs “regularly reviewed . . . to identify the registration exemption on which [the customers] were relying and to verify that the securities described in the letters matched the related deposits.” Although the Commission faulted the BDs for “not independently verify[ing] the facts forming
Legal Alert: What Does It Take to Make the SEC Happy?
SEC Criticism of Broker-Dealers’ Due Diligence for Sales of Unregistered Securities Leaves More Questions Than Answers
continued

the basis for [the attorneys’] opinions,” the BDs did “research[] the attorneys who had authored the opinions to identify any potentially negative information about them, including confirming that the attorneys were not on a list of banned attorneys maintained” by the Pink Sheets.26

With the exception of the BDs’ reliance on the attorney opinion letters, each of these steps, particularly those taken during the “enhanced” review period, were consistent with previous Commission guidance, making it difficult to determine how, exactly, the BDs’ inquiries fell short. However, most troubling from the perspective of a BD trying to learn from the Commission’s enforcement action, the SEC then acknowledged in a footnote that the BDs conducted additional research into the securities at issue in the case. As part of their “enhanced” review program, “[p]rior to accepting each penny stock deposit from the customers, and for each such stock, [the BDs] reviewed, among other things: the security’s rating on pinksheets.com, six month trading charts showing price and volume and the SEC’s website to determine if there were any actions against the issuer or those affiliated with it. [The BDs] also obtained confirmation of shares outstanding from the transfer agent and conducted internet searches to learn information about the issuer, its affiliates, or a potential stock promotion.”27

According to the SEC, however, the additional steps undertaken during the BDs’ “enhanced due diligence” review were “not sufficient” because they either “revealed facts that called into question whether the claimed exemptions [by the firms’ customers] were available, or they did not address sufficiently facts that were necessary to support the claims of [two customers] that those exemptions were available to them.”28 In particular, the Commission took issue with the BDs’ reliance on its customers’ attorney opinion letters, which “did not provide [the BDs] with a reasonable basis upon which to conclude that the claimed exemptions were available,” because: (1) “[the BDs] were aware of facts that should have called into question whether the representations that the customers and the issuers made to attorneys who issued the opinions were accurate”; (2) “nearly all of the letters were based primarily on conclusory representations by the issuers and [two customers]”; (3) “some of the letters described facts to support the tacking of holding periods that should have put [the BDs] on notice that such tacking was not permitted, and thus the claimed exemption was not available”; and (4) “nearly half of the letters did not describe all of the elements of the exemptions they identified and they did not describe facts showing that those elements were met.”29 The Commission provided no further details as to any of these points, relying instead on conclusory statements that the BDs should have known that the transactions were improper.

III. Identifying the Commission’s Concerns: Reaffirming the Status Quo or Rulemaking by Enforcement?

Beyond its criticism of the BDs’ reliance on attorney opinion letters, the Commission’s enforcement action gives little guidance as to how, exactly, the
BDs’ review policies were deficient and what else the BDs could have done as part of their Section 4(a)(4) “reasonable inquiry” obligation. This is troubling for firms trying to maintain compliance with the Securities Act. In particular, the Commission’s enforcement action is amenable to several different interpretations, each of which could have a different effect on BDs’ sales of unregistered securities.

First, the enforcement action could be seen largely as a criticism of the BDs’ somewhat modest inquiry during the initial three-year period at issue in the case. However, if this is the SEC’s area of concern, the Commission does not identify whether any of the BDs’ practices during the first period of review were, as they would seem to be, not only acceptable, but perhaps beyond what might ordinarily be required. In particular, during the initial period of review, the BDs made “multiple” visits to customers’ offices “in an effort to gain comfort that they were responsible customers” and also reviewed “the trading history for securities that [two customers] had already resold, to assess whether those securities had been subject to market manipulation.”30

Second, the Commission gives hints that it believes that the BDs should have conducted a number of review steps earlier than they ultimately did. For example, the Commission notes that the BDs did not “initially” identify its customers’ claimed registration exemptions,31 and elsewhere suggests that some practices, such as visiting the customers’ offices and reviewing their trading history for signs of market manipulation—neither of which occurred until at least two years into the BDs’ relationships with the customers—should have occurred earlier. However, the Commission gives no suggestion as to whether practices such as these would have been sufficient under Section 4(a)(4) if they had occurred earlier.

Third, given that the Commission reserved its only real analysis of the BDs’ deficiencies for their reliance on the customers’ attorney opinion letters, the enforcement action could be seen primarily as a reaffirmation of the Commission’s long-standing policy that attorney opinion letters cannot always be taken at face value.32

Fourth, and most troubling, the enforcement action could be interpreted as a signal that the Commission views even some of the BDs’ “enhanced” due diligence practices as inadequate to satisfy Section 4(a)(4). Notably, as the Commission acknowledged in a footnote, “[p]rior to accepting each penny stock deposit from the customers, and for each such stock, [the BDs] reviewed, among other things: the security’s rating on pinksheets.com, six month trading charts showing price and volume and the SEC’s website to determine if there were any actions against the issue or those affiliated with it. [The BDs] also obtained confirmation of shares outstanding from the transfer agent and conducted internet searches to learn information about the issuer, its affiliates, or a potential stock promotion.”33 Once again, however, the Commission does not indicate whether even these practices might be insufficient to satisfy Section
4(a)(4).

Finally, the enforcement action could simply be viewed as a criticism of the BDs’ review policies as a whole. However, if this is the case, the enforcement action lacks context that might help other BDs modify their current practices. For example, the Commission notes that the additional inquiries conducted under the BDs’ “enhanced due diligence” programs were “not sufficient,” in part because they “revealed facts that called into question whether the claimed exemptions were available.”34 However, the Commission does not state whether any additional inquiry could have satisfied the firms’ obligations and, if so, what that additional inquiry might look like. Once again, BDs are simply left to guess at what the Commission views as adequate under Section 4(a)(4).

This enforcement action will likely not be the last word on what controls are required of BDs that sell unregistered securities. As noted earlier, the SEC’s Office of Compliance Inspections and Examinations referred “[t]he overwhelming majority of the firms examined” in its sweep for possible enforcement action, which should result in some clarification on what practices the Commission views as adequate under Section 4(a)(4). However, given the number of avenues the Commission left open for itself in its most recent enforcement action, for now, BDs are left to simply read the Commission’s tea leaves.

---

2 In re Midas Securities LLC & Jay S. Lee, Release No. 34-66200 at 13 (SEC 2012) (internal quotation marks omitted) (emphasis added); see also In re Jacob Wonsover, Release No. 34-41123 at 7 (SEC 1999) (“The Section 4(4) exemption . . . is unavailable to any broker-dealer acting as an agent when the broker knows or has reasonable grounds to believe that his principal is an underwriter.”). 
3 Midas at 13 (internal quotation marks omitted). See also In re ACAP Financial Inc., Release No. 34-70046 at 4 (SEC 2013) (“[i]t is essential for broker-dealers and their associated persons, in determining whether a sale of securities is exempt from registration under the Securities Act, to make routine inquiries of customers, as well as conduct independent inquiries as a matter of course regarding the possibility of an unlawful distribution.”) (internal quotation marks omitted). 
5 Sales of Unregistered Securities by Broker-Dealers, Release Nos. 33-5168; 34-9239 (SEC 1971) [hereinafter 1971 SEC Distribution Release]. See, e.g., ACAP Financial at 5 (finding a broker-dealer’s investigation of a purportedly exempt transaction deficient where “[n]o one at [the broker-dealer] would undertake any effort to determine how the customer obtained the stock, how long the customer had held it, what the customer paid for the stock, or whether the customer was an officer, director, control person, or otherwise an affiliate of the issuer”). 
7 Unregistered Resales of Restricted Securities, FINRA Notice to Members 09-05 at 5 (Jan. 2009). FINRA’s suggestions come from the interpretative notes to SEC Rule 144(g)(4). 
8 Id. In addition, FINRA suggests that “[f]irms should also try to physically inspect share certificates, if possible, as an opportunity to identify red flags and deter risks from forgery and fraudulent certificates.” Id.
Legal Alert: What Does It Take to Make the SEC Happy? SEC Criticism of Broker-Dealers’ Due Diligence for Sales of Unregistered Securities Leaves More Questions Than Answers continued


10 In re ACAP Financial at 4. See also FINRA NTM 09-06 at 3-4 (identifying similar factors and several other indicia of a potentially unlawful distribution such as “[s]hare certificates referenc[ing] a company or customer name that has been changed or that does not match the name on the account,” “[t]he lack of a restrictive legend on deposited certificates seem[ing] inconsistent with the date the customer acquired the securities or the nature of the transaction in which the securities were acquired,” and “[t]here [being] a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security”).

11 ACAP Financial at 4.


15 See supra note 12 at 1.

16 Supra note 14 at 2.

17 Id.

18 Id.

19 Id. at 2-3.

20 Id. at 4-5.

21 Id. at 4-5.

22 Id. at 5.

23 Id.

24 Id.

25 Id.

26 Id. The “prohibited attorney list” maintained by OTC Markets (the successor to the Pink Sheets) is made up of attorneys against whom the SEC has brought enforcement actions. See Prohibited Attorney List, OTC MARKETS, available at http://www.otcmarkets.com/research/prohibited-attorney.

27 Id. at 5 n.5.

28 Id. at 8.

29 Id. at 9.

30 Id. at 5.
Legal Alert: What Does It Take to Make the SEC Happy?
SEC Criticism of Broker-Dealers’ Due Diligence for Sales of Unregistered Securities Leaves More Questions Than Answers

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed under ‘Related People/Contributors’ or the Sutherland attorney with whom you regularly work.

31 Id. at 2-3.

32 See Distribution by Broker-Dealers of Unregistered Securities, Release Nos. 33-4445; 34-6721 (SEC 1962) (‘It is not sufficient for [a broker-dealer] merely to accept self-serving statements of his sellers and their counsel without reasonably exploring the possibility of contrary facts.’) (internal quotation marks omitted).

33 Supra note 14 at 5 n.5.

34 Id. at 8.