

Chapter 1A

What Is a Broker-Dealer?

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§ 1A:1 Exchange Act Registration Requirement

§ 1A:1.1 Section 15

A central element of the investor protection scheme established by the federal securities laws is the comprehensive framework for the registration and regulation of persons engaged in the business of buying and selling securities.

The Securities Exchange Act of 1934 (“Exchange Act”) is the primary federal legislation governing “brokers” and “dealers” in securities.¹ With certain exceptions, section 15 of the Exchange Act requires registration with the Securities and Exchange Commission (SEC) of all broker-dealers using interstate commerce or the facilities of any national securities exchange to effect transactions in

1. As discussed below, the Exchange Act defines a “broker” and a “dealer” differently. However, most rules do not distinguish between a “broker” or a “dealer” in their application. In the rest of this chapter, the term “broker-dealer” will be used unless there is a need to distinguish between a “broker” and a “dealer.”

securities (other than exempted securities² and certain short-term debt instruments). The Exchange Act, rules of the SEC thereunder, and the rules of self-regulatory organizations (SROs) prescribe an extensive scheme of regulation for broker-dealers. Certain Exchange Act provisions and implementing rules apply to all broker-dealers, whether or not registered, whereas others only apply to those registered with the SEC (“Registered Broker-Dealers”).

Section 15, as originally enacted in 1934 (“Original Section 15”), did not impose specific registration requirements on broker-dealers. Instead, Original Section 15 delegated to the SEC the authority to prescribe rules regulating over-the-counter (OTC) transactions.³ Under this authority, the SEC promulgated rules requiring the registration of all broker-dealers involved in OTC transactions. Regulation of transactions on national securities exchanges was mostly conducted by registered exchanges pursuant to their internal rules. In 1936, Congress codified the rules promulgated by the SEC, making registration mandatory.⁴ Section 15, however, initially excluded broker-dealers who traded exclusively on national securities exchanges. As a result, various classes of exchange members, such as specialists, floor traders, and so-called \$2 brokers, all of whom performed vital roles for the market, were not subject to the oversight of the SEC.⁵ To strengthen the authority of the SEC as part of a regulatory reform following the paperwork crisis of 1968–1970, Congress passed the Securities Acts Amendments of 1975,⁶ which eliminated that exclusion and enacted section 15(a) in its current form.⁷

The underlying policy for the broker-dealer registration requirement and associated regulatory framework is to provide important

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2. Exchange Act § 3(a)(12) defines “exempted security” to include: (i) government securities; (ii) municipal securities; (iii) interest in common trust fund that is not an investment company; (iv) interest in a single or collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company in connection with a qualified plan; (v) security issued in any pooled income fund, collective trust fund, collective investment fund, or similar fund that is not an investment company; (vi) security issued in any church plan, company or account that is not an investment company; and (vii) other securities exempted by the SEC by rules and regulations. However, 3(a)(12) provides that “municipal securities” are not deemed exempted securities for the purposes of the section 15 registration requirement.
 3. Original Section 15.
 4. See Exchange Act § 15(a), (b), and (c), enacted by Pub. L. No. 621, 49 Stat. 1375, 1377 (1936).
 5. See H.R. REP. NO. 94-123, 94th Cong., 1st Sess.; H.R. 4111 (1975).
 6. Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97.
 7. See H.R. REP. NO. 94-123, 94th Cong., 1st Sess.; H.R. 4111 (1975).

safeguards to investors.⁸ The Exchange Act's regulatory scheme is designed to ensure that all Registered Broker-Dealers and their associated persons satisfy professional standards, have adequate capital, treat their customers fairly, and provide adequate disclosures to investors.⁹

Section 15(a)(1) compels registration of most broker-dealers by prohibiting the use by any broker or dealer of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered with the SEC in accordance with the Exchange Act.¹⁰ The registration requirement extends not just to entities, but also to natural persons (other than natural persons who are associated with a broker-dealer).¹¹

Sections 1A:2 and 1A:3 below discuss the definitions of "broker" and "dealer."

Section 1A:4 below discusses the definition of "security" for purposes of the Exchange Act's registration requirements, and, section 1A:5 discusses "exempted securities."

Section 1A:6 explores the extent to which broker-dealers engaged in purely intra-state activities enjoy an exemption from federal registration requirements, and section 1A:7 discusses various other exemptions (including for banks and foreign broker-dealers), and the SEC's exemptive authority with respect to broker-dealer registration generally.

§ 1A:1.2 Consequences of Registration

Once registered, a Registered Broker-Dealer is subject to numerous compliance requirements and obligations under the Exchange Act, as well as rules and regulations promulgated thereunder. The compliance requirements include: meeting certain standards of operational capability and standards of training, experience, competence, and other qualifications established by the SEC;¹² becoming a member of a

8. See Persons Deemed Not To Be Brokers, SEC Release No. 34-20943 (May 9, 1984) [hereinafter Rule 3a4-1 Proposing Release].

9. *Id.*; *Eastside Church of Christ v. Nat'l Plan Inc.*, 391 F.2d 357, 382 (5th Cir. 1968).

10. See Exchange Act § 15(a)(1).

11. "Person associated with a broker or dealer" is defined in Exchange Act § 3(a)(18).

12. Exchange Act § 15(b)(7); Rule 15b7-1. References in this chapter to "Rules" shall be to rules and regulations of the SEC under the Exchange Act, unless otherwise specified.

self-regulatory organization;¹³ being subject to investigations,¹⁴ inspections,¹⁵ and disciplinary actions¹⁶ by the SEC; complying with minimum net capital requirements,¹⁷ customer protection rules,¹⁸ specific record keeping, financial compliance, and financial reporting requirements.¹⁹ Registered Broker-Dealers are also subject to the general anti-fraud and anti-manipulation provisions of the federal securities laws and implementing rules, as well as specific antifraud requirements.²⁰ Registered Broker-Dealers must also establish, maintain, and enforce policies and procedures reasonably designed to prevent insider trading,²¹ and comply with rules limiting extensions of securities-related credit to customers under certain circumstances.²² Registered Broker-Dealers are also subject to anti-money laundering regulations²³ and many other requirements and obligations under the securities laws, rules, and regulations thereunder.

One of the most important requirements for broker-dealers, however, may be the obligation to be a member of an SRO, which includes national securities exchanges and registered securities associations. A broker-dealer must join the Financial Industry Regulatory Authority (FINRA),²⁴ unless it:

- (i) is a member of a national securities exchange;
- (ii) carries no customer accounts; and

13. Exchange Act § 15(b)(8).

14. Exchange Act § 21.

15. Exchange Act § 15(b)(2)(C); Rules 15b2-2, 17d-1.

16. Exchange Act § 15(b)(4), (5) and (6).

17. Exchange Act § 15(c)(3); Rules 15c3-1, 15c3-3 and 17a-11.

18. See Rules 15c3-3, 15c3-2, and 8c-1.

19. See Rules 17a-3, 17a-4, 17a-5, and 17a-11.

20. See Securities Act of 1933, § 17(a); Exchange Act §§ 9(a), 10(b), and 15(c)(1) and (2). As noted in Subsection C below, these requirements also apply to unregistered broker-dealers.

21. Exchange Act § 15(f).

22. Exchange Act § 11(d); Regulation T of the Board of Governors of the Federal Reserve System.

23. Broker-dealers have broad obligations under the Bank Secrecy Act (BSA) to guard against money laundering and terrorist financing. Rule 17a-8 requires broker-dealers subject to the Currency and Foreign Transactions Reporting Act of 1970 to comply with certain reporting and recordkeeping requirements; SRO rules (e.g., NASD Rule 3011 and Incorporated NYSE Rule 445) also require broker-dealers to establish anti-money-laundering compliance programs.

24. The Financial Industry Regulatory Authority (FINRA) was renamed from the National Association of Securities Dealers, Inc. (NASD) in July 2007, in order to reflect the combination of the NASD's regulatory arm with that of the New York Stock Exchange (NYSE).

- (iii) has annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than \$1,000.²⁵

In addition, the Securities Investor Protection Act of 1970 (codified at 15 U.S.C. § 78aaa through §78iii) requires that a Registered Broker-Dealer become a member of the Securities Investor Protection Corporation (SIPC),²⁶ with limited exceptions. Membership in a national securities exchange, FINRA or SIPC subjects a broker-dealer to the rules and requirements of that organization.

§ 1A:1.3 Application of Certain Rules to Broker-Dealers Even If Not Registered

Regardless of whether a broker-dealer is required to register, it is still subject to the fraud, manipulation, and insider trading prohibitions²⁷ under the federal securities laws, if it transacts in²⁸ securities. Section 17(a) of the Securities Act of 1933 (“Securities Act”) prohibits any person from committing fraud in securities transactions.²⁹ Exchange Act § 9(a) makes it unlawful for any person to engage in market manipulation practices or make false or misleading statements to induce securities transactions.³⁰ Exchange Act § 10(b) outlaws the use of any manipulative or deceptive device or contrivance in securities transactions.³¹ Exchange Act § 15(c) prohibits all broker-dealers, including municipal securities dealers and government securities broker-dealers, from engaging in or inducing transactions of securities by means of any manipulative, deceptive, or other fraudulent device or

25. See Exchange Act § 15(b)(8) and Rule 15b9-1.

26. SIPC was created under the Securities Investor Protection Act of 1970 and it administers a fund which provides insurance for brokerage firm customers against losses arising out of financial failures of brokerage firms.

27. See Securities Act § 17(a); Exchange Act §§ 9(a), 10(b), and 15(c)(1) and (2).

28. See *SEC v. Clean Care Tech., Inc., et al.*, 08 CIV 01719 (S.D.N.Y. Feb. 21, 2008); *SEC v. Braintree Energy, Inc.*, Civil Action No. 100:07-cv-10307 (D.Ma. Feb. 21, 2007); *SEC v. Corp. Relations Group, Inc., et al.*, Civil Action No. 99-1222-CV-22-A (M.D. Fla. Sept. 27, 1999); *SEC v. Staples, et al.*, Case No. 98-1061-CV-22c (M.D. Fla. Sept. 24, 1998); Vorys, Sater, Seymour and Pease, Letter to Edward R. Schrag, Jr., SEC No-Action Letter (Sept. 3, 1991); Registration Requirements for Foreign Broker-Dealers, SEC Release No. 34-27017 (July 11, 1989) [hereinafter Rule 15a-6 Adopting Release]; Ohio Division of Securities, Department of Commerce (Oct. 27, 1973).

29. Securities Act § 17(a).

30. Exchange Act § 9(a).

31. See Exchange Act § 10(b). Certain of the SEC’s rules under § 10(b) also apply to “any person,” such as Rules 10b-5 and 10b-21.

contrivance, or fictitious quotations.³² Exchange Act § 15(c)(7) makes it unlawful for government securities broker-dealers, bidders for or purchasers of securities, from knowingly or willfully making any false or misleading written statement.³³

§ 1A:1.4 State Registration Requirements

In addition to the federal regulatory system, broker-dealers are subject to state securities laws, known as the “Blue Sky Laws.”³⁴

Most states have adopted the Uniform Securities Act of 1956 (the “1956 Act”), and more and more states are adopting the Uniform Securities Act of 2002 (the “2002 Act”). Both the 1956 Act and 2002 Act make it unlawful for any person to transact business in a state as a broker-dealer or agent³⁵ unless registered with the state’s securities

32. Exchange Act § 15(c).

33. Exchange Act § 15(c)(7).

34. The state laws were given the name of “Blue Sky Laws” to indicate the evil at which they were aimed, that is, speculative schemes which have no more basis than so many feet of “blue sky.” See *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917). Many state securities laws were in existence before the enactment of the federal securities laws. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 8.1 (4th ed. 2001); J. Parks Workman, *The South Carolina Uniform Securities Act of 2005: A Balancing Act Under a New Blue Sky*, 57 S.C. L. REV. 409 (2006) (citing Hazen)

35. “Agent” is defined in the 1956 Act as “any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities.” Under the 1956 Act, the term “Agent” does not include an individual who represents an issuer in (i) effecting transactions in:

- any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing; or any certificate of deposit for any of the foregoing;
- any security issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government with which the United States currently maintains diplomatic relations, if the security is recognized as a valid obligation by the issuer or guarantor;
- any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank, savings institution, or trust company organized and supervised under the laws of any state;
- a promissory note, draft, bill of exchange or bankers’ acceptance that evidences an obligation to pay cash within nine months after the date of issuance, exclusive of days of grace, is issued in denominations of at

regulatory authority subject to certain exemptions in the case of the 2002 Act.³⁶

In the National Securities Markets Improvement Act of 1996 (NSMIA), Congress preempted certain aspects of state regulation of broker-dealer operations.³⁷ NSMIA added section 15(h) to the

least \$50,000, and receives a rating in one of the three highest rating categories from a nationally recognized statistical rating organization; or a renewal of such an obligation that is likewise limited, or a guarantee of such an obligation or of a renewal; and

- any investment contract issued in connection with an employees' stock purchase, savings, pension, profit-sharing, or similar benefit plan if the Administrator is notified in writing thirty days before the inception of the plan or, with respect to plans which are in effect on the effective date of this act, within sixty days thereafter (or within thirty days before they are reopened if they are closed on the effective date of this act).

In addition, "Agent" does not include (i) an individual who represents an issuer in effecting transactions exempted by section 402(b), which includes exemptions for private placements, institutional sales and for various categories of "non-issuer" transactions or (ii) effecting transactions with existing employees, partners or directors of the issuer if no commission or other remuneration is paid or given directly or indirectly for soliciting any person in this state. A partner, officer, or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is an agent only if he otherwise comes within this definition.

"Agent" is defined in section 102 of the 2002 Uniform Securities Act as "an individual, other than a broker-dealer, who represents a broker-dealer in effecting or attempting to effect purchases or sales of securities or represents an issuer in effecting or attempting to effect purchases or sales of the issuer's securities. But a partner, officer, or director of a broker-dealer or issuer, or an individual having a similar status or performing similar functions is an agent only if the individual otherwise comes within the term. The term does not include an individual excluded by rule adopted or order issued under this [Act]."

36. See Uniform Securities Act of 1956 § 201; Uniform Securities Act of 2002 § 401. Section 401 of the Uniform Securities Act of 2002 provides two exemptions: (i) a broker-dealer without a place of business in the state does not have to register if its only transactions effected in the state with certain defined categories of persons; and (ii) a person that deals solely in the U.S. government securities and is supervised as a dealer in government securities by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision is exempted from the registration requirement. In addition, the 2002 Uniform Securities Act provides that pursuant to a rule or order issued under the act a foreign broker-dealer may be exempt under certain conditions. For examples of state registration requirements, see CAL. CORP. CODE § 25210 (2009); CONN. GEN. STAT. § 36B-6 (2008); FLA. STAT. § 517.12 (2009).
37. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

Exchange Act, which prohibits states from establishing different or additional rules with respect to capital, custody, margin, financial responsibility, records making and keeping, bonding, or financial or operational reporting requirements for SEC-registered broker-dealers.

§ 1A:1.5 Consequences of Illegally Doing Business As an Unregistered Broker-Dealer

Absent an exemption, effecting securities transactions without proper registration may subject a broker-dealer to SEC and state enforcement actions as well as private actions for rescission. There are a number of potential adverse consequences of doing business illegally as an unregistered broker-dealer, including:

- (i) cease-and-desist orders from the SEC or relevant state regulator or court injunctions;
- (ii) civil penalties including fines and disgorgement;
- (iii) criminal liabilities;
- (iv) potential rescission rights of investors under federal or state law; and
- (v) reputational harm.

For a more detailed discussion of these possible adverse consequences, see *infra* section 1A:8.

§ 1A:2 What Is a Broker?

§ 1A:2.1 Generally

Section 3(a)(4)(A) of the Exchange Act defines a “broker” as “any person³⁸ engaged in the business of effecting transactions in securities for the account of others.”³⁹ The definition focuses on three elements. A broker must:

- (i) be “engaged in the business,”
- (ii) of “effecting transactions in securities” and
- (iii) “for the account of others.”

The terms “effecting transactions” and “engaged in the business” are not defined in the Exchange Act or the SEC rules thereunder. The courts and the SEC have taken an expansive view of the scope of these terms.

38. The term “person” means “a natural person, company, government, or political subdivision, agency, or instrumentality of a government.” See Exchange Act § 3(a)(9).

39. Exchange Act § 3(a)(4)(A).

§ 1A:2.2 **Effecting Transactions**

Courts and the SEC have determined that a person “effects transactions in securities” if the person participates in such transactions “at key points in the chain of distribution.”⁴⁰ According to the SEC, such participation may include, among other activities:

- (i) assisting an issuer to structure prospective securities transactions;
- (ii) helping an issuer to identify potential purchasers of securities;
- (iii) screening potential participants in a transaction for creditworthiness;
- (iv) soliciting securities transactions (including advertising⁴¹);
- (v) negotiating between the issuer and the investor;
- (vi) making valuations as to the merits of an investment or giving advice;
- (vii) taking, routing or matching orders, or facilitating the execution of a securities transaction;
- (viii) handling customer funds and securities; and (ix) preparing and sending transaction confirmations (other than on behalf of a broker-dealer that executes the trades).⁴²

Not all of the factors are of equal importance, however. Many of these factors are not in themselves sufficient to trigger broker registration, but rather indicate broker activity in conjunction with other criteria, especially compensation. Thus, evaluating the merits of investments

40. *See* Mass. Fin. Servs., Inc. v. Sec. Investor Prot. Corp., 411 F. Supp. 411, 415 (D. Mass.), *aff'd* 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977); *see also* SEC v. Nat'l Executive Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation to Lori Livingston, Transfer Online, Inc. (May 13, 2000).

41. *See* SEC v. Margolin, 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992).

42. *See* BondGlobe, Inc., SEC Denial of No-Action Request (Feb. 6, 2001); Progressive Technology Inc., SEC Denial of No-Action Request (Oct. 11, 2000); BD Advantage, Inc., SEC Denial of No-Action Request (Oct. 11, 2000); Broker-Dealer Activities of Transfer Online, Inc., SEC No-Action Letter (May 13, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Myles C.S. Harrington, President, MuniAuction, Inc. (Mar. 13, 2000); Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, SEC Release No. 34-44291 (May 11, 2001); SEC v. Hansen, 1984 WL 2413 (S.D.N.Y. Apr. 6, 1984).

and issuing confirmations are relatively weak factors. In contrast, helping an issuer identify potential purchasers, and handling customer funds and securities are moderate factors. In contrast, structuring issuances, soliciting transactions negotiating with investors and taking and executing orders are strong indicators of broker activity. Each of these factors are substantially heightened when combined with transaction-based compensation.

§ 1A:2.3 Clerical and Ministerial Activities

Some acts of participation, however, will not be deemed “effecting” securities transactions. The SEC has stated that “[i]n our view, the term ‘effect’ should be construed broadly to encompass not only persons who are engaged directly in the offer or sale of securities, but also those persons who perform other than purely ministerial or clerical functions with respect to securities transactions.”⁴³ That is, a person who conducts activities that go beyond those that are merely clerical or ministerial in nature will be required to register with the SEC as a broker-dealer, unless an exemption is available.⁴⁴

In determining whether a person has performed functions beyond those that are clerical and ministerial in nature, the SEC considers the same set of relevant factors taken into account in determining whether a person has engaged in effecting the transactions of securities. Examples of persons providing certain limited clerical or ministerial services to broker-dealers include those that provide payroll processing services, communications services, and confirmation or other back-office services. For a more detailed discussion of each of these services, see *infra* section 1A:2.6.

§ 1A:2.4 “In the Business”

Courts have read “engaged in the business” as connoting a certain regularity of participation in purchasing and selling activities rather

43. See Letter from Harvey L. Pitt, Chief Counsel, Division of Market Regulation, to Brian Pendelton, on behalf of Financial Surveys, Inc. [Aug. 29, 1973].

44. See Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Harold J Smotkin, Clearing Service, Inc. (Feb. 1, 1972) (Clearing Service was required to register as broker-dealer, inasmuch as the services it performed went beyond those of purely clerical or ministerial nature); Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to William F. Clare, ESE Stock Transfer Corp. (Nov. 20, 1971) (ESE Stock Transfer Corp. was required to register because the services it intended to perform went beyond those which are merely clerical or ministerial in nature).

than a few isolated transactions.⁴⁵ Two factors are important in determining whether there is “regularity of business”: (i) the number of transactions and clients,⁴⁶ and (ii) the dollar amount of securities sold; and the extent to which advertisement and investor solicitation were used.⁴⁷ However, neither of these factors is determinative. While a single isolated advertisement by a person seeking to purchase or sell securities may not in all cases cause a person to be a “broker,” transactions by a person as the first step in a larger enterprise could still be found to meet the regularity requirement.⁴⁸ While dollar amount of the transactions can indicate regularity, courts have held that there is no requirement that such activity be a person’s principal business or principal source of income.⁴⁹ The SEC has stated that:

. . . nothing . . . would warrant a conclusion that a person is not “engaged in the business” merely because his securities activities are only a small part of his total business activities, or merely because his income from such activities is only a small portion of his total income. On the contrary, if the securities activities are engaged in for commissions or other compensation with sufficient recurrence to justify the inference that the activities are part of the

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45. SEC v. Am. Inst. Counselors, Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.C. 1975). See also SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1 (D.C. 1998); *Margolin*, 1992 WL 279735; SEC v. Hansen, 1984 WL 2413 (S.D.N.Y. Apr. 6, 1984); SEC v. Nat’l Executive Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); *Mass. Fin. Servs., Inc. v. Sec. Investor Prot. Corp.*, 411 F. Supp. 411, 415 (D. Mass.), *aff’d* 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977).
46. *Margolin*, 1992 WL 279735; Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Joseph McCulley (Aug. 2, 1972) (an individual seeking to purchase or sell securities may advertise on a single, isolated basis without being considered a “broker.” However, one engaging in repeated advertising encompassing offers to buy as well as to sell must register as a broker-dealer).
47. *Nat’l Executive Planners*, 503 F. Supp. at 1073 (National Executive Planners solicited clients actively, and sold \$4,300,000.00 worth of TVM instruments. NEP thus had a certain regularity of participation in securities transactions at key points in the chain of distribution); *Kenton Capital Ltd.*, 69 F. Supp. 2d 1 (citing SEC v. Deyon, 977 F. Supp. 510 (D. Me. 1997), and *Nat’l Executive Planners*, 503 F. Supp. 1066).
48. *Kenton Capital Ltd.*, 69 F. Supp. 2d 1 (defendants’ securities transactions were not a single, isolated transaction, but rather the first step in a larger enterprise. Kenton was established for the exclusive purpose of participating in trading programs).
49. See *UFITEC v. Carter*, 20 Cal. 3d 238, 571 P.2d 990 (1977); see also *Kenton Capital Ltd.*, 69 F. Supp. 2d 1 (a corporation could be a broker even though securities transactions are only a small part of its business activity).

person's business, he will be deemed to be "engaged in the business."⁵⁰

Besides "regularity of business," courts and the SEC have identified several other factors which indicate that a person is "engaged in the business." These factors include:

- (i) receiving transaction-related compensation;⁵¹
- (ii) holding oneself out as a broker, as executing trades, or as assisting others in settling securities transactions;⁵² and
- (iii) soliciting securities transactions.⁵³

§ 1A:2.5 Role of Compensation in Analysis

In the SEC's no-action guidance and enforcement actions, receiving commissions or other transaction-related compensation is one of the determinative factors in deciding whether a person is a "broker" subject to the registration requirements under the Exchange Act.⁵⁴

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- 50. InTouch Global, LLC, SEC No-Action Letter (Nov. 14, 1995).
 - 51. See SEC v. Margolin, 1992 WL 279735 (S.D.N.Y. 1992); BondGlobe, Inc., SEC Denial of No-Action Request (Feb. 6, 2001); Progressive Technology Inc., SEC Denial of No-Action Request (Oct. 11, 2000); BD Advantage, Inc., SEC Denial of No-Action Request (Oct. 11, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation to Lori Livingston, Transfer Online, Inc. (May 13, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation to Myles C.S. Harrington, President, MuniAuction, Inc. (Mar. 13, 2000).
 - 52. See *Kenton Capital Ltd.*, 69 F. Supp. 2d 1; BondGlobe, Inc., SEC Denial of No-Action Request (Feb. 6, 2001); Progressive Technology Inc., SEC Denial of No-Action Request (Oct. 11, 2000); BD Advantage, Inc., SEC Denial of No-Action Request (Oct. 11, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation to Lori Livingston, Transfer Online, Inc. (May 13, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Myles C.S. Harrington, President, MuniAuction, Inc. (Mar. 13, 2000).
 - 53. See, e.g., SEC v. Deyon, 977 F. Supp. 510 (D. Me. 1997) (both defendants solicited investors by phone and in person); SEC v. Century Inv. Transfer Corp., et al., Fed. Sec. L. Rep. (CCH) ¶ 93,232 (S.D.N.Y. Oct. 5, 1971) (defendant "engaged in the broker-dealer business" by soliciting customers through ads in the *Wall Street Journal*).
 - 54. See Wolff Jull Investments, LLC, SEC Denial of No-Action Request (May 17, 2005); Birchtree Financial Services, Inc., SEC Denial of No-Action Request (Sept. 22, 1998); Vanasco, Wayne & Genelly, SEC Interpretive Letter (Feb. 17, 1999); SEC v. FTC Capital Markets, Inc. et al., Civil Action No. 09-cv-4755 (S.D.N.Y. May 20, 2009); SEC v. UBS AG, 100:09-CV-00316 (D.D.C. Feb. 18, 2009); SEC v. Milken and MC Group, 98 Civ. 1398 (S.D.N.Y. Feb. 26, 1998).

Transaction-related compensation refers to compensation based, directly or indirectly, on the size, value or completion of any securities transactions.⁵⁵ The receipt of transaction-based compensation often indicates that a person is engaged in the business of effecting transactions in securities.⁵⁶ As a policy consideration, transaction-related compensation can induce high pressure sales tactics and other problems of investor protection often associated with unregulated and unsupervised brokerage activities.⁵⁷

Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities generally would be viewed as a broker-dealer.⁵⁸ The rationale for this position is summarized by the SEC as follows:

Persons who receive transaction-based compensation generally have to register as broker-dealers under the Exchange Act because, among other reasons, registration helps to ensure that persons with a “salesman’s stake” in a securities transaction operate in a manner consistent with customer protection standards governing broker-dealers and their associated persons, such as sales practice rules. That not only mandates registration of the individual who

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55. See GlobalTec Solutions, LLP, SEC No-Action Letter (Dec. 28, 2005). The SEC will look behind the terms of a compensation arrangement to determine its economic substance, that is, to determine whether it is transaction-related. Thus, a fee arrangement designed to compensate a person for what that person would have received if the person directly received transaction-related compensation (for example, a flat fee that is recalculated periodically to reflect an increase or decrease in the number of transactions) would be the equivalent of transaction-related compensation. In this regard, a flat fee representing a percentage of expected future commissions could be considered transaction-related. See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Exchange Act, SEC Release No. 34-44291, n.46 (May 11, 2001).
56. See SEC v. Margolin, 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992); Bond-Globe, Inc., SEC Denial of No-Action Request (Feb. 6, 2001); Progressive Technology Inc., SEC Denial of No-Action Request (Oct. 11, 2000); BD Advantage, Inc., SEC Denial of No-Action Request (Oct. 11, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation to Lori Livingston, Transfer Online, Inc. (May 13, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Myles C.S. Harrington, President, MuniAuction, Inc. (Mar. 13, 2000).
57. SEC Release No. 34-20943 (May 9, 1984).
58. See SEC v. FTC Capital Mkts., Inc. et al., Civil Action No. 09-cv-4755 (S.D.N.Y. May 20, 2009); SEC v. UBS AG, 100:09-CV-00316 (D.D.C. Feb. 18, 2009); Wolff Juall Investments, LLC, SEC Denial of No-Action Request (May 17, 2005); Birchtree Financial Services, Inc., SEC Denial of No-Action Request (Sept. 22, 1998); Vanasco, Wayne & Genelly, SEC Interpretive Letter (Feb. 17, 1999).

directly takes a customer's order for a securities transaction, but also requires registration of any other person who acts as a broker with respect to that order, such as the employer of the registered representative or any other person in a position to direct or influence the registered representative's securities activities.⁵⁹

Whether a person receives transaction-related compensation is often an important factor in the SEC staff's decision in granting or denying no-action relief to, or bring enforcement actions against, persons providing services to broker-dealers. For example, the SEC staff has denied no-action relief to personal services companies that are established by registered representatives of a broker-dealer and receive commissions earned by the registered representatives from the broker-dealer.⁶⁰ At the same time, the SEC has granted no-action relief to companies providing payroll processing services to broker-dealers for a flat, pre-determined administrative fee not related to commissions earned by the employees of the broker-dealer.⁶¹

In the letter granting no-action relief to e-Media, a company providing communications services for its registered broker-dealer clients, the SEC noted that, among other things, neither e-Media nor its personnel would "receive compensation from its client broker-dealers other than a flat transmission fee and that such fee w[ould] not be made contingent upon the outcome or completion of any securities transaction, upon the size of the offering, or upon the number of prospective investors accessing the [services]."⁶² The SEC has granted

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59. 1st Global, Inc., No-Action Letter (May 7, 2001). *See also* SEC Release No. 34-61884 (Apr. 9, 2010) (granting exemptions to the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 in connection with restructuring of debt instruments acquired by the Federal Reserve Bank of New York when it facilitated the acquisition of the Bear Stearns Companies Inc. by JP Morgan Chase & Co., including permitting receipt of compensation that is calculated by reference to underwriting fees received by other parties to the restructuring); Brumberg, Mackey & Wall, P.L.C., SEC Denial of No-Action Request (May 17, 2010) (denying no-action request where a law firm would be compensated for providing introductions to investors upon the closing of a financing based upon a percentage of the amounts raised).
60. *See, e.g.*, Wolff Juall Investments, LLC, SEC Denial of No-Action Request (May 17, 2005); Vanasco, Wayne & Genelly, SEC Interpretive Letter (Feb. 17, 1999); Birchtree Financial Services, Inc., SEC Denial of No-Action Request (Sept. 22, 1998).
61. *See, e.g.*, ADP TotalSource, Inc., SEC No-Action Letter (Dec. 4, 2007); eEmployers Solutions, Inc., SEC No-Action Letter (Dec. 3, 2007); Investacorp Group, Inc., Investacorp, Inc., SEC No-Action Letter (Sept. 26, 2003).
62. *See* e-Media, LLC, SEC No-Action Letter (Dec. 14, 2000).

no-action relief to investment advisers that did not receive compensation for its activity of assisting securities transactions,⁶³ but denied no-action relief to investment advisers that proposed to receive transaction-related compensation.⁶⁴ The SEC has identified the receipt of transaction-related compensation as a factor in its decision to deny no-action relief to some stock bulletin boards.⁶⁵ Although the SEC has previously granted no-action relief under limited circumstances in which a celebrity acting as finder “sold his rolodex,”⁶⁶ and would receive a success-based fee, it has since publicly distanced itself from that precedent.⁶⁷ The SEC has brought enforcement actions against persons for violation of section 15(a) registration requirements partly based on the fact that they had received transaction-based compensation.⁶⁸

Receiving transaction-related compensation, however, is not the only factor that the SEC has considered in its decision to grant or deny no-action relief or bring enforcement actions. For example, even in the absence of commissions or other specific transaction-related fees, the SEC has declined to grant no-action relief regarding the broker-dealer registration of an investment adviser that proposed to locate issuers, solicit new clients, and act as a customers’ agent in structuring or

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63. See McGovern Advisory Group, Inc., SEC No-Action Letter (Aug. 7, 1984) (the company assisted securities transactions by transmitting orders for securities to registered broker-dealers).
64. See Boston Advisory Group, SEC Denial of No-Action Request (Sept. 2, 1980).
65. See King & Spalding, SEC No-Action Letter (Nov. 17, 1992); National Royalty Exchange, SEC Denial of No-Action Request (Dec. 21, 1988).
66. A “finder” is a person who places potential buyers and sellers of securities in contact with one another for a fee. For more information about “finders,” see *infra* 1A:2.6[A].
67. See Paul Anka, SEC No-Action Letter (July 24, 1991), in which the SEC granted no-action relief despite the fact that Anka received a transaction-based finder’s fee for units sold either to Anka himself or to investors he identified without any involvement of Anka in the sales. Although the Paul Anka letter is still part of the SEC staff’s guidance, in a number of public speeches, the SEC staff has indicated that it would not provide no-action relief under a comparable fact pattern as regards compensation arrangements today. See, e.g., John W. Loofbourrow Associates, Inc, SEC Denial of No-Action Request (June 29, 2006); Comments by Kristina Fausti, Special Counsel, Office of Chief Counsel, SEC Division of Trading and Markets, at the Private Placement Broker and M&A Broker Panel at the SEC’s Forum on Small Business Capital Formation (Nov. 20, 2008); Brumberg, Mackey & Wall, P.L.C., SEC Denial of No-Action Request (May 17, 2010).
68. SEC v. FTC Capital Mkts., Inc. et al., Civil Action No. 09-cv-4755 (S.D.N.Y. May 20, 2009); SEC v. UBS AG, 100:09-CV-00316 (D.D.C. Feb. 18, 2009); SEC v. Clean Care Tech., Inc., et al., 08 CIV 01719 (S.D.N.Y. Feb. 21, 2008); SEC v. Black, No. 8:00CV383-T-26B (M.D. Fla. Feb. 25, 2000); SEC v. Milken and MC Group, 98 Civ. 1398 (S.D.N.Y. Feb. 26, 1998).

negotiating transactions.⁶⁹ In addition, the SEC has brought enforcement actions for violation of section 15(a) against persons who had induced and attempted to induce the purchase and sale of securities for the accounts of others.⁷⁰

§ 1A:2.6 Specific Contexts

[A] Finders

As noted above, the SEC staff has historically recognized a very narrow exception to the broker-dealer registration requirements for certain “finders.”⁷¹ A “finder” is a person who places potential buyers and sellers of securities in contact with one another for a fee. There is no “finder exception” in the Exchange Act or SEC rules; instead, the finder analysis is based on SEC no-action letters. The SEC’s decision to grant no-action treatment in some cases to permit finders to engage in limited activities without registration as broker-dealers is presumably based on the idea that certain limited activities in relation to securities transactions do not create risks sufficient to warrant registration.

[B] Business Brokers, Private Placement Agents, and M&A Advisers

[B][1] Private Placement Agents

Private placements agents must register as broker-dealers under the Exchange Act. A security sold in a transaction that is exempt under the Securities Act of 1933 (the “Securities Act”) is not necessarily an “exempted security” under the Exchange Act.⁷² Therefore, a person who sells securities through private placements that are exempt from registration under the Securities Act is not exempted from registration as a broker-dealer under the Exchange Act, unless that person otherwise falls within the finder exception or within some other registration exemption.⁷³

69. See PRA Securities Advisers, L.P., SEC Denial of No-Action Request (Mar. 3, 1993).

70. See SEC v. Am. Energy Resources Corp., et al., Case No. 08-CV-01847-REB-BNB (D. Colo. Aug. 28, 2008); SEC v. Harbour Bay Fin. Co., Civil Action No. 90-3580 (E.D.P.A. May 25, 1990).

71. See, e.g., Paul Anka, SEC No-Action Letter (July 24, 1991).

72. See SEC Division of Trading and Markets, Guide to Broker-Dealer Registration (Apr. 2008) [hereinafter SEC Guide to Broker-Dealer Registration], available at www.sec.gov/divisions/marketreg/bdguide.htm.

73. See *id.*; John W. Loofbourrow Associates, Inc., SEC Denial of No-Action Request (June 29, 2006).

[B][2] M&A Advisers

Persons engaged in merger and acquisition activities are subject to the broker registration requirements when these activities involve, for example, a sale or exchange of securities.⁷⁴ Whether an intermediary in an M&A transaction would be considered to be a broker depends on the precise nature of the services performed.⁷⁵ The expectations or subjective understandings of the parties as to the role of the intermediary are not relevant. The SEC has taken the position that individuals who do nothing more than bring merger- or acquisition-minded people or entities together, and do not participate in negotiations or settlements between them, may not be brokers in securities or subject to the registration requirements of section 15 of the Exchange Act—especially where their compensation does not depend upon the size or success of the transaction.⁷⁶ On the other hand, persons (other than professionals such as lawyers or accountants acting as such) who participate in or otherwise facilitate negotiations in effecting mergers or acquisitions, and receive transaction-based compensation, are required to register as broker-dealers.⁷⁷ In addition, the activities of an intermediary in raising venture capital by soliciting investors may constitute an independent basis, apart from the intermediary's activities in corporate mergers and acquisitions, for requiring registration with the SEC as a broker-dealer.⁷⁸

The analysis under section 15 for an M&A adviser is, therefore, similar to that for a finder. An M&A adviser, who acts as a “finder” by merely identifying and locating M&A prospects and bringing together buyers and sellers, and not participating directly or indirectly in the sale of securities nor sharing in any profits realized (for example,

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- 74. Garrett/Kushell/Assocs., SEC No-Action Letter (Sept. 7, 1980).
 - 75. Henry C. Coppelt d/b/a May Pac Management Co., SEC No-Action Letter (June 2, 1974); SEC v. Randy, 38 F. Supp. 2d 657, 667 (N.D. Ill. 1999).
 - 76. Garrett/Kushell/Assocs., SEC No-Action Letter (Sept. 7, 1980); IMF Corp., SEC No-Action Letter (May 15, 1979); Henry C. Coppelt d/b/a May Pac Management Co., SEC No-Action Letter (June 2, 1974).
 - 77. John R. Wirthlin, SEC Denial of No-Action Request (Jan. 19, 1999); Davenport Management, Inc., SEC No-Action Letter (Apr. 13, 1993); C&W Portfolio Management, Inc. SEC Denial of No-Action Request (July 20, 1989); Garrett/Kushell/Assocs., SEC No-Action Letter (Sept. 7, 1980); IMF Corp., SEC No-Action Letter (May 15, 1979); Equity Development Corp., SEC No-Action Letter (Dec. 10, 1976); Henry C. Coppelt d/b/a May Pac Management Co., SEC No-Action Letter (June 2, 1974); *see also* SEC v. Michael R. Milken and MC Group, 98 Civ. 1398 (S.D.N.Y. Feb. 26, 1998).
 - 78. Henry C. Coppelt d/b/a May Pac Management Co., SEC No-Action Letter (June 2, 1974).

receiving only a flat fee), may not have to register as a broker.⁷⁹ However, if the M&A adviser solicits potential investors or participates in the negotiation of the issuance or exchange of securities and receives a transaction-based fee, the advisor may have to register as a broker-dealer.⁸⁰ A key determining factor is whether the M&A adviser receives transaction-based compensation.⁸¹

Naturally, if the transaction involves only a sale of non-securities assets and/or assumption of liabilities, no broker-dealer registration issue would be presented.

[B][3] Business Brokers

Business brokers have developed as a special case because for many years there was an open question as to whether sale of a business through conveying all the shares was a securities transaction. However, in 1985, the U.S. Supreme Court held that this type of transaction involves a sale of securities.⁸²

A business broker usually receives commissions in connection with the sale of a commercial firm.⁸³ A business broker will not have to register as a broker-dealer if there is no distribution, sale or exchange of securities.⁸⁴ However, if the sale of companies engaged by the business broker includes a transfer of securities, the business broker may have to register as a broker-dealer if he is engaged in the business of effecting

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79. Victoria Bancroft, SEC No-Action Letter (July 9, 1987); Russell R. Miller & Co., Inc., SEC No-Action Letter (July 14, 1977); May-Pac Management Co., SEC No-Action Letter (Dec. 20, 1973); Ruth H. Quigley, SEC No-Action Letter (July 14, 1973); Corporate Forum, Inc., SEC No-Action Letter (Dec. 10, 1972).
80. Dominion Resources, Inc., SEC Revocation of No-Action Letter (Mar. 7, 2000) (the SEC withdrew a prior letter dated August 22, 1985, granting no-action relief to Dominion Resources, Inc. for the same activities; the staff clarified its position which is consistent with that in the following no-action letters); John R. Wirthlin, SEC Denial of No-Action Request (Jan. 19, 1999); Davenport Management, Inc., SEC No-Action Letter (Apr. 13, 1993); C&W Portfolio Management, Inc. SEC Denial of No-Action Request (July 20, 1989); May-Pac Management Co., SEC No-Action Letter (Dec. 20, 1973); Ruth H. Quigley, SEC No-Action Letter (July 14, 1973); Fulham & Co., Inc., SEC No-Action Letter (Dec. 20, 1972).
81. See Hallmark Capital Corp., SEC No-Action Letter (June 11, 2007).
82. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). In some cases, the sale of a business would involve the transfer of corporate assets without any transfer of stock by individual shareholders of the selling corporation; in other cases, the sale may involve the transfer of 100 percent of the outstanding stock by current shareholders to the purchasers.
83. See Pleger, Gary L., Esq./Pleger, Duderwicz & Prince, SEC No-Action Letter (Oct. 11, 1977).
84. See *id.*; Hallmark Capital Corp., SEC No-Action Letter (June 11, 2007).

the securities transactions for others' account.⁸⁵ The analysis is similar to the analysis for M&A advisers.

There have been calls for the SEC to promulgate an exemption to the broker-dealer registration requirement for business brokers.⁸⁶

[C] Networking Arrangements

[C][1] Banks

Banks have entered into arrangements with Registered Broker-Dealers pursuant to which a Registered Broker-Dealer offers brokerage services on or off the premises of a bank and to bank customers. In these arrangements, the bank typically receives a share of the compensation related to brokerage transactions the broker-dealer effects as a result of the networking arrangement.⁸⁷ At the same time, unregistered bank employees may engage in limited securities-related activities and receive incentive compensation such as a one-time cash fee of a fixed dollar amount for referring bank

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85. *Id.* Country Business, Inc., SEC No-Action Letter (Nov. 8, 2006) (the SEC granted no-action relief to Country Business Inc. because it (i) would only have a limited role in negotiations and would not have power to bind parties in the transaction, (ii) would not engage in any transaction in securities, (iii) would receive a fixed fee, and (iv) would not assist purchasers with obtaining financing other than providing uncompensated introductions to third-party lenders); *cf.* Hallmark Capital Corp., SEC Denial of No-Action Request (June 11, 2007) (the SEC denied Hallmark Capital Corp.'s no-action request when its proposed activities included (i) identifying companies that might be interested in buying the client company; (ii) identifying possible acquisition target for the client and preparing an acquisition profile on the target company for the purpose of preliminary screening; (iii) identifying bank lenders, assisting clients with loan application process, and arranging meetings leading to the extension of bank credit facilities to the client; and (iv) receiving a modest upfront retainer and a fee based on the outcome of the transaction).
86. *See, e.g.*, Letter to SEC Chairman Mary Schapiro, from Tabb, Inc. (Texas Association of Business Brokers) (Oct. 19, 2009) (arguing that the cost of registration for "main street business brokers" who deal in small business sale transactions would be prohibitive and exceeds any public benefit), *available at* <http://sec.gov/rules/petitions/2010/petn4-599.pdf>. *See also* Report and Recommendations of the Task Force on Private Placement Broker-Dealers, A.B.A. SEC. BUS. L. (June 7, 2005) (advocating, among other things, expansion of existing relief for small business brokers), *available at* www.amaonline.com/files/ABA%20Task%20Force%20Report%20-%20Private%20Placement%20Broker-Dealers%206-7-05.pdf.
87. *See* SEC Release No. 34-49879 [hereinafter Regulation B Proposing Release]; Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, SEC Release No. 34-56501 (Sept. 24, 2007) [hereinafter Regulation R Adopting Release].

customers to the broker-dealer.⁸⁸ These activities may be deemed broker-dealer activities under certain circumstances.

Prior to the adoption of the Gramm-Leach-Bliley Act (GLBA),⁸⁹ banks⁹⁰ were excluded altogether from the definitions of “broker” and “dealer” under the Exchange Act.⁹¹ The GLBA replaced this exclusion with eleven conditional exemptions for banks from the statutory definition of “broker,”⁹² including an exemption for banks’ “networking” arrangements.⁹³

88. Regulation R Adopting Release, *supra* note 87.

89. Also known as the Financial Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

90. A “bank” is defined in section 3(a)(6) of the Exchange Act to include: (A) a banking institution organized under the laws of the United States, or a Federal savings association, as defined in section 2(5) of the Home Owners’ Loan Act [12 U.S.C.S. § 1462(5)], (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the currency pursuant to section 92a of Title 12, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph. “Bank” has been interpreted to include the U.S. branches and agencies of foreign banks to the extent that they are supervised and examined by a federal or state banking authority. *See* SEC Release No. 34-27017, n.16 (July 18, 1989).

It is important to note that exceptions applicable to banks under the Exchange Act, as amended by the GLBA, are not applicable to other entities, including bank subsidiaries and affiliates, that are not themselves banks. At the same time, the SEC has provided no-action relief to a service corporation that proposed to enter into networking arrangements with broker-dealers where the establishment of the service corporations was required by the laws or regulations governing the financial institution. *See* SEC Letter to Christine A. Bruenn, the State of Maine (Apr. 9, 2002); SEC Guide to Broker-Dealer Registration, *supra* note 72.

91. Before adoption of the GLBA, Exchange Act § 3(a)(4) defined the term “broker” as “any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.” Before the GLBA, Exchange Act § 3(a)(5) defined the term “dealer” as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank. . . .”

92. *See* Exchange Act §§ 3(a)(4) and 3(a)(5). For a more detailed discussion on the GLBA and exemptions for banks under the Exchange Act as amended by the GLBA, see *infra* section 1A:7.

93. *See* Exchange Act § 3(a)(4)(B)(i). While section 3(a)(4)(B)(i) only applies to banks, the SEC has permitted certain other financial institutions, such as

The exception for networking arrangements in section 3(a)(4)(B)(i) sets out nine conditions.⁹⁴ The conditions are designed to ensure that bank employees (other than associated persons of a broker-dealer who are qualified pursuant to the rules of an SRO) do not perform brokerage service (other than clerical or ministerial functions) and that consumers of the bank understand that the brokerage services are performed by the broker-dealer, not the bank.⁹⁵ One of the conditions prohibits a bank employee that refers a customer to a broker-dealer from receiving “incentive compensation” for a securities brokerage transaction other than a “nominal” one-time cash fee for making the

credit unions, to make similar networking arrangements with affiliated or third-party broker-dealers to make securities available to their customers without registering as broker-dealers. *See* SEC Guide to Broker-Dealer Registration, *supra* note 72.

94. These conditions include: (i) such broker or dealer is clearly identified as the person performing the brokerage services; (ii) the broker or dealer performs brokerage services in an area that is clearly marked and, to the extent practicable, physically separate from the routine deposit-taking activities of the bank; (iii) any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement clearly indicate that the brokerage services are being provided by the broker or dealer and not by the bank; (iv) any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement are in compliance with the federal securities laws before distribution; (v) bank employees (other than associated persons of a broker or dealer who are qualified pursuant to the rules of self-regulatory organization) perform only clerical or ministerial functions in connection with brokerage transactions including scheduling appointments with the associated persons of a broker or dealer, except that bank employees may forward customer funds or securities and may describe in general terms the types of investment vehicles available from the bank and the broker or dealer under the arrangement; (vi) bank employees do not receive incentive compensation for any brokerage transaction unless such employees are associated persons of a broker or dealer and are qualified pursuant to the rules of a self-regulatory organization, except that the bank employees may receive compensation for the referral of any customer if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction; (vii) such services are provided by the broker or dealer on the basis that all customers that receive any services are fully disclosed to the broker or dealer; (viii) the bank does not carry a securities account of the customer (with exceptions); and (ix) the bank, broker, or dealer informs each customer that the brokerage services are provided by the broker or dealer and not by the bank and that the securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not insured by the Federal Deposit Insurance Corporation. *See* Exchange Act § 3(a)(4)(B)(i).

95. *See* SEC Release No. 34-56501 (Sept. 24, 2007).

referral that is not contingent on whether the referral results in a securities transaction.⁹⁶

[C][2] Insurance

The SEC has, through no-action letters, permitted networking arrangements between Registered Broker-Dealers and insurance agencies in connection with the offer and sale of insurance securities. Under such arrangements, a third-party broker-dealer or affiliated broker-dealer of the insurance company or agency can provide insurance products that are also securities (such as variable annuities) and share commission from the sale of those products.⁹⁷ This exemption was designed to respond to the unique nature of insurance securities and address the difficulties posed by insurance and securities laws applicable to the sale of these products.⁹⁸ In granting no-action relief, the SEC staff has emphasized that the Registered Broker-Dealer must control, supervise, and assume responsibility for all securities activities in connection with the sale of such insurance products.⁹⁹

Through networking arrangements, insurance companies and agencies can share in the commissions generated by their referred

96. See Exchange Act § 3(a)(4)(B)(i). Rule 700 of Regulation R includes four different alternatives for satisfying the requirement that a referral fee be “nominal.” In addition, Rule 701 of Regulation R, permits a bank to pay an employee a contingent referral fee of more than a nominal amount for referring to a broker-dealer an institutional customer or high net-worth customer under the networking arrangement, provided that the bank meets the other requirements under section 3(a)(4)(B)(i). The exemption is subject to certain conditions designed to ensure that institutional and high net-worth customers receive appropriate investor protections and have the information to understand the financial interest of the bank employee so they can make informed choices.

97. See SEC Guide to Broker-Dealer Registration, *supra* note 72.

98. Insurance securities such as variable annuity contracts and variable life insurance policies are subject to state insurance law requirements regarding the licensing and payment of insurance commissions. The laws of most states prohibit the payment of insurance commissions to entities not licensed to sell insurance in those states. In addition, the laws of many states prohibit non-domestic corporations or corporations not primarily engaged in the business of insurance from being licensed to sell insurance within those states. See Lincoln Financial Advisors Corp., SEC No-Action Letter (Feb. 20, 1998); First America Brokerage Service, Inc., SEC No-Action Letter (Aug. 18, 1993); SEC Guide to Broker-Dealer Registration, *supra* note 72.

99. See First of America Brokerage Services, Inc., SEC No-Action Letter (Sept. 28, 1995); FIMCO Securities Group, Inc., SEC No-Action Letter (July 16, 1993); Delta First Financial, Inc., SEC No-Action Letter (Sept. 21, 1992); Investment Centers of America, Inc., SEC No-Action Letter (June 5, 1992).

customers under certain conditions.¹⁰⁰ Insurance networking arrangements are limited to insurance products that are also securities.¹⁰¹ The networking exemption does not apply to arrangements for the sales of mutual funds¹⁰² and other non-insurance securities that do not present the same regulatory difficulties posed by dual state and federal laws applicable to insurance securities.¹⁰³

[D] Issuers and Their Associated Persons

[D][1] Issuers

Issuers generally are not considered “brokers” under the Exchange Act because they sell securities for their own account and not for the account of others.¹⁰⁴ Issuers whose activities go beyond selling their own securities, however, may be required to register as broker-dealers. The SEC staff has stated that such activities could include, among others, issuers purchasing their securities from investors, as well as issuers effectively operating markets in their own securities or in securities whose features or terms can change or be altered.¹⁰⁵ The SEC has also asserted that an issuer that operates a dividend reinvestment and stock purchase plan (DRSPP)¹⁰⁶ may be required to register as a broker-dealer if it induces or attempts to induce the purchase or sale of its securities, receives compensation based on securities transactions, or holds and maintains the funds, securities, and accounts of DRSPP participants.¹⁰⁷

100. See SEC Guide to Broker-Dealer Registration, *supra* note 72.

101. See *id.*

102. See The Wolper Ross Corp., SEC No-Action Letter, n.1 (Oct. 16, 1991).

103. See Lincoln Financial Advisors Corp., SEC No-Action Letter (Feb. 20, 1998).

104. The SEC has stated: “[T]he Act has customarily been interpreted not to require the issuer itself to register as either a broker or a dealer; the issuer would not be effecting transactions for the account of others nor, generally, would it be engaged in the business of both buying and selling securities for its own account.” SEC Release No. 34-13195 (Jan. 21, 1977).

105. See SEC Guide to Broker-Dealer Registration, *supra* note 72.

106. A DRSPP is a program offered by a corporation or closed-end fund that allows participants to accumulate shares of an issuer’s common stock directly from the issuer by reinvesting dividends and, in many cases, by making optional cash payments. See Exemption From Rule 10b-6 For Certain Dividend Reinvestment and Stock Purchase Plans, SEC Release No. 34-35041 (Dec. 1, 1994).

107. For a more detailed discussion of when the issuer operating a DRSPP program will need to register, see Exemption From Rule 10b-6 For Certain Dividend Reinvestment and Stock Purchase Plans, SEC Release No. 34-35041 (Dec. 1, 1994).

[D][2] Associated Persons of Issuers

Frequently, issuers sell their own securities through their directors, officers and employees rather than using a Registered Broker-Dealer. Even though the issuer itself usually does not have to register as a broker because it is not selling for the account of others, directors, officers or employees of the issuer, who act on behalf of the issuer in distributing its securities may, depending on the circumstances, be brokers under the Exchange Act.¹⁰⁸ Section 15(a)(1) requires a broker-dealer that is a natural person not associated with a broker-dealer (which is a person other than a natural person) to register with the SEC.¹⁰⁹ Directors, officers or employees of an issuer, therefore, will have to register under section 15 if they are considered to be brokers.

Although the determination of whether a director, officer, or employee needs to register under section 15 is fact-specific, courts and the SEC have identified the following factors as relevant:

- the director, officer, or employee's prior securities activities: whether the person is a registered representative of a Registered Broker-Dealer or whether the person has been engaged in a professional capacity in buying and selling securities;
- whether the director, officer, or employee was hired to participate in the offering, and whether each has substantial duties other than selling shares;
- the method of compensation, whether the person receives, directly or indirectly, compensation based upon success in placing securities or the amount of funds raised through the sale of securities;
- the director, officer, or employee's intention to remain with the issuer after the conclusion of the offering (whether or not the offering is successful) and the likelihood of participation in other offerings by the same or another issuer.¹¹⁰

108. See SEC Release No. 34-13195 (Jan. 21, 1977).

109. See Exchange Act § 15(a)(1).

110. See Midland-Guardian Co., SEC No-Action Letter (Dec. 27, 1978); North Albuquerque Associates, SEC No-Action Letter (Aug. 18, 1978); China Trade Corp., SEC No-Action Letter (July 24, 1978); ITT Financial Corp., SEC No-Action Letter (July 17, 1978); Scotch Investments, Ltd. No-Action Letter (Oct. 12, 1975); Corporate Investment Co., SEC No-Action Letter (Apr. 20, 1974); Altman Homes, Inc., SEC No-Action Letter (Mar. 2, 1974); Stratford Texas, Inc., SEC No-Action Letter (Nov. 6, 1972); Woodmoor Corp., SEC No-Action Letter (Mar. 5, 1972); Landcom, Inc., SEC No-Action Letter (June 5, 1971); Choice Communities, Inc., SEC No-Action Letter (Dec. 29, 1972); see also SEC v. Bravata, Civil Action

Exchange Act Rule 3a4-1 provides a non-exclusive safe harbor from broker-dealer registration for “associated persons of an issuer.”¹¹¹ Compliance with the conditions to the safe harbor is not the only means by which associated persons of an issuer may sell that issuer’s securities without registration as a broker-dealer. Rule 3a4-1, however, does provide legal certainty to those persons whose activities meet the conditions of the rule.¹¹²

“Associated persons of an issuer,” under Rule 3a4-1, include any natural person who is a partner, officer, director, or employee of the issuer, and employees of companies or partnerships in a control relationship with the issuer.¹¹³ Under the rule, an associated person of an issuer who participates in the sale of “the securities of such issuer”¹¹⁴ would not have to register as a broker-dealer if the associated person, at the time of participation:

- (i) is not subject to a “statutory disqualification,” as defined in section 3(a)(39) of the Exchange Act;¹¹⁵
- (ii) is not compensated, directly or indirectly, by commissions or transaction-based compensation in connection with the sale of the issuer’s securities;¹¹⁶
- (iii) is not an associated person of a broker or dealer;¹¹⁷ and
- (iv) meets any one of three alternative conditions:
 - Restricts his participation to transactions involving offers and sales of securities to a limited class of financial institutions, including Registered Broker-Dealers, banks,

No. 09-12950 (E.D. Mich. July 27, 2009) (quoting *SEC v. George*, 426 F.3d 786, 797 (6th Cir. 2005); *SEC v. McMillin, et al.*, 07 CV 2636-REB-MEH (D. Colo. Jan. 12, 2009); *SEC v. Sarad, et al.*, Case No. 2:08-cv-02252-GEB-DAD (E.D. Cal. Sept. 25, 2008); *SEC v. Am. Energy Resources Corp., et al.*, Case No. 08-CV-01847 REB BNB (D. Colo. Aug. 28, 2008); *SEC v. McDuff*, Civil Action No. 3:08-CV-00526 (N.D. Tex. Mar. 26, 2008); *SEC v. Rabinovich & Assocs., LP, et al.*, 07-CV-10547 (S.D.N.Y. Nov. 26, 2007); *SEC v. Martino*, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003).

111. *See* Rule 3a4-1; SEC Release No. 34-22172 (June 27, 1985) [hereinafter Rule 3a4-1 Adopting Release].

112. Rule 3a4-1.

113. *See* Rule 3a4-1(c)(1).

114. The term “securities of such issuer” in Rule 3a4-1 is intended to cover the issuer’s sale of its own securities through its associated persons. The rule does not address situations where an issuer’s employees assist potential buyers and sellers in connection with secondary market transactions in the issuer’s securities. *See* Rule 3a4-1.

115. Exchange Act § 3(a)(39); Rule 3a4-1(a)(1).

116. Rule 3a4-1(a)(2).

117. Rule 3a4-1(a)(3).

investment companies registered under the Investment Company Act of 1940 (the “Investment Company Act”), and state-regulated insurance companies;¹¹⁸

- Performs, at the end of the offering, substantial duties on behalf of the issuer other than marketing the issuer’s securities or in connection with transactions in securities; was not a broker-dealer, or an associated person of a broker-dealer, within the preceding 12 months; and does not participate in the sale of securities for the issuer more than once every 12 months; or
- Restricts activities to:
 - (i) preparing written materials, which are approved by a partner, officer, or director of the issuer;
 - (ii) responding to investor-initiated inquiries, provided that the content of such responses are limited to information contained in a registration statement filed under the Securities Act or other offering document; or
 - (iii) ministerial and clerical work.¹¹⁹

Rule 3a4-1 does not cover attorneys, accountants, insurance brokers, financial service organizations, or financial consultants who for a fee assist issuers in the sale of securities.

**[D][3] Issuers and Associated Persons in
Demutualizations, Exchange Offers,
Conversions, Proxy Solicitations**

The SEC has addressed the issue of whether a company or its associated persons need to register under section 15 when the associated persons provide assistance, including proxy solicitation,¹²⁰ during the process of a company’s demutualization, conversion, or

118. *Id.* This leg of the safe harbor does not extend to sales to all categories of “accredited investors,” as defined in Rule 501(a) under the Securities Act.

119. This alternative is essentially available to associated persons engaged in what the SEC deems to be “passive” sales efforts. Rule 3a4-1 Adopting Release, *supra* note 111; Rule 3a4-1(a)(3).

120. The associated persons of the company and other personnel hired for the transactions can contact voting persons who have not returned a proxy card and remind them to vote and to inform them that the board of directors of the company has approved the plan and recommends that they vote to approve the plan. *See* EIG Mutual Holding Company, SEC No-Action Letter (Oct. 25, 2006); Anthem Insurance Co., SEC No-Action Letter (Oct. 25, 2001).

exchange offer. The SEC has provided relief subject to the following conditions:

- the transaction and its related activities by the associated persons are one-time, non-recurring events;
- no compensation of the associated persons will be payable contingent upon the transaction;
- the associated persons will not be compensated, directly or indirectly, for their efforts in connection with the transaction;
- the associated persons will receive only the compensation they already receive as directors, officers, or employees of the company;
- activities of the associated persons will be strictly limited and supervised;
- the associated persons will not handle customer funds or securities in connection with the transaction;
- no associated persons will be hired solely for the purpose of assisting the transaction;
- the associated persons will have substantial, full-time duties unrelated to the transaction;
- the associated persons will not discuss the potential market value of the stock; and
- the associated persons' contact with policyholders will be limited and will not discuss the potential value of the stocks, or advise policyholders on how to vote on the demutualization or conversion plan, other than confirming that the board of directors has voted to adopt the plan.¹²¹

In addition, in one no-action letter, the SEC required that the associated persons participating in the solicitation of exchange offers have not participated within the preceding two years in the distribution or sale of any securities pursuant to Rule 3a4-1.¹²²

Although personnel who are hired solely for the purpose of a transaction and are not employees of the company, such as call center personnel, are not be able to rely upon the safe harbor in Rule 3a4-1, the SEC has also provided relief subject to the following conditions:

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121. See EIG Mutual Holding Co., SEC No-Action Letter (Oct. 25, 2006); Anthem Insurance Co., SEC No-Action Letter (Oct. 25, 2001); John Hancock Mutual Life Insurance Co., SEC No-Action Letter (Nov. 1, 1999); The Manufacturers Life Insurance Co., SEC No-Action Letter (May 18, 1999); The Equitable Life Assurance Society of the United States, SEC No-Action Letter (Feb. 28, 1992).
122. Mortgage Investors of Washington, SEC No-Action Letter (Jan. 31, 1981).

- (i) the transaction and its related activities are one-time extraordinary events;
- (ii) the call center personnel are compensated on an hourly or salaried basis;
- (iii) the activities of the call center personnel are strictly limited and supervised;
- (iv) the call center personnel do not handle customer funds and securities in connection with the activities discussed; and
- (v) the call center personnel do not discuss the potential value of the stock, make recommendations to the policyholders regarding the transaction, or solicit policyholders except to answer questions.¹²³

[E] Bulletin Boards

The SEC staff has considered the application of the broker-dealer registration requirements to bulletin boards for an issuer's stock, including bulletin boards set up by a company to facilitate trading in its own stock, and bulletin boards operated by an unaffiliated third party¹²⁴ for the securities of multiple companies.¹²⁵ In determining whether the operator of a bulletin board must register as a broker-dealer, the SEC has considered the same factors used in deciding whether a person is a broker discussed above. The SEC has given no-action relief to a company with "passive bulletin board systems" that provide information to prospective sellers and buyers of the company's securities, provided that:

- (i) no transactions would be effected by the systems themselves;
- (ii) the companies would have no role in effecting transactions between participants; and

123. Anthem Insurance Co., SEC No-Action Letter (Oct. 25, 2001); Principal Mutual Holding Co., SEC No-Action Letter (Oct. 9, 2001); Phoenix Home Life Mutual Insurance Co., SEC No-Action Letter (May 31, 2001); John Hancock Mutual Life Insurance Co., SEC No-Action Letter (Nov. 1, 1999).

124. *See, e.g.*, Portland Brewing Co., SEC No-Action Letter (Dec. 14, 1999); Flamemaster Corp., SEC No-Action Letter (Oct. 29, 1996); Real Goods Trading Corp., SEC No-Action Letter (June 24, 1996).

125. *See, e.g.*, Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation to Lori Livingston, Transfer Online, Inc. (May 13, 2000); Investex Investment Exchange Inc., SEC No-Action Letter (Apr. 9, 1990); Petroleum Information Corp., SEC No-Action Letter (Nov. 28, 1989).

- (iii) all transactions would be effected only by direct contact between the bulletin board participants.¹²⁶

The SEC identified several activities by the sponsors of bulletin boards that could require them to register as broker-dealers. The activities include:

- (i) the publication of quotations;
- (ii) active solicitation of investors (for example, by targeting potential investors with direct mailings and follow-up email);
- (iii) involvement in negotiations or other discussions with buyers and sellers;
- (iv) providing advice to issuers for their offering materials or investment advice with respect to any particular security;
- (v) involvement in any way with the execution, settlement, or clearance of transactions, including preparing or sending transaction confirmations (other than providing the functionality of order transmission);
- (vi) matching buyers and sellers either by matching the list of interested buyers with the list of interested sellers or through a bid and ask process that allows interested buyers to bid on the listed interest;
- (vii) handling of customer funds or securities;
- (viii) screening counterparties for creditworthiness or extension of credit in connection with the transactions;
- (ix) receipt of transaction-related compensation; and
- (x) exercising discretion over the bulletin board website and having its name on the website.¹²⁷

[F] ATs and Securities Exchanges

As the bulletin board letters show, the roles of a broker and an exchange can blur. The SEC has sought to distinguish these roles.

126. See Portland Brewing Co., SEC No-Action Letter (Dec. 14, 1999); Flame-master Corp., SEC No-Action Letter (Oct. 29, 1996); PerfectData Corp., SEC No-Action Letter (Aug. 5, 1996); Real Goods Trading Corp., SEC No-Action Letter (June 24, 1996).

127. See GlobalTec Solutions, LLP, SEC No-Action Letter (Dec. 28, 2005); Swiss American Securities, Inc., Streetline, Inc., SEC No-Action Letter (May 28, 2002); Oil-N-Gas, Inc., Section No-Action Letter (June 8, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Lori Livingston, Transfer Online, Inc. (May 13, 2000); King & Spalding, SEC No-Action Letter (Nov. 17, 1992).

Section 3(a)(1) of the Exchange Act defines the term “exchange” as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.”¹²⁸ Exchange Act Rule 3b-16(a) interprets the section 3(a)(1) definition to mean any organization, association, or group of persons that: (i) brings together the orders of multiple buyers and sellers; and (ii) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.¹²⁹

Rule 3b-16(b) expressly excludes the following systems from the meaning of “exchange”: (i) systems that merely route orders to other facilities for execution; (ii) systems operated by a single registered market maker to display its own bids and offers and the limit orders of its customers, and to execute trades against such orders; and (iii) systems that allow persons to enter orders for execution against the bids and offers of a single dealer.¹³⁰ Absent an exemption, an exchange must register as a national securities exchange pursuant to section 6 and section 19(a) of the Exchange Act.

In 1998, the SEC adopted Regulation ATS, which allows alternative trading systems (ATSs) to choose whether to register as national securities exchanges or to register as broker-dealers and comply with additional requirements of Regulation ATS depending on their activities and trading volume.¹³¹ An “alternative trading system” means any organization, association, person, group of persons, or system (i) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-16 under the Exchange Act, and (ii) that does not set rules governing the conduct of subscribers other than the conduct of such subscribers’ trading on such organization, association, person, group of persons, or system; or discipline subscribers other than by exclusion from trading.¹³²

128. See Exchange Act § 3(a)(1).

129. Rule 3b-16(a).

130. Rule 3b-16(b).

131. See Regulation of Exchanges and Alternative Trading Systems, SEC Release No. 34-40760 (Dec. 8, 1998).

132. Regulation ATS, Rule 300(a).

Any system exercising self-regulatory powers, such as regulating its members' or subscribers' conduct when engaged in activities outside of that trading system, must register as an exchange or be operated by a national securities association. In addition, the SEC can effectively require a dominant alternative trading system to register as a national securities exchange if it finds in a particular case that it is necessary or appropriate in the public interest or consistent with the protection of investors.¹³³

Security-based swap execution facilities, a concept introduced in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Dodd-Frank Act"),¹³⁴ are discussed in *infra* section 1A:4.4.

[G] Payroll Processing Services

The SEC has granted no-action relief to companies ("service companies") that proposed to provide "professional employer organization services," commonly known as "employee leasing services," on behalf of, and under the control of, Registered Broker-Dealers.¹³⁵ The services provided to broker-dealer clients usually consist of payroll processing services, human resources consulting, employee benefits services which include provision of various types of insurance¹³⁶ to employees of its broker-dealer clients. Although the employees placed on the service company's payrolls are employees of the service company for purpose of applicable employment laws, they are associated persons¹³⁷ of the broker-dealers for purposes of the

133. See Rule 3a1-1(b).

134. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

135. See ADP TotalSource, Inc., SEC No-Action Letter (Dec. 4, 2007); eEmployers Solutions, Inc., SEC No-Action Letter (Dec. 3, 2007); TriNet Group, Inc., SEC No-Action Letter (Feb. 17, 2006); R & H Management, L.L.C., SEC No-Action Letter (Apr. 25, 2005); Headway Corporate Staff Administration, SEC No-Action Letter (Aug. 30, 2002); EPIX Holdings Corp., SEC No-Action Letter (Apr. 2, 2001); Staff Management, Inc., SEC No-Action Letter (Apr. 27, 2000); T.T.C. Illinois, SEC No-Action Letter (Feb. 1, 1999); The Cura Group, Inc., SEC No-Action Letter (Feb. 1, 1999); EMPOWER, Inc., SEC No-Action Letter (Feb. 1, 1999); Action Staffing, Inc., SEC No-Action Letter (June 7, 1989).

136. The insurance products to be provided cannot be "securities" as defined under the federal securities laws.

137. A broker-dealer's supervisory responsibilities under the federal securities laws, including Section 15(b) and Section 20(a) of the Exchange Act, are not affected by whether the broker-dealer treats its representatives as "employees" or as "independent contractors" for other purposes. See Letter from Douglas Scarff, Director, Division of Market Regulation, SEC, to Gordon S. Macklin, President, National Association of Securities Dealers, Inc. (June 18, 1982), reprinted in [1982-83 Transfer Binder] Fed. Sec. L.

securities laws and these broker-dealers maintain direction and control over them.

In the no-action letters granted by the SEC staff, when providing payroll processing services for any one of its broker-dealer clients, the service company is permitted to receive payment from the broker-dealer for salaries, wages and commissions, which the company will then pay to personnel of the broker-dealers. The service company will impose an administrative fee for its services. This fee is usually a flat, pre-determined fee based on the number of employees serviced. The fee may not be based on a percentage of payroll, nor on brokerage commissions earned by either the employees of the broker-dealer or the broker-dealer itself.

The SEC staff has imposed two conditions for granting no-action relief to service companies that provide employee leasing services without registering as broker-dealers: (i) the service companies must have no discretion concerning the amount or frequency of the salary, wage, commission or bonus payments to employees of the broker-dealers who have been placed on the service companies' payrolls,¹³⁸ and (ii) the service companies' broker-dealer clients must have sole and exclusive discretion and control over the day-to-day professional activities of all of their employees.¹³⁹ The staff has refused to grant no-action relief when the service company had some control over the employees' compensation and the potential to interfere with and unduly influence the employment relationship between the registered representatives and the broker-dealer.¹⁴⁰ The SEC staff articulated the policy considerations behind its positions in its letter to Investacorp Group:

Rep. (CCH) ¶ 77,303. The broker-dealer is responsible for supervising the representatives' securities activities regardless of the representatives' status under state law. *See, e.g.,* In the Matter of William V. Giordano, SEC Release No. 34-36742 (Jan. 19, 1996).

138. The SEC recognizes that the service companies will require that all compensation be paid in a timely manner as required by law.

139. *See* ADP TotalSource, Inc., SEC No-Action Letter (Dec. 4, 2007); eEmployers Solutions, Inc., SEC No-Action Letter (Dec. 3, 2007); Investacorp Group, Inc., Investacorp, Inc., SEC No-Action Letter (Sept. 26, 2003); Action Staffing, Inc., SEC No-Action Letter (June 7, 1989). Often, the company that provides payroll processing services to a broker-dealer is not a subsidiary or an affiliate with the broker-dealer. *See, e.g.,* eEmployers Solutions, Inc., SEC No-Action Letter (Dec. 3, 2007); Action Staffing, Inc., SEC No-Action Letter (June 7, 1989). A subsidiary or affiliate of a registered broker-dealer does not have to register unless it engages in the broker-dealer activity of its registered parent or affiliate.

140. *See* Herbruck, Alder & Co., SEC Denial of No-Action Request (May 3, 2002).

... a broker-dealer must control the amount of securities-related compensation received by its registered representatives, and the timing of that compensation. Any other arrangement could permit unregistered persons to interfere with the broker-dealer's control over its representatives' securities activities. That type of interference would conflict with self-regulatory organization rules requiring broker-dealer to supervise the securities activity of their personnel, and could undercut investor protection by weakening the application of customer protection rules governing registered representatives' securities activities. Moreover, permitting unregistered persons to influence the securities compensation of registered representatives could facilitate other abuses, such as providing a means for statutorily disqualified persons to engage in securities activities.¹⁴¹

[H] Personal Service Companies

The SEC has distinguished companies providing employee leasing services from those personal service companies owned by registered representatives of broker-dealers.¹⁴² The SEC staff has consistently declined to grant no-action relief with respect to personal service companies owned by registered representatives operating without registration under section 15 of the Exchange Act, in particular where the following factors are present:¹⁴³

- The company would receive commissions or other transaction-related compensation earned by the registered representatives directly or indirectly from the broker-dealer;
- the company would then use the money to make payments to the registered representatives including commissions payments and benefits and cover other company expenses;
- the business purpose of the company would be to provide various services and employee benefits to its employees;

141. See Investacorp Group, Inc., Investacorp, Inc., SEC No-Action Letter (Sept. 26, 2003).

142. See ADP TotalSource, Inc., SEC No-Action Letter (Dec. 4, 2007); eEmployers Solutions, Inc., SEC No-Action Letter (Dec. 3, 2007).

143. See, e.g., Wolff Juall Investments, LLC, SEC Denial of No-Action Request (May 17, 2005); Vanasco, Wayne & Genelly, SEC Interpretive Letter (Feb. 17, 1999); Birchtree Financial Services, Inc., SEC Denial of No-Action Request (Sept. 22, 1998); First Financial of Citrus County Inc., SEC Denial of No-Action Request (Sept. 22, 1998); Century Investment Group Inc., SEC Denial of No-Action Request (Jan. 29, 1996); Voluntary Benefit Systems Corp. of America, SEC Denial of No-Action Request (Nov. 14, 1995); Lombard Securities Inc., SEC Denial of No-Action Request (July 12, 1994).

- and, unlike the companies that provide employee leasing services, the personal service companies make decisions regarding the payments of commissions and other benefits to the registered representatives who are employees of the personal service companies.

The SEC staff has taken the position that the receipt of securities commissions or other transaction-related compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer,¹⁴⁴ and that, absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities generally is required to register as a broker-dealer under section 15 of the Exchange Act.¹⁴⁵

[I] Other Service Providers to the Securities Industry, Broker-Dealers or Issuers

[I][1] Communications Services

The SEC has granted no-action relief to companies that proposed to provide communications services to support or assist securities transactions without registering under section 15 of the Exchange Act. The factors that the SEC has identified in granting no-action relief to providers of the communications services include, among others, that the providers will not:

- (i) hold or have access to or handle funds or securities;
- (ii) recommend or endorse specific securities;
- (iii) become involved (other than by routing messages) with the financial services offered by broker-dealers, including, among others, the opening, maintenance, administration, or closing of accounts, or the solicitation, processing or facilitation of transactions of any kind relating to accounts;
- (iv) participate in any purchase or sale negotiations;
- (v) directly or indirectly make any statement about, or endorsement or recommendation of any kind of, any broker-dealer to any manager;

144. See Wolff Jull Investments, LLC, SEC Denial of No-Action Request (May 17, 2005); Birchtree Financial Services, Inc., SEC Denial of No-Action Request (Sept. 22, 1998); Vanasco, Wayne & Genelly, SEC Interpretive Letter (Feb. 17, 1999).

145. See *id.*

- (vi) receive compensation based, directly or indirectly, on the size, value, or occurrence of securities transactions; or
- (vii) hold itself as providing securities-related services.¹⁴⁶

[1][2] Confirmation and Other Processors

As discussed in *supra* section 1A:2.3, an entity generally does not need to register as a broker-dealer if it performs only clerical or ministerial functions for Registered Broker-Dealers.¹⁴⁷ The SEC has granted no-action relief to entities that send out confirmation of securities transactions to investors without being engaged in the effecting of the securities transactions.¹⁴⁸

The confirmation must be sent out under the supervision of the broker-dealer that executed the transaction.¹⁴⁹ The broker-dealer must

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- 146. *See, e.g.,* e-Media, LLC, SEC No-Action Letter (Dec. 14, 2000) (no-action relief granted to e-Media which proposed to offer and perform its transmission services to unaffiliated issuers through its registered broker-dealer clients' websites); Evare, LLC, SEC No-Action Letter (Nov. 30, 1998) (no-action relief granted to Evare which proposed to offer an online communication system linking professional money managers, broker-dealers, and custodians that would enable managers to obtain quotes from, and enter orders with, broker-dealers, and to communicate information to custodians for settlement of trades); Vedder, Price, Kaufman & Kammholz, SEC No-Action Letter (May 21, 1997) (no-action relief granted to financial research centers which proposed to install dedicated communication links between the centers and a registered broker-dealer to accommodate the broker-dealer's customers using the research centers at a fixed flat per use fee).
 - 147. *See* SS&C Technologies, Inc., SEC No-Action Letter (Aug. 13, 2008); The Securities Transfer Ass'n, Inc., SEC No-Action Letter (Dec. 1, 1994); Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Harold J. Smotkin, Clearing Service, Inc. (Feb. 1, 1972) (Clearing Service was required to register as broker-dealer, inasmuch as the services it performed went beyond those of purely clerical or ministerial nature); Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to William F. Clare, ESE Stock Transfer Corp. (Nov. 20, 1971) (ESE Stock Transfer Corp. was required to register because the services it intended to perform went beyond those which are merely clerical or ministerial in nature).
 - 148. *See* Omgeo LLC, SEC No-Action Letter (Dec. 14, 2006); Scotch Whisky Investment Co., SEC No-Action Letter (Jan. 20, 1973) (no-action relief granted to Scotch Whisky Investment Co., provided that: (i) all sales of the securities are made through registered broker-dealers; (ii) such broker-dealers will comply with all applicable suitability, confirmation and record keeping requirements with respect to such sales; and (iii) Scotch Whisky Investment Co. will in no way assist the investors in the resale or liquidation of their investment, and will not be engaged in the activities of a "dealer" as that term is defined in section 3(a)(5) of the Exchange Act by buying and selling the warehouse receipts for its own account).
 - 149. *See* Central Federal Savings & Loan Ass'n, SEC No-Action Letter (Jan. 31, 1987); The Woodmoor Corp., SEC No-Action Letter (Mar. 5, 1972).

ensure that all applicable provisions of the federal securities laws, including the record keeping and confirmation requirements, are complied in connection with each sale.¹⁵⁰ Absent such responsibility, supervision and record keeping by a broker-dealer, the entity that provides confirmation services may be required to register as a broker-dealer with the SEC.¹⁵¹

[1][3] Transfer Agents and Stock Plan Services

The SEC has provided no-action relief to transfer agents¹⁵² that act as an intermediary between issuers and Registered Broker-Dealers without effecting securities transactions.¹⁵³ The SEC has also granted relief to issuers who are registered transfer agents, when they provide services to their employees or shareholders as part of an employee stock purchase plan or other similar programs, provided that they do not execute transactions. For example, the SEC granted no-action relief to Digital Equipment Corporation (“Digital”), a registered transfer agent, for its employee stock purchase plan procedures (“Plan”) to help its employees in the sale of shares.¹⁵⁴ Under the Plan, Digital deducted certain amounts from the salary of each employee participating in the Plan during each of the two payment periods in the year and purchased Digital’s common stock for employees automatically under options granted to the employees.¹⁵⁵ To assist employees in selling

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150. See *The Depository Trust Co.*, SEC No-Action Letter (Feb. 28, 1983); *Benal Beach Corp., S.A.*, SEC No-Action Letter (Apr. 5, 1974); *Scotch Whisky Investment Co.*, SEC No-Action Letter (Jan. 20, 1973).
151. See *Benal Beach Corp., S.A.*, SEC No-Action Letter (Apr. 5, 1974); *Scotch Whisky Investment Company*, SEC No-Action Letter (Jan. 20, 1973); *The Woodmoor Corp.*, SEC No-Action Letter (Mar. 5, 1972).
152. A “transfer agent” is defined in section 3(a)(25) of the Exchange Act as “any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.” Transfer agents are required to register with the SEC under Section 17A of the Exchange Act.
153. See *Columbia Transfer Co.*, SEC No-Action Letter (May 28, 1976) (Columbia proposed to perform certain services incidental to the proposed offering of an issuer for a fee; proposed services included reviewing proposed offering and disseminating information regarding the proposed offering to the participating broker-dealers, acting as an intermediary between the issuer and any participating broker-dealers interested in acting as underwriters, and facilitating the negotiation of terms regarding the underwriting agreement).
154. See *Digital Equipment Corp.*, SEC No-Action Letter (Oct. 2, 1978).
155. See *id.*

shares purchased under the Plan, Digital proposed to group together on a daily basis all employee orders to sell and forward such orders to a Registered Broker-Dealer for execution.¹⁵⁶ Digital would not receive any compensation for these services and would only perform these services as a convenience for its employees.¹⁵⁷ In another no-action letter, the SEC permitted American Transtech to act as transfer agent to its shareholders in transmitting the shares they wished to sell to a broker-dealer for execution without registering as a broker-dealer itself.¹⁵⁸

The SEC staff has indicated reluctance to grant no-action relief to transfer agents whose proposed services go beyond those that are merely clerical or ministerial in nature and involve the purchase or sale of securities, or maintaining custody or possession of funds or securities at any stage of a securities transaction,¹⁵⁹ and a transfer agent administering stock plans may be obliged to register under section 15(a) if it effects securities transactions, absent an available exemption or exemptive relief.¹⁶⁰

Subject to certain conditions,¹⁶¹ a bank is not considered a broker or dealer if it effects transactions, as part of its transfer agency activities, in the securities of an issuer as part of any employee pension, retirement, profit-sharing, bonus, or other similar benefits plans, as part of the issuer's dividend reinvestment plan, or as part of a plan or program for the purchase or sale of that issuer's shares.¹⁶² In addition, the SEC has, pursuant to its authority under section 15(a)(2) and section 36 of the Exchange Act, provided a limited conditional

156. *See id.*

157. *See id.*

158. American Transtech Inc., SEC No-Action Letter (Sept. 22, 1985).

159. *See* The Stallion Fund, Inc., SEC Denial of No-Action Request (Oct. 13, 1971); *see also* Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Lori Livingston, Transfer Online, Inc. (May 13, 2000).

160. *See* Order Exempting CIBC Mellon Trust Company From Broker-Dealer Registration, SEC Release No. 34-60136 (June 18, 2009); Order Exempting Computershare Trust Company of Canada and Computershare Investor Services Inc. From Broker Registration, SEC Release No. 34-53667 (Apr. 18, 2006); Transfer Agents Operating Direct Registration System, SEC Release No. 34-35038 (Dec. 1, 1994).

161. Conditions set forth by section 3(a)(4)(B)(iv) include: (i) the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan or program; and (ii) for dividend reinvestment plans and issuer plans, the bank does not net shareholders' buy and sell orders, other than for programs for add-lot holders or plans registered with the Commission. *See* Exchange Act § 3(a)(4)(B)(iv).

162. *Id.*

exemption to an entity in connection with its administration of stock plans with U.S. resident investors for issuers for which the entity acted as transfer agent, subject to certain conditions including that the entity must maintain its registration as transfer agent with the SEC.¹⁶³

[1][4] Research Services

A person who provides research services in connection with its brokerage business or receives transaction-based compensation in connection with that research may be required to register as a broker-dealer with the SEC.¹⁶⁴ The SEC has granted no-action relief to research providers who do not participate in securities transactions (other than providing research or information that is deemed to be solicitation) or receive transaction-based compensation.¹⁶⁵ One exception to the requirement that the research services providers cannot receive transaction-based compensation is that the research service providers can receive payments from client commissions through a client commission arrangement qualified under the safe harbor of section 28(e)¹⁶⁶ of the Exchange Act without registering as

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163. See Order Exempting CIBC Mellon Trust Company From Broker-Dealer Registration, SEC Release No. 34-60136 (June 18, 2009); Order Exempting Computershare Trust Company of Canada and Computershare Investor Services Inc. From Broker Registration, SEC Release No. 34-53667 (Apr. 18, 2006); Transfer Agents Operating Direct Registration System, SEC Release No. 34-35038 (Dec. 1, 1994).
164. Charles Schwab & Co., Inc., SEC No-Action Letter (Sept. 18, 1997); Citicorp, SEC No-Action Letter (Sept. 14, 1986).
165. Charles Schwab & Co., Inc., SEC No-Action Letter (Sept. 18, 1997). The SEC has also granted no-action relief to other service providers and to investors where there is no involvement by the service provider in effecting securities transactions or transaction-based compensation. See The Investment Archive, LLC, SEC No-Action Letter (May 14, 2010).
166. Section 28(e) establishes a safe harbor that allows money managers to use client funds to purchase “brokerage and research services” for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. This section permits the arrangements where one broker-dealer provides research and other services while another broker-dealer clears or settles the trade, and they share in the client commissions for the transaction. Section 28(e) requires that the broker-dealer receiving commissions for “effecting” transactions must “provide” the brokerage or research services. The SEC has interpreted this section to permit money managers to use client commissions to pay for research produced by a third-party research provider that is not the executing broker-dealer. See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, SEC Release No. 34-54165 (July 18, 2006) [hereinafter Section 28(e) Interpretative Release].

broker-dealers.¹⁶⁷ To qualify for the exemption, the arrangement must satisfy certain conditions:

- (i) the money manager must independently determine the value of the research services;
- (ii) the research services providers must receive payment from the commissions set aside for research services;
- (iii) payment to research providers is not conditioned, directly or indirectly, on the execution of any particular transaction or transactions in securities that are described or analyzed in the research services; and
- (iv) the research services providers must not perform other functions that are typically characteristic of broker-dealer activity.¹⁶⁸

If a research services provider does not receive transaction-based compensation but receives a separate advisory fee, he or she may have to register as an investment adviser under the Investment Advisers Act of 1940 (the "Investment Advisers Act").¹⁶⁹ A person or entity who provides research services in connection with its brokerage business and charges a separate advisory fee may have to register as both broker-dealer and investment adviser.¹⁷⁰

[I][5] Accountants

The SEC staff generally has not granted no-action relief to accountants who have arrangements with broker-dealers to receive referral fees, finders' fees, and commissions for references or sales of securities. The basis for the SEC's analysis in this situation has been the same as that for personal service companies: absent an exemption, an entity that receives commissions or other transaction-related compensation

167. Capital Institutional Services, Inc., SEC No-Action Letter (Apr. 13, 2007); Goldman Sachs & Co., SEC No-Action Letter (Jan. 17, 2007).

168. *Id.*

169. Sterling Research Corp., SEC No-Action Letter (May 20, 1982); Citicorp, SEC No-Action Letter (Sept. 14, 1986); Investment Mgmt. & Research, Inc., SEC No-Action Letter (Jan. 27, 1977).

170. Tax Shelter Advisory Service, Inc., SEC No-Action Letter (Nov. 30, 1973); Citicorp, SEC No-Action Letter (Sept. 14, 1986) (Section 202(a)(11)(C) of the Investment Advisers Act only exempts from registration persons or entities who render investment advice solely incidental to activities as a registered broker-dealer and receives no special compensation for the advisory services).

in connection with securities-based activities generally is required to register as a broker-dealer.¹⁷¹

The SEC staff has denied a CPA firm's no-action request under section 15(a) for its proposal to enter into an arrangement with a Registered Broker-Dealer, through which it would have received transaction-related compensation.¹⁷² Under that arrangement, the broker-dealer would offer certain financial products and services to clients of the CPA firm on the premises of the CPA firm.¹⁷³ The broker-dealer would not pay referral fees, finders' fees or commissions to the CPA firm but the rent it would pay would be based on the value of the square footage leased plus the value of the income generated from the CPA firm's clients. By contrast, the SEC staff has granted no-action relief to several tax preparers and accountants who proposed to enter a contract with a Registered Broker-Dealer, under which they would refer prospective clients to the broker-dealer for a one-time referral fee.¹⁷⁴ The fees paid to the tax preparers and accountants would not depend on the amount of commissions or compensation received by the broker-dealer and would be paid only once for each account regardless of whether there would be subsequent commissions from this account.¹⁷⁵ This letter appears to be inconsistent with prior and succeeding letters and provides little ongoing guidance.

When a CPA is also a registered representative of a broker-dealer, he may be able to receive transaction-based compensation from the broker-dealer, provided that no other CPAs who are not Registered Broker-Dealers or associated persons of a Registered Broker-Dealer will directly or indirectly benefit from the arrangement.¹⁷⁶ As the SEC has stated: ". . . the direct or indirect receipt by CPAs who are not Registered Broker-Dealers, or associate[d] persons thereof, of referral fees, finder's fees, commissions . . . or similar transaction-based compensation in connection with transactions in securities still would require these CPAs to register as broker-dealers with the SEC."¹⁷⁷

171. See 1st Global Inc., SEC No-Action Letter (May 7, 2001) (*citing* Birchtree Financial Services, Inc., SEC Denial of No-Action Request (Sept. 22, 1998)); Joseph K. Bannon, CPA, SEC No-Action Letter (Dec. 9, 1988).

172. See Flexible Financial Marketing, Inc., SEC Denial of No-Action Request (Sept. 13, 1996).

173. See *id.*

174. See Redmond Associates and John Kendall Redmond, SEC No-Action Letter (Jan. 12, 1985).

175. See *id.*

176. See Joseph K. Bannon, CPA, SEC No-Action Letter (Dec. 9, 1988).

177. See *id.*

The SEC has described two scenarios involving accountants where it would deny no-action relief: (i) where a broker-dealer pays securities commissions to its registered representative who is also a CPA and the registered representative must turn those commissions over to an unregistered CPA firm or “voluntarily” turns those commissions over to an unregistered CPA firm, and (ii) where securities commissions are paid to another Registered Broker-Dealer, if that other broker-dealer is owned by an unregistered CPA firm or its partners.¹⁷⁸

[J] Investment Advisers

There is no general exemption for investment advisers from federal broker-dealer registration. The SEC staff has addressed the issue of whether registered investment advisers must also register as broker-dealers in a number of specific circumstances. The SEC staff has summarized its approach as follows:

the staff has declined to take a no-action position with respect to broker-dealer registration for a registered investment adviser that proposed to assist a broker-dealer with solicitation and receive transaction-related compensation. Moreover, even in the absence of commissions or other transaction-related fees, the staff has declined to take a no-action position regarding the broker-dealer registration of an investment adviser that proposed to locate issuers, solicit new clients, and act as a customers’ agent in structuring or negotiating transactions.¹⁷⁹

§ 1A:3 What Is a Dealer?

§ 1A:3.1 Section 3(a)(5)(A)

[A] Generally

The term “dealer” is defined in section 3(a)(5)(A) of the Exchange Act as “any person engaged in the business of buying and selling

178. See 1st Global Inc., SEC No-Action Letter (May 7, 2001).

179. InTouch Global, LLC, SEC No-Action Letter (Nov. 14, 1995) (citing PRA Securities Advisers, L.P., SEC Denial of No-Action Request (Mar. 3, 1993) (notwithstanding the fact that PRA would be compensated by an annual fee based on the percentage of assets under management, the staff refused to take no-action position with PRA based on three representations by PRA: (i) PRA would be actively engaged in locating prospective real estate investment trusts (“REITs”) issuers and negotiating the terms of the private placement transaction and the securities on behalf of clients; (ii) PRA would be approaching new clients to interest them in purchasing the REITs; and (iii) a registered broker-dealer would not be involved in effecting these transactions); Boston Advisory Group, SEC Denial of No-Action Request (Oct. 2, 1980)).

securities for such person's own account through a broker or otherwise." Section 3(a)(5)(B) explicitly excludes from the "dealer" definition "a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." Hence, whether a person is a "dealer" turns on two factual questions: (i) whether a person is "buying and selling securities for its own account," and (ii) whether a person is engaged in that activity "as part of a regular business."¹⁸⁰

As discussed above, before the GLBA was enacted in 1999, banks were excluded from the definitions of both "brokers" and "dealers." The GLBA amended sections 3(a)(4) and 3(a)(5) and replaced the blanket exclusion for banks with eleven exemptions.¹⁸¹

The Dodd-Frank Act amends the definition of "dealer" to provide that a dealer in security-based swaps with eligible contract participants is not required to register as a broker-dealer. In addition, it creates a new designation of, and requires registration and regulation of, "security-based swap dealers." These topics are discussed further in *infra* section 1A:4.4.

[B] Buying and Selling Securities for Own Account

To be a dealer, a person has to both buy and sell securities.¹⁸² In contrast, a person is a broker as long as he participates in securities transactions, which can be either purchase or sale, at key points in the chain of distribution.¹⁸³

A dealer purchases and sells securities in principal transactions where it either buys securities from customers and takes them into its own inventory or sells securities to customers from its inventory.¹⁸⁴

180. See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, SEC Release No. 34-47364 (Feb. 13, 2003).

181. See Exchange Act § 3(a)(5)(C). For a detailed discussion on Section 3(a)(5)(C) exemptions, see *infra* section 1A:7.

182. Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Joseph McCulley (Aug. 2, 1972); *Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357, 361 (5th Cir. 1968).

183. See Exchange Act § 3(a)(4); *Mass. Fin. Servs., Inc. v. Sec. Investor Prot. Corp.*, 411 F. Supp. 411, 415 (D. Mass.), *aff'd* 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977); see also *SEC v. Nat'l Executive Planners, Ltd.*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Lori Livingston, Transfer Online, Inc. (May 13, 2000).

184. See Proposing Release, Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, SEC Release No. 34-46745 (Oct. 30, 2002).

These transactions also include so-called “riskless principal” transactions,¹⁸⁵ in which, after receiving an order to buy (or sell) from a customer, the broker-dealer purchases (or sells) the security from (or to) another person in a contemporaneous offsetting transaction.¹⁸⁶ Entities that engage in such transactions as a matter of course would be involved in the business of buying and selling securities for their own accounts, even if the risk associated with the transactions is minimal or non-existent.¹⁸⁷

The SEC has taken the position that a dealer must buy and sell, or be willing to buy and sell, contemporaneously.¹⁸⁸ This approach is necessary to distinguish dealers from investors who buy and sell a security for investment purposes, but sometimes hold the position for only a short amount of time. The distinction between active trader and dealer can be very fine.

The Dodd-Frank Act adds “security-based swaps” to the definition of “security” in section 3(a)(10) of the Exchange Act. In addition, it introduces the concept of a non-dealer “major security-based swap participant” and imposes registration and regulatory requirements on these entities. Therefore, significant participation in security-based swaps may require an entity to register as a major security-based swap participant even if it does not qualify as a “dealer” or “security-based swap dealer.” The Dodd-Frank Act is discussed further in *infra* section 1A:4.4.

[C] Engaged in the Business

Section 3(a)(5)(A) requires a “dealer” to be “engaged in the business” of buying and selling securities for its own account.¹⁸⁹ As discussed previously, courts have read into the term “engaged in the business” a certain regularity of participation in purchasing and selling activities.¹⁹⁰ To be “engaged in the business” of buying and selling

185. *Id.*

186. *See* SEC Release No. 34-46745, n.28 (Oct. 30, 2002); *see also* Rule 10b-10(a)(2)(ii)(A) [17 C.F.R. § 240.10b-10(a)(2)(ii)(A)]; SEC Release No. 34-33743, n.11 (Mar. 9, 1994).

187. *See* SEC Release No. 34-46745 (Oct. 30, 2002).

188. *See, e.g.*, Letter from Susan J. Walters, Office of Chief Counsel, to Martin E. Lybecker, National Council of Savings Institutions (July 27, 1986) (discussing the distinction between a dealer and a trader).

189. *See* Exchange Act § 3(a)(5)(A).

190. *See* SEC v. Am. Inst. Counselors, Inc., Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.C. 1975) (citing Loss, Securities Regulation (2d ed. 1961)); *also see* SEC v. Kenton Capital Ltd., 69 F. Supp. 2d 1 (D.C. 1998); SEC v. Margolin, 1992 WL 279735 (S.D.N.Y. 1992); SEC v. Hansen, 1984 WL 2413 (S.D.N.Y. 1984); SEC v. Nat'l Executive Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); Mass. Fin. Servs., Inc. v. Sec. Investor Prot. Corp., 411 F. Supp. 411, 415 (D. Mass.), *aff'd*, 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977).

securities, a person has to conduct securities transactions as a part of a regular business,¹⁹¹ and more often than on a single isolated basis.¹⁹²

§ 1A:3.2 “Traders” versus “Dealers”—Section 3(a)(5)(B)

[A] Generally

Section 3(a)(5)(B) explicitly excludes those who buy or sell securities for their own accounts, “but not as a part of a regular business.” These persons are commonly known as “traders.”¹⁹³ Individuals who buy and sell securities for their own investment accounts and do not carry on a public securities business generally are traders and not dealers.¹⁹⁴ The level of a dealer’s activity in securities transactions is usually more than that of an active trader.¹⁹⁵ However, regularity and level of participation in buying and selling securities or volume of transactions are often not enough to make a person a “dealer.”¹⁹⁶ The SEC, through its no-action letters, has identified some activities that are typical for dealers, but are not usually engaged in by ordinary traders.

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191. See *Eastside Church of Christ v. Nat’l Plan, Inc.*, 391 F.2d 357, 361 (5th Cir. 1968) (National Plan, Inc. was found to be a dealer because it purchased many church bonds prior to the ones in question for its own account as a part of its regular business and sold some of them).
192. See Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Joseph McCulley (Aug. 2, 1972); also see *SEC v. Am. Institute Counselors, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.C. 1975) (citing *Loss, Securities Regulation* (2d ed. 1961)); Hart, Stephen V., SEC No-Action Letter (Mar. 6, 1980) (isolated transactions for one’s own account will not subject a person to the requirement of registration as a “dealer in securities,” particularly when a person’s securities activities are relatively minor measured against his other activities . . .).
193. See SEC Release No. 34-46745 (Oct. 30, 2002); Public Securities Locating Services, SEC No-Action Letter (Sept. 8, 1973).
194. SEC Guide to Broker-Dealer Registration, *supra* note 72; see also Testimony of Richard R. Lindsey, Director, Division of Market Regulation, SEC, before the House Committee on Banking & Financial Services, Concerning Hedge Fund Activities in the U.S. Financial Markets, n.2 (Oct. 1, 1998), available at www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm.
195. See *SEC v. Robert L. Ridenour*, 913 F.2d 515 (8th Cir. 1990).
196. See *United Trust Co. (Morris, Larson, King)*, SEC Denial of No-Action Request (Sept. 6, 1978) (“While the volume of such municipal securities activity appears to have been low, the level of a firm’s activity with respect to municipal securities is not the measure of whether it is ‘engaged in the business’ of buying and selling municipal securities for its own account. The Company’s apparent willingness to continue to engage in such municipal securities activity when requested to do so by customers suggests that the Company is ‘engaged in the business.’”).

Factors that indicate a person is acting as a dealer include:

- (i) issuing or originating securities;¹⁹⁷
- (ii) having a regular clientele;¹⁹⁸
- (iii) advertising or otherwise holding itself out as buying or selling securities on a continuous basis or at a regular place of business;¹⁹⁹
- (iv) actively soliciting clients;²⁰⁰
- (v) having a regular turnover of inventory (or participating in the sale or distribution of new issues, such as by acting as an underwriter);²⁰¹
- (vi) acting as a market maker or specialist on an organized exchange or trading system;²⁰²
- (vii) generally transacting a substantial portion of its business with investors (or, in the case of a dealer who is a market maker, other professionals);²⁰³
- (viii) generally providing liquidity services in transactions with investors (or, in the case of a dealer who is a market maker, for other professionals);²⁰⁴
- (ix) buying and selling as principal directly from or to securities customers together with conducting any of an assortment of professional market activities such as providing investment advice, extending credit and lending securities in connection

197. See *Louis Dreyfus Corp.*, SEC No-Action Letter (July 23, 1987).

198. See SEC Release No. 34-46745 (Oct. 30, 2002); see also *SEC v. Robert L. Ridenour*, 913 F.2d 515 (8th Cir. 1990).

199. See SEC Release No. 34-46745 (Oct. 30, 2002); *SEC v. Schmidt*, Fed. Sec. L. Rep. (CCH) ¶ 93,202 (S.D.N.Y. Aug. 26, 1971); Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation to Joseph McCulley (Aug. 2, 1972); *Continental Grain Company*, SEC No-Action Letter (Nov. 6, 1987); *Instant Funds, Inc.*, SEC No-Action Letter (Mar. 14, 1971); see also *United Trust Co. (Morris, Larson, King)*, SEC Denial of No-Action Request (Sept. 6, 1978) (the company's apparent willingness to continue to engage in such municipal securities when requested to do so by customers suggests that the company is "engaged in the business").

200. *SEC v. Nat'l Executive Planners*, 503 F. Supp. 1066 (M.D.N.C. 1980).

201. See SEC Release No. 34-47364 (Feb. 13, 2003). The term "underwriter" is defined in section 2(a)(11) of the Securities Act of 1933. It should be noted that the fact that an offering is exempt from registration under the Securities Act does not necessarily affect the status of a participant in that offering as an "underwriter" as defined in Securities Act § 2(a)(11).

202. SEC Release No. 34-46745 (Oct. 30, 2002).

203. *Id.*

204. SEC Release No. 34-47364 (Feb. 13, 2003).

with transactions in securities, and carrying a securities account;²⁰⁵

- (x) using an interdealer broker (other than a retail screen broker) to effect securities transactions;²⁰⁶ and
- (xi) running a matched book of repurchase and reverse repurchase agreements.²⁰⁷

In contrast, some of the factors that have been relevant to determining that a person is acting as a trader rather than a dealer have been:

- (i) not buying and selling the same security simultaneously;²⁰⁸
- (ii) engaging in securities activities which are relatively minor measured against its other activities;²⁰⁹
- (iii) not handling others' money or securities;
- (iv) engaging in securities transactions with registered brokers or dealers only;²¹⁰
- (v) not holding itself out as being willing to buy and sell securities for its own account on a continuous basis;
- (vi) not making a market;
- (vii) not having memberships in exchanges or associations of dealers;²¹¹ and
- (viii) not furnishing the services that are usually provided by dealers, such as quoting the market in one or more securities,

205. *Id.*; see also Louis Dreyfus Corp., SEC No-Action Letter (July 23, 1987).

206. *See id.*

207. *See id.*; see generally, SEC Release No. 34-46745 (Oct. 30, 2002); SEC Release No. 34-47364 (Feb. 13, 2003); InTouch Global, LLC, SEC No-Action Letter (Nov. 14, 1995); Fairfield Trading Corp., SEC No-Action Letter (Jan. 10, 1988); United Savings Ass'n of Texas, SEC No-Action Letter (Apr. 2, 1987); Continental Grain Co., SEC No-Action Letter (Nov. 6, 1987); Burton Securities, SEC No-Action Letter (Dec. 5, 1977); Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Joseph McCulley (Aug. 2, 1972).

208. SEC Release No. 34-46745 (Oct. 30, 2002); see also Letter from Susan J. Walters, Office of Chief Counsel, to Martin E. Lybecker, National Council of Savings Institutions (July 27, 1986).

209. *See* Hart, Stephen V., SEC No-Action Letter (Mar. 6, 1980).

210. *See* Bankers Guarantee Title and Trust Co., SEC No-Action Letter (Jan. 22, 1991); Citicorp Homeowners, Inc., SEC No-Action Letter (Oct. 7, 1987).

211. *See* Hart, Stephen V., SEC No-Action Letter (Mar. 6, 1980).

rendering investment advice, extending or arranging for credit, or lending securities.²¹²

A person does not have to exhibit all or any given number of these above-listed factors in order to be considered a dealer.²¹³ The practical distinction between a “trader” and a “dealer” is often difficult to make and depends substantially upon all of the relevant facts and circumstances of a given situation.²¹⁴

While an underwriter would usually be a dealer, in limited circumstances being designated as “underwriter” under the Securities Act does not necessarily make an entity a dealer under the Exchange Act. The SEC granted Acqua Wellington North American Equities Fund, Ltd.’s no-action request under section 15 because the fund, while technically being a statutory underwriter, did not otherwise possess the characteristics of a dealer under the circumstances and subject to the conditions specified in that letter.²¹⁵

There is no requirement that the purchase and sale of securities be a dealer’s principal business or principal source of income.²¹⁶ A person can be “engaged in the business” if the person’s securities activities are only a small part of its total business activities, or its income from such activities is only a small portion of its total income.²¹⁷ In addition, there is nothing in the concept of a “business” that precludes a person from being a broker or dealer because the person handles, with regularity, only a single issue of securities.²¹⁸

A dealer can buy and sell securities for its own account through a broker or on its own.²¹⁹ The fact that a person buys or sells shares through a broker does not negate the possibility that the person is a dealer under section 3(a)(5).²²⁰ Therefore, a dealer cannot avoid

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212. SEC Release No. 34-46745 (Oct. 30, 2002); Letter from Susan J. Walters, Office of Chief Counsel, to Martin E. Lybecker, National Council of Savings Institutions (July 27, 1986).
213. *Conroy v. Andeck Resources*, 137 Ill. App. 3d 375, 484 N.E.2d 525 (Ill. App. Ct. 1985) (citing LOSS, *SECURITIES REGULATIONS* (2d ed. 1961)).
214. Letter from Susan J. Walters, Office of Chief Counsel, to Martin E. Lybecker, National Council of Savings Institutions (July 27, 1986); Hart, Stephen V., SEC No-Action Letter (Mar. 6, 1980); Burton Securities, SEC No-Action Letter (Dec. 5, 1977).
215. *See* Acqua Wellington North American Equities Fund, Ltd., SEC No-Action Letter (July 11, 2001).
216. *See* Hart, Stephen V., SEC No-Action Letter (Mar. 6, 1980); *UFITEC v. Carter*, 20 Cal.3d 238, 571 P.2d 990 (1977).
217. *See* *InTouch Global, LLC*, SEC No-Action Letter (Nov. 14, 1995); *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1 (D.D.C. 1998).
218. *SEC v. Am. Institute Counselors, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.D.C. Dec. 30, 1975).
219. Exchange Act § 3(a)(5).
220. *Instant Funds, Inc.*, SEC No-Action Letter (Mar. 14, 1971).

section 15 registration requirements merely by transacting securities through another Registered Broker-Dealer.²²¹

[B] Funds As Traders

The trader exception to the definition of dealer is often claimed by private equity funds, venture capital funds and hedge funds.²²² These funds are usually structured so that they will be exempt from regulation under the Investment Company Act, and rely on a private placement exemption from registration of securities issued by them under the Securities Act. In general, such funds seek to rely upon the “trader exception” to avoid federal broker-dealer registration requirements.

As a general matter, a fund does not have to register as a “dealer” under the Exchange Act if it does not:

- (i) act as an underwriter;
- (ii) carry a dealer inventory in securities;
- (iii) purchase or sell securities as principal from or to customers;
- (iv) handle other people’s money or securities;
- (v) hold itself out as being willing to buy and sell securities for its own account on a continuous basis;
- (vi) quote the market in one or more securities;
- (vii) render incidental investment advice;
- (viii) extend or arrange for the extension of credit in connection with securities activities;
- (ix) run a book of repurchase and reverse repurchase agreements;
- (x) issue or originate securities;
- (xi) use an interdealer broker to effect securities transactions; and
- (xii) otherwise engage in other dealer activities.²²³

221. See, e.g., Boetel & Co., SEC No-Action Letter (Sept. 29, 1971).

222. See *Hedge Fund Activities in the U.S. Financial Markets: Hearing Before the H. Comm. on Banking & Financial Services*, 105th Cong. (Oct. 1, 1998) (testimony of Richard R. Lindsey, Director, Division of Market Regulation, SEC), available at www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm.

223. See *Acqua Wellington North American Equities Fund, Ltd.*, SEC No-Action Letter (July 11, 2001); *Davenport Management, Inc.*, SEC No-Action Letter (Apr. 13, 1993); *Louis Dreyfus Corp.*, SEC No-Action Letter (July 23, 1987); *National Council of Savings Institutions*, SEC No-Action Letter (June 26, 1986); SEC Release No. 34-46745 (Oct. 30, 2002).

The SEC staff has provided no-action relief regarding hedging activities in government securities, provided that they were conducted with registered government securities broker-dealers.²²⁴ In a no-action letter to Bankers Guarantee Title and Trust Company, the SEC granted no-action relief to the company's hedging activities in mortgage-related assets based on its representation that the company purchased and sold government securities for its own account and only engaged in transactions with government securities brokers and dealers.²²⁵ In its letter granting no-action relief to Citicorp Homeowner Incorporated regarding its hedging activities, the SEC noted the company's representation that it would purchase and sell government securities:

- (i) solely for its own account;
- (ii) solely for risk management purposes and not for speculation; and
- (iii) solely in transactions with registered government securities dealers.²²⁶

[C] Issuers

Issuers generally are not usually considered "dealers" under the Exchange Act because they do not typically buy and sell securities for their own account.²²⁷ However, under certain circumstances, issuers can be engaged in both purchasing and selling of their securities from and to investors, which could require them to register under the Exchange Act.²²⁸

224. See Bankers Guarantee Title and Trust Co., SEC No-Action Letter (Jan. 22, 1991); see also Citicorp Homeowners, Inc., SEC No-Action Letter (Oct. 7, 1987).

225. See Bankers Guarantee Title and Trust Co., SEC No-Action Letter (Jan. 22, 1991).

226. See Citicorp Homeowners, Inc., SEC No-Action Letter (Oct. 7, 1987).

227. The SEC has stated: "[T]he Act has customarily been interpreted not to require the issuer itself to register as either a broker or a dealer; the issuer would not be effecting transactions for the account of others nor, generally, would it be engaged in the business of both buying and selling securities for its own account." SEC Release No. 34-13195 (Jan. 21, 1977).

228. See SEC Guide to Broker-Dealer Registration, *supra* note 72 (issuers whose activities go beyond selling their own securities need to consider whether they would need to register as broker-dealers. This includes issuers that purchase their securities from investors, as well as issuers that effectively operate markets in their own securities or in securities whose features or terms can change or be altered).

In contrast, a life insurance company that distributed fixed and variable annuity contracts²²⁹ through a separate account was determined to be both a “broker” and a “dealer” under the Exchange Act.²³⁰ According to the SEC, since the insurance company engaged in the purchase and sale of its own portfolio securities, planned to make purchases and sales of securities for the portfolio of the separate account, and to distribute the variable annuity interests of which it and the separate account are co-issuers, the insurance company met the definition of “broker” and “dealer.”²³¹

However, an issuer can avoid broker-dealer registration by forming a wholly owned broker-dealer subsidiary to conduct the securities transactions. In the case above, if the insurance company forms a wholly owned subsidiary to engage in the offer and sale of the variable annuity interests, and if the subsidiary registers as a broker-dealer and complies with all applicable rules and regulations, including the requirement to direct and supervise all persons engaged directly or indirectly in the offer and sale of such securities, the insurance company itself should generally not have to register as a broker-dealer under the Exchange Act.²³²

[D] Dealers in OTC Derivatives

Under the Exchange Act, dealers engaged in OTC derivatives transactions that are securities, such as OTC options on securities, would, absent the availability of an exemption, generally need to register under section 15 and fulfill all requirements applicable to other securities broker-dealers, notwithstanding that such entities may be regarded as “issuers” of the instruments.²³³ As noted below,

229. “Variable annuity contracts,” “variable annuity interests” or simply “variable annuities” have been found to be investment contracts, thus securities within Section 2(1) of the Securities Act and Section 3(a)(10) of the Exchange Act. *See* SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); *Teherpin v. Knight*, 389 U.S. 332 (1967); *see also* Distributions of Variable Annuities by Insurance Companies Broker-Dealer Registration and Regulation Problems Under the Securities Exchange Act of 1934, SEC Release No. 34-8389 (Aug. 29, 1968).

230. *See* Distributions of Variable Annuities by Insurance Companies Broker-Dealer Registration and Regulation Problems Under the Securities Exchange Act of 1934, SEC Release No. 34-8389 (Aug. 29, 1968); *see also* National Integrity Life Ins. Co., SEC No-Action Letter (May 1, 1987).

231. *See* Distributions of Variable Annuities by Insurance Companies Broker-Dealer Registration and Regulation Problems Under the Securities Exchange Act of 1934, SEC Release No. 34-8389 (Aug. 29, 1968).

232. *See id.*

233. *See* OTC Derivative Dealers, SEC Release No. 34-40594 (Oct. 23, 1998) [hereinafter OTC Derivative Dealers Adopting Release]; SEC Guide to Broker-Dealer Registration, *supra* note 72.

Dodd-Frank introduces new requirements for dealers in security-based swaps.

The SEC's "net capital rule" for broker-dealers (Exchange Act Rule 15c3-1) is particularly onerous for OTC derivatives activities. Accordingly, securities firms typically organize their OTC derivatives activities wherever possible to avoid conducting these activities in a registered broker-dealer, by separating non-securities derivatives activities into a non-broker-dealer affiliate, and by conducting securities derivatives through an affiliated bank²³⁴ or from offshore entities pursuant to Rule 15a-6 under the Exchange Act.²³⁵ The fragmentation of business hindered firms' ability to manage risk and operate a competitive OTC derivatives business when compared to banks.

To help address these concerns, in 1998, the SEC adopted a separate regulatory regime for OTC derivatives dealers with lessened requirements. This regime has acquired the nickname of "broker-dealer lite." Registration as an OTC derivatives dealer under these rules is optional and is an alternative to registration as a broker-dealer under the traditional broker-dealer regulatory structure.

Under the "broker-dealer lite" regimen, U.S. securities firms are allowed to establish separately capitalized affiliates that may engage in dealer activities in "eligible OTC derivative instruments,"²³⁶ which include both securities and non-securities OTC derivative instruments.²³⁷ These entities, as affiliates of fully regulated broker-dealers, can register with the SEC under section 15(b) of the Exchange Act as OTC derivatives dealers, subject to specially tailored capital, margin, and various other requirements.²³⁸

OTC derivatives dealers that register under this special regime are exempt from certain regulatory requirements for broker-dealers, including:

- (i) membership in a SRO;
- (ii) regular broker-dealer margin rules; and
- (iii) application of the Securities Investor Protection Act of 1970, including membership in the SIPC.

Certain transactions effected by a fully regulated broker-dealer for the account of an OTC derivatives dealer affiliate are exempted from

234. For a discussion of the ability of banks to engage in swaps under their authority to deal in "identified banking products" under GLB push-out rules, see *infra* section 1A:7.3, note 408 and accompanying text.

235. For a discussion of Rule 15a-6, see *infra* section 1A:7.2.

236. "Eligible OTC derivative instrument" is defined in Rule 3b-13.

237. OTC Derivative Dealers Adopting Release, *supra* note 233.

238. *Id.*

the requirements of section 11(a) of the Exchange Act, which generally prohibits a member of a national securities exchange from effecting transactions on the exchange for the accounts of affiliates. However, registered OTC derivatives dealers are subject to special requirements, including specified internal risk management control systems, record-keeping obligations, reporting responsibilities, and alternative net capital treatment. Unless otherwise provided by the broker-dealer lite rules, an OTC derivatives dealer remains subject to all other rules applicable to “fully regulated broker-dealers” under the Exchange Act.²³⁹

Dodd-Frank was signed into law by President Obama on July 21, 2010. When it is effective, Dodd-Frank will bring under regulation previously unregulated “swaps” and “security-based swaps,” modify the definition of “security” to include “security-based swaps,” introduce new regimes for “swap dealers,” “security-based swap dealers,” “major swap participants” and “major security-based swap participants,” and exclude certain security-based swaps from the definition of “dealer.” Not all derivatives are affected by Dodd-Frank. Dodd-Frank is discussed further in *infra* section 1A:4.4.

§ 1A:4 What Is a Security?

§ 1A:4.1 Statutory Definition

To be a “broker” or “dealer,” a person must be engaged in the business of effecting transactions in securities. Therefore, in analyzing whether an entity must register under section 15 of the Exchange Act, it is often necessary to consider the status of the instruments in which it deals.

The body of law on whether particular instruments are securities under the Exchange Act is vast, and the following discussion provides only a general overview.

The term “security” is defined in section 3(a)(10) of the Exchange Act as:

. . . any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or

239. *Id.*

based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.²⁴⁰

It was Congress’ intent to define “security” in general terms so as to include within the definition the many types of instruments that in the commercial world fall within the ordinary concept of a “security,”²⁴¹ and courts have interpreted the definition of “security” broadly.²⁴² In determining whether an instrument is a security, courts will look at the economic reality and focus on the substance rather than form.²⁴³

The Dodd-Frank Act, signed into law on July 21, 2010, adds “security-based swaps” to the definition of “security” in section 3(a)(10) of the Exchange Act. “Security-based swaps” are discussed further in *infra* section 1A:4.4.

§ 1A:4.2 Case Law on “Investment Contracts”

[A] Generally

The term “investment contract” is the residual category in the definition that captures securities that do not fall within other categories. Although not defined in the securities laws, it refers to an interest that is not a conventional security like “stock” or “bond,” but has the essential properties of a security and is treated as one for purposes of the securities laws.²⁴⁴ It is a descriptive term capable of adaptation to meet many different types of investment schemes.²⁴⁵ There is a considerable body of case law on whether a given arrangement is an investment contract when it does not fall under the definition of other more commonly known securities. In the leading

240. Exchange Act § 3(a)(10).

241. H.R. REP. NO. 85, at 11 (1933).

242. *See* *Reves v. Ernst & Young*, 494 U.S. 56 (1990); *SEC v. Edwards*, 540 U.S. 389 (2004).

243. *See* *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *Reves*, 494 U.S. 56.

244. *SEC v. Lauer*, 52 F.3d 667 (7th Cir. 1995).

245. *See* *SEC v. W.J. Howey Co.*, 328 U.S. 293 (May 27, 1946), *reh’g denied*, 329 U.S. 819 (Oct. 14, 1946); *SEC v. Joiner Leasing Corp.*, 320 U.S. 344 (Nov. 22, 1943).

case, *SEC v. W.J. Howey Co.*, the U.S. Supreme Court defined an “investment contract” as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”²⁴⁶ The definition establishes a four-part test in determining whether a particular scheme is an investment contract. Specifically, the test requires that there is:

- (i) an investment of money;
- (ii) in a common enterprise;
- (iii) with an expectation of profits;
- (iv) which are derived solely from the efforts of the promoter.

[B] Investment of Money

The investment does not have to be in the form of “money,” but it can be any form of consideration in return for a separable financial interest with the characteristics of a security.²⁴⁷

[C] Common Enterprise

There is a split in authority among the federal circuit courts regarding what constitutes a “common enterprise.” A majority of the circuit courts require or recognize a showing of “horizontal commonality” which involves the pooling of assets from multiple investors in such a manner that all share in the profits and risks of the enterprise.²⁴⁸ In horizontal commonality, the fortunes of each investor depend upon the profitability of the enterprise as a whole.²⁴⁹

246. *W.J. Howey Co.*, 328 U.S. at 298–99.

247. *Int’l Bhd. Teamsters v. Daniel*, 439 U.S. 551, 559 (1979).

248. The First, Second, Third, Fourth, Sixth, Seventh and D.C. Circuits have recognized “horizontal commonality” as satisfying the requirement of “common enterprise.” *See, e.g.*, *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001); *Revak v. SEC Realty Corp.*, 18 F.3d 81 (2d Cir. 1994); *SEC v. The Infinity Group Co.*, 212 F.3d 180, 188 (3rd Cir. 2000), *cert. denied*, 532 U.S. 905 (2001); *Teague v. Bakker*, 35 F.3d 978 n.8 (4th Cir. 1994); *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385 (6th Cir. 1989); *Union Planters Nat’l Bank of Memphis v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174 (6 Cir. 1981), *cert. denied*, 454 U.S. 1124 (1981); *Cooper v. King*, 114 F.3d 1186 (6th Cir. 1997); *SEC v. Lauer*, 52 F.3d 667, 670 (7th Cir. 1995); *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016 (7th Cir. 1994); *SEC v. Banner Fund Int’l*, 211 F.3d 602 (D.C. Cir. 2000); *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (1996), *reh’g denied*, 102 F.3d 587 (D.C. Cir. 1996).

249. *Revak*, 18 F.3d 81 (citing *Hart v. Pulte Homes of Michigan Corp.*, 735 F.2d 1001 (6th Cir. 1984) (horizontal commonality ties the fortunes of each investor in a pool of investors to the success of the overall venture; a finding of horizontal commonality requires a sharing or pooling of funds)).

Other circuit courts have held that a “common enterprise” exists by virtue of “vertical commonality,” which focuses on the relationship between the promoter and the body of investors.²⁵⁰ In this approach, an investor’s fortunes are tied to the promoter’s success rather than to the fortunes of his or her fellow investors.²⁵¹ The approach focuses on the community of interest between the individual investor and the manager of the enterprise.²⁵² In vertical commonality, the investors’ fortunes need not rise and fall together, and a pro rata sharing of profits and losses is not required.²⁵³ It is also not necessary that the funds of investors be pooled.²⁵⁴

The doctrine of “vertical commonality” as developed by various courts has two variants: “broad vertical commonality” and “narrow vertical commonality” (or “strict vertical commonality”). “Broad vertical commonality” requires that the fortunes of the investors be linked only to the expertise or efforts of the promoter.²⁵⁵ The promoter’s efforts impact the individual investors collectively, and the promoter does not share in the returns or risks of each investor. In contrast, “narrow vertical commonality” requires that the investors’ fortunes be “interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.”²⁵⁶ Under this approach, the promoter shares in the returns of the investors.²⁵⁷ The various judicial circuits are divided regarding whether horizontal or vertical commonality is required (and, in the latter case, whether the broad or narrow variety is required) to satisfy the *Howey* common enterprise requirement.

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250. *Revak*, 18 F.3d 81 (discussing *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974)).
251. *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001); *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195 (11th Cir. 1999).
252. *See, e.g., Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989).
253. *Revak*, 18 F.3d 81.
254. *SEC v. Goldfield Deep Mines Co.*, 758 F.2d 459 (9th Cir. 1985).
255. *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001); *Revak*, 18 F.3d 81; *Long*, 881 F.2d 1 (citing *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974)); *Koscot Interplanetary*, 497 F.2d at 478–79.
256. *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973) (*internal citations omitted*).
257. *SEC v. R. G. Reynolds Enters., Inc.*, 952 F.2d 1125 (9th Cir. 1991) (vertical commonality may be established by showing that the fortunes of the investors are linked with those of the promoters; the fact that Reynolds made his management fee based on a percentage of the profits was sufficient to show vertical commonality); *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978) (merely furnishing investment counsel to another for a commission, even when done by way of a discretionary commodities account, does not amount to a “common enterprise”; since there is no direct correlation on either the success or failure side, the court held that there was no common enterprise between Bache and Brodt).

[D] Expectation of Profits

Under the *Howey* test, profits can be either capital appreciation resulting from the development of the initial investment, or a participation in earnings resulting from the use of investors' funds.²⁵⁸ Profits are income or return that investors seek on their investment, not the profits of the scheme in which they invest.²⁵⁹ Profits include, for example, dividends, other periodic payments, or the increased value of the investment.²⁶⁰ Tax deductions, government subsidies, and welfare benefits, on the other hand, are not "profits" for purposes of the securities laws, since they do not derive from the efforts of third parties.²⁶¹ The analysis should not distinguish between promises of fixed returns and promises of variable returns for purposes of the test.²⁶²

The determining factor under this prong of the *Howey* test is that the investor is "attracted solely by the prospects of a return" on his investment.²⁶³ The investor may not have been motivated by a desire to use or consume the item purchased.²⁶⁴ In determining whether an investor was "attracted or led" by the expectation of profits, courts look

258. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975), *reh'g denied*, 423 U.S. 884 (1975); for an example of profits as capital appreciation resulting from the development of the initial investment, see *SEC v. Joiner*, 320 U.S. 344 (1943) (sale of oil leases conditioned on promoters' agreement to drill exploratory well); for an example of profits as a participation in earnings resulting from the use of investors' funds, see *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (dividends on the investment based on savings and loan association's profits).

259. *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

260. *Id.*

261. *United Hous. Found.*, 421 U.S. 837.

262. Because, in both cases, the investing public is attracted by representations of investment income. Moreover, as the Court has noted, investments pitched as low risk (such as those offering a "guaranteed" fixed return) are particularly attractive to individuals more vulnerable to investment fraud, including older and less sophisticated investors. *Edwards*, 540 U.S. at 390.

263. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *United Hous. Found.*, 421 U.S. 837.

264. *See W.J. Howey Co.*, 328 U.S. at 300 (the Court found that the investors had no desire to occupy the land or to develop it themselves, and they were attracted solely by the prospects of a return on their investment; if the purchasers wanted to occupy the land or to develop it themselves, the securities laws would not apply); *see also United Hous. Found.*, 421 U.S. at 852–54 (1975) (the Court concluded that sale of shares in a housing cooperative did not give rise to a securities transaction where the investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments; when a purchaser is motivated by a desire to use or consume the item purchased, the securities laws do not apply). On July 22, 2010, the SEC staff released a report on the life

at whether the promoter has induced prospective investors with proposed or promised profits.

[E] Solely from the Efforts of the Promoter or a Third Party

The *Howey* test requires that the profits of the investment be derived “solely from the efforts of the promoter or a third party.” The courts of appeals have uniformly declined to give literal meaning to the word “solely,” and have adopted liberal interpretations, emphasizing the economic reality of the transaction.²⁶⁵ The interpretation by the Ninth Circuit has been widely cited and adopted by other circuit courts, and it requires that the efforts made by those other than the investor be “undeniably significant” ones and be “essential managerial efforts which affect the failure or success of the enterprise.”²⁶⁶

§ 1A:4.3 Case Law on “Notes”

Under the definitions of “security” in the Exchange Act, “note” is listed as a specific category of “security.” Therefore, a note can be a security even if it does not meet the test for “investment contract.”²⁶⁷ While the statutory definition of “security” includes “any note,” this is not interpreted literally.²⁶⁸ “Note” is a relatively broad term that

settlements market, which discusses the SEC staff’s views regarding the status of life settlements as securities. Life Settlements Task Force, Report to the U.S. Securities and Exchange Commission (July 22, 2010), available at www.sec.gov/news/studies/2010/lifeselements-report.pdf.

265. SEC v. SG Ltd., 265 F.3d 42, 55 (1st Cir. 2001); SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577 (2d Cir. 1982); Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir. 1984), *overruled on other grounds*, Zosky v. Boyer, 856 F.2d 544 (1988); Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236 (4th Cir. 1988); SEC v. Koscot, 497 F.2d 473 (5th Cir. 1974); SEC v. Professional Assocs., 731 F.2d 349 (6th Cir. 1984); Kim v. Cochenour, 687 F.2d 210 (7th Cir. 1982); Fargo Partners v. Dain Corp., 540 F.2d 912 (8th Cir. 1976); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir. 1973); *McCown v. Caldwell*, 527 F.2d 204 (10th Cir. 1975).
266. *Glenn W. Turner Enters.*, 474 F.2d 476. Some circuits have adopted the Ninth Circuit’s interpretation, *see SEC v. SG Ltd.*, *supra*, at 55; *Turner Enters.*, 474 F.2d at 482, *accord Rivanna Trawlers Unlimited*, 840 F.2d at 240 n.4.
267. The fact that certain notes may not be “investment contracts” does not necessarily mean that they are not “notes” and thus not securities. *See Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990).
268. *Reves*, 494 U.S. at 67. The name assigned to a transaction by the parties, although not dispositive, is relevant in determining security status. There may be associations when the use of a traditional name such as “stocks” or “bonds” will lead a purchaser justifiably to assume that the federal

encompasses instruments with widely varying characteristics, depending on whether issued in consumer context or in some other investment context.²⁶⁹ The U.S. Supreme Court, in *Reves v. Ernst & Young*, has adopted a specialized test—the “family resemblance” test—to determine whether a “note” is a security.²⁷⁰ Whether a given note is or is not a “security” is a matter that requires specific analysis.

Under the “family resemblance” test, courts *presume* that every “note” is a “security.”²⁷¹ This presumption may be rebutted only by a showing that the note bears a strong resemblance to one of the enumerated categories of instrument on a judicially developed list of exceptions from the rule.²⁷² If an instrument is not sufficiently similar to an item on the list, courts will decide whether another category should be added to the list.²⁷³

The Supreme Court in *Reves* adopted the list created by the Second Circuit.²⁷⁴ The Second Circuit’s list includes instruments commonly denominated “notes” that nonetheless fall outside of the “security” category, such as:

- (i) a note delivered in consumer financing;
- (ii) a note secured by a mortgage on a home;
- (iii) a short-term note secured by a lien on a small business or some of its assets;
- (iv) a note evidencing a character loan to a bank customer;
- (v) a short-term note secured by an assignment of accounts receivable;
- (vi) a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized); and

securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument. *See United Hous. Found.*, 421 U.S. 850.

269. *See Landreth Timber Co. v. Landreth et al.*, 471 U.S. 681, 694 (1985). An investor cannot justifiably assume that a sale of a note is covered by the securities laws, because not all notes involve investments. *See Reves*, 494 U.S. 56.

270. *Reves*, 494 U.S. 56.

271. *Id.*

272. *Id.* If an instrument bearing the name “note” does not meet the family resemblance test, it can still be security if it meets the *Howey* test and falls under the category of “investment contract.”

273. *Id.*

274. *Reves*, 494 U.S. 56.

- (vii) a note evidencing loans by commercial banks for current operations.²⁷⁵

In determining whether a note bears a strong resemblance to the items on the list or whether another category of instrument should be added to the list, courts consider four factors:

- (i) motivation of seller and buyer;
- (ii) plan of distribution of the instrument;
- (iii) reasonable expectations of the investing public; and
- (iv) presence of alternative regulatory regime.²⁷⁶

It should be noted that section 3(a)(10) of the Exchange Act expressly excludes from the definition of “note” “any note . . . which has a maturity at the time of issuance of not exceeding nine months.”²⁷⁷ However, the SEC has taken the view that the only instruments that qualify for this exclusion are those that fall under section 3(a)(3) of the Securities Act which requires that the note arise out of a current transaction or the proceeds of which have been or are to be used for current transactions.²⁷⁸

Bank certificates of deposit (CDs), which have been analyzed as a type of “note,” have been the subject of considerable litigation both before and after *Reves*. The presence or absence of risk reducing factors, such as banking regulations and insurance, has typically played a key role in the determination of whether a CD is a security. In *Marine Bank v. Weaver*, the Supreme Court held that a federally insured CD was not a security subject to regulation under the Exchange Act.²⁷⁹ Although the CD in *Marine Bank* had similarities to other types of long-term debt instruments that are usually treated as securities, the Supreme Court found it important that the CD was issued by a federally regulated bank, which provided the purchaser of the CD protection under federal banking laws and made payment in full to the purchaser of the CD almost guaranteed. Thus, the Court held that this risk reducing factor made it unnecessary to subject these instruments to regulation under the Exchange Act.²⁸⁰ However, the Court stated that CDs could be securities subject to the Act in other

275. *Id.*; Exchange Nat. Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, (2d Cir. 1976), and Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir. 1984), *cert. denied*, 469 U.S. 884 (1984).

276. For a more detailed discussion of each factor, see *Reves*, 494 U.S. at 66.

277. Exchange Act § 3(a)(10).

278. See SEC Release No. 33-4412 (Sept. 20, 1961).

279. *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

280. *See id.*

contexts, and that instruments “must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served and the factual setting as a whole.”²⁸¹ Several Courts extended the *Marine Bank* exclusion beyond federally regulated banks to the CDs of state-regulated and foreign-regulated banks. On the other hand, some lower courts have treated CDs as securities in certain circumstances.²⁸²

The Court of Appeals for the Ninth Circuit in *Wolf v. Banco Nacional de Mexico* extended the *Marine Bank* holding to foreign-regulated banks, explaining that the *Marine Bank* exclusion should apply if “a bank is sufficiently well regulated that there is virtually no risk that insolvency will prevent it from repaying the holder of one of its certificates of deposit in full.”²⁸³ However, the exact scope of foreign bank CDs that will, and will not, be treated as securities is still unsettled.²⁸⁴

§ 1A:4.4 OTC Derivatives

[A] Case Law on Derivatives Prior to the Adoption of the Commodity Futures Modernization Act

Although some derivative instruments are securities, others are not. For example, OTC options on equity securities or on U.S. government securities are securities within the literal word meaning of section 3(a)(10) of the Exchange Act. Other OTC instruments are less clearly securities.

Prior to the enactment of the Commodity Futures Modernization Act of 2000 (“CFMA”),²⁸⁵ both the SEC and the Commodity Futures Trading Commission (CFTC)²⁸⁶ (which has exclusive jurisdiction over most commodity futures and options in such futures) sought to assert

281. *Id.*

282. *See* Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 756 F.2d 230 (2d Cir. 1985) (that federally insured CDs were securities in the context of a CD program in which distributor, Merrill Lynch, performed certain additional services that were relevant to investors’ investment decisions).

283. *Wolf v. Banco Nacional de Mexico, S.A.*, 739 F.2d 1458, 1463 (9th Cir. 1984).

284. *See, e.g.*, SEC v. Sanford Int’l Bank, et al., Case No. 3-09CV0298-L (N.D. Tex. Feb. 17, 2009) (SEC advocates that certain CDs issued by Antigua bank are securities).

285. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

286. The Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463 (Oct. 23, 1974), amended the CEA (7 U.S.C. §§ 1-22 (1972) and created the CFTC as an independent regulatory agency with powers greater than those of its predecessor agency, the Commodity Exchange Authority.

jurisdiction over certain OTC derivative contracts. The SEC viewed certain swaps as “securities” for the purposes of the Securities Act and the Exchange Act and the CFTC took the view that swaps and certain other OTC derivatives were futures subject to its oversight.²⁸⁷ Partly to address the uncertainties, Congress passed the CFMA in December 2000.

[B] CFMA—Section 3A, 15(i)

The CFMA inserted section 3A into the Exchange Act (which, as discussed below, is modified upon the effectiveness of Dodd-Frank) to exclude from the definition of “security” any security-based or non-security-based swap agreement.²⁸⁸ In addition, section 3A(b) expressly prohibits the SEC from registering, or requiring, recommending, or suggesting the registration of any security-based swap agreement

287. The SEC asserted that a “treasury-linked swap” had sufficient optionality to be viewed as a security. *See In re BT Securities Corp.*, Release No. 34-35136 (Dec. 22, 1994), and *In the Matter of Mitchell A. Vazquez*, Release No. 34-36909 (Feb. 29, 1996). A later court decision concluded that interest rate swaps and floating-for-floating interest rate swaps were not securities. *See The Procter & Gamble Co. v. Bankers Trust Co. and BT Sec. Corp.*, 925 F. Supp. 1270 (S.D. Ohio 1996). In a later case, *Caiola v. Citibank*, 295 F.3d 312 (2d Cir. 2002), the Second Circuit reversed a decision by the Southern District of New York that relied in large part on the conclusion expressed in *Procter & Gamble*, and held that a cash-settled OTC option based on a security is a security under section 3(a)(10) of the Exchange Act.

288. *See* section 301 of the CFMA, Exchange Act § 3A. The CFMA defines “swap agreement,” “security-based swap agreement,” and “non-security-based swap agreement” by inserting sections 206A, 206B and 206C into the Gramm-Leach-Bliley Act (GLBA).

The inclusion of the definitions of “swap agreement,” “security-based swap agreement,” and “non-security-based swap agreement” into the GLBA, rather than in the federal securities or commodities laws was apparently to prevent the SEC and CFTC from interpreting these definitions. *See* 146 CONG. REC. S11867 (2000) (statement of Senator Phil Gramm) (“It is important to emphasize that nothing in the title should be read to imply that swap agreements are either securities or futures contracts. To emphasize that point, the definition of a ‘swap agreement’ is placed in a neutral statute, the Gramm-Leach-Bliley Act, that is, legislation that is not specifically part of a banking, securities, or commodities law.”). Although the CFMA excepted the security-based swap agreements from the definition of security, the CFMA amended the antifraud provisions of section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1)(A), (B) and (C) of the Exchange Act to make clear that those sections apply to both securities and security-based swap agreements. *See* Securities Act § 17(a); Exchange Act §§ 10(b), 15(c)(1)(A), (B) and (C). In contrast, non-security-based swap agreements are not subject to the anti-fraud, anti-manipulation, anti-insider trading provisions and short swing profit provisions under these statutes.

under the Exchange Act.²⁸⁹ The SEC has been prohibited from imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement.²⁹⁰ Prior to the effectiveness of Dodd-Frank, security-based swap agreements are generally subject to the fraud, manipulation, short-swing profit, insider trading, and manipulation prohibitions under the securities laws.²⁹¹

Under section 206A(a), which will be modified upon the effectiveness of Dodd-Frank, subject to exceptions set forth in section 206A(b), “swap agreement” means, in pertinent part: “any agreement, contract, or transaction between eligible contract participants . . . the material terms of which (other than price and quantity) are subject to individual negotiation, and that . . . provides on an executor basis for the exchange, on a fixed or contingent basis, or one or more payments based on the value . . . of one or more . . . securities . . . or other financial or economic interests . . . and that transfers, as between the parties to the transaction . . . the financial risk associated with a future change in any such value or level without also conveying a current or future direct or ownership interest in an asset . . . that incorporates the financial risk so transferred, including any such agreement . . . known as a . . . credit default swap.” Section 206B defines “security-based swap agreement” as “a swap agreement . . . of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.”²⁹² Section 206C defines “non-security-based swap agreement” as any swap agreement that is not a security-based swap agreement.

It should be noted that, until Dodd-Frank takes effect, certain OTC derivatives are still securities, because section 206A(b) contains a list of exclusions from the term “swap agreement.” Specifically, the term “swap agreement” does not include:

- (i) any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities;
- (ii) any put, call, straddle, option, or privilege entered into on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 relating to foreign currency;

289. Exchange Act § 3A(b)(2).

290. Exchange Act § 3A(b)(3). An exception to this rule is provided in section 16(a) of the Exchange Act. *See* Exchange Act § 16(a).

291. *See* Securities Act § 17(a); Exchange Act §§ 9(a), 10(b) and 15(c)(1)(A), (B) and (C).

292. *See* *Rorech v. SEC*, 2010 WL 2595111 (S.D.N.Y. June 25, 2010) (interpreting these provisions).

- (iii) any agreement, contract, or transaction providing for the purchase or sale of one or more securities on a fixed basis;
- (iv) any agreement, contract, or transaction providing for the purchase or sale of one or more securities on a contingent basis, unless such agreement, contract, or transaction predicates such purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction;
- (v) any note, bond, or evidence of indebtedness that is a security as defined in section 2(a)(1) of the Securities Act of 1933 or section 3(a)(10) of the Securities Exchange Act of 1934; or
- (vi) any agreement, contract, or transaction that is—(A) based on a security; and (B) entered into directly or through an underwriter (as defined in section 2(a) of the Securities Act of 1933) by the issuer of such security for the purposes of raising capital, unless such agreement, contract, or transaction is entered into to manage a risk associated with capital raising.

The CFMA also amended section 15(i) of the Exchange Act, limiting the SEC's rulemaking and enforcement authority regarding new hybrid products²⁹³ offered by banks.

[C] The Dodd-Frank Wall Street Reform and Consumer Protection Act

In the wake of the recent financial crisis, 2010 saw the enactment on July 21, 2010 of the Dodd-Frank Act, which adopted sweeping revisions to the securities and banking laws. One significant emphasis of Dodd-Frank is on the regulation of swaps and other over-the-counter derivatives. Among many other changes, the derivatives title (Title VII) of Dodd-Frank effects the following:

- (i) creates new definitions of (and new regulatory requirements for) “swaps,” “security-based swaps” (SBS), “swap dealers,” “security-based swap dealers” (“SBS dealers”), “major swap participants” (MSPs), “major security-based swap participants” (SBS MSPs), swap execution facilities (SEFs), and security-based swap execution facilities (SBS SEFs);
- (ii) generally allocates jurisdiction over swaps, swap dealers, SEFs, and MSPs to the CFTC and over SBS, SBS dealers, SBS SEFs, and SBS MSPs to the SEC;

293. “New hybrid product” is defined in Exchange Act § 15(i)(6)(A).

- (iii) amends the definition of “security” in the Exchange Act to include SBS;
- (iv) modifies exclusions from regulation of OTC derivatives in section 3A of the Exchange Act;
- (v) amends the definition of “dealer” in the Exchange Act to exclude dealing activities relating to SBS (other than with non-eligible contract participants (“non-ECPs”));
- (vi) creates new mandatory clearing and exchange trading (or SEF/SBS SEF trading) requirements for swaps and SBS (subject to limited exceptions);
- (vii) incorporates SBS into the Exchange Act’s beneficial ownership reporting requirements; and
- (viii) requires that persons holding collateral for cleared SBS be registered as a broker-dealer or SBS dealer.

In addition, Dodd-Frank contains a provision, known as the “Volcker Rule,” that bans certain banking entities from proprietary trading and investing in and sponsoring hedge funds and private equity funds, subject to certain exceptions and another provision, known as the “Swaps Pushout Rule.” The Swaps Pushout Rule prohibits certain forms of federal assistance to swap dealers, SBS dealers, MSPs, and SBS MSPs subject to certain exceptions.

In general, the derivatives provisions of Dodd-Frank are effective 360 days after the enactment of the Act, or July 16, 2011.²⁹⁴ It is worth noting, however, that the derivatives title of Dodd-Frank includes a large number of regulatory rulemaking requirements. Where the SEC, CFTC, or other agency is required to promulgate a rule under the derivatives title, such rule is required to be adopted by July 16, 2011, and will become effective the later of July 16, 2011 and sixty days after the final rule is adopted.²⁹⁵

[C][1] New and Amended Definitions

[C][1][a] “Swap,” “SBS” and “Security”

The Dodd-Frank derivatives title, as part of its new regime for the supervision of certain OTC derivatives activities, defines a host of key terms and, in addition, alters existing securities law terms in important ways. This title introduces certain key terms with respect to the

294. Dodd-Frank §§ 754 and 774.

295. *Id.*

SEC's oversight of the SBS market.²⁹⁶ It is important to note at the outset that these definitions are all subject to further revision and explication by the SEC.

Dodd-Frank categorizes the derivatives instruments within its scope as "swaps," which are subject to primary CFTC jurisdiction, and "security-based swaps," which are subject to primary SEC jurisdiction. Dodd-Frank first defines the universe of "swaps" through an amendment to the CEA, then carves out of this definition those "security-based swaps" for which the SEC is provided primary jurisdiction. Mixed swaps, those that share characteristics of both "swaps" and "security-based swaps," are classified as both and are subject to joint jurisdiction by the SEC and the CFTC.

The definition of "swap" is complex and is provided in *infra* Appendix 1A-A. For present purposes, the definition includes credit default swaps, interest rate swaps, and total return swaps on a broad range of asset categories. The definition of "swap" *excludes*, among other transactions:

...

- (ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled;
- (iii) any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to—
 - (I) the Securities Act of 1933 (15 U.S.C. 77a *et seq.*); and
 - (II) the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*);
- (iv) any put, call, straddle, option, or privilege relating to a foreign currency entered into on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a));
- (v) any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to—
 - (I) the Securities Act of 1933 (15 U.S.C. 77a *et seq.*); and
 - (II) the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*);

296. Similar, though not entirely parallel, definitions exist for the products and market participants under the CFTC's jurisdiction. A discussion of such terms is outside the scope of this chapter.

- (vi) any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a contingent basis that is subject to the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) and the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction;
 - (vii) any note, bond, or evidence of indebtedness that is a security, as defined in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1));
 - (viii) any agreement, contract, or transaction that is—
 - (I) based on a security; and
 - (II) entered into directly or through an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933 (15 U.S.C. 77b(a)(11)) by the issuer of such security for the purposes of raising capital, unless the agreement, contract, or transaction is entered into to manage a risk associated with capital raising;
- . . . [and]
- (x) any security-based swap, other than a [mixed swap].²⁹⁷

“Security-based swap” is defined in section 3(a)(68) of the Exchange Act as any agreement, contract or transaction that:

- (i) is a swap, as that term is defined under section 1a of the Commodity Exchange Act (without regard to paragraph (47)(B)(x) of such section); and
- (ii) is based on—
 - (I) an index that is a narrow-based security index, including any interest therein or on the value thereof;
 - (II) a single security or loan, including any interest therein or on the value thereof; or
 - (III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.²⁹⁸

297. CEA § 1a(47), as amended by Dodd-Frank § 721(a).

298. Exchange Act § 3(a)(68)(A), as amended by Dodd-Frank § 761(a).

However, “security-based swap” specifically does not include agreements, contracts or transactions that only meet the definition of SBS due to referencing, being based upon, or settling through the transfer, delivery or receipt of government securities and certain other “exempted securities” (not including municipal securities).²⁹⁹ The effect of this is to allocate jurisdiction of swaps on government securities to the CFTC.

Certain options and physically settled forwards on securities are excluded from the definitions of “swap” and “security-based swap,” but continue to be “securities” under the Exchange Act.³⁰⁰

Dodd-Frank adds “security-based swap” to the definition of “security” in section 3(a)(10) of the Exchange Act.³⁰¹ Before Dodd-Frank, section 3A of the Exchange Act excluded “non-security-based swap agreements” from the definition of “security” for all purposes of the Exchange Act, and “security-based swap agreements” for purposes of the Exchange Act other than certain anti-fraud, anti-manipulation, and insider trading purposes. Section 3A has been amended to remove reference to “non-security-based swap agreements.” New section 3A(b)(1) of the Exchange Act provides that the definition of security “shall not include any security-based swap agreement.”

New and amended definitions of “swap agreement” and “security-based swap agreement” can be found in *infra* Appendix 1A-A. Significantly, the definition of “security-based swap agreement” excludes any SBS. Therefore, amended section 3A only serves to exclude from the definition of “security” only certain securities-related derivatives that do not constitute SBS as defined above.

[C][1][b] “SBS Dealer,” “SBS MSP” and “SBS SEF”

In addition to regulation of swap and SBS products, Dodd-Frank establishes a regime for the regulation of participants in the swap and

299. Exchange Act § 3(a)(68)(C), as amended by Dodd-Frank § 761(a).

300. The Dodd-Frank derivatives title excludes from the definitions of SBS and “security-based swap agreement” certain “identified banking products” that are effected by a bank under the jurisdiction of an appropriate federal banking agency: (1) a deposit account, savings account, certificate of deposit or other deposit instrument issued by a bank; (2) a banker’s acceptance; (3) a letter of credit issued or a loan made by a bank; (4) a debit account at a bank arising from a credit card or similar arrangement; and (5) a participation, sold to certain persons, in a loan that the bank or an affiliate of the bank, other than a broker or dealer, has funded and participates in or owns. However, Dodd-Frank authorizes the appropriate federal banking agency to except an identified banking product from the exclusion above if it determines, in consultation with the CFTC and the SEC, that the product has been structured to evade the Commodity Exchange Act or the Exchange Act.

301. Exchange Act § 3(a)(10), as amended by Dodd-Frank § 761(a).

SBS markets. In particular, with respect to SBS, participants may be required to register as “SBS dealers” or “SBS MSPs,” thereby becoming subject to significant regulation of their SBS activities as described below. Dodd-Frank defines a SBS dealer as:

any person who—

- (i) holds themselves out as a dealer in security-based swaps;
- (ii) makes a market in security-based swaps;
- (iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or
- (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.³⁰²

The definition of SBS dealer specifically excludes “a person that enters into security-based swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of regular business”³⁰³ and contains an exemption for an entity that “engages in a de minimis quantity of security-based swap dealing in connection with transactions with or on behalf of its customers.”³⁰⁴ A person may be designated a SBS dealer for one type, class, or category of SBS, and not be considered a SBS dealer for other types, classes or categories of SBS or activities.³⁰⁵

In addition to the new category of “SBS dealer,” Dodd-Frank creates a new designation for significant SBS market participants that are not dealers—SBS MSP. A SBS MSP is defined in Dodd-Frank as:

any person—

- (i) who is not a security-based swap dealer; and
- (ii) (I) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

302. Exchange Act § 3(a)(71)(A), as amended by Dodd-Frank § 761(a).

303. Exchange Act § 3(a)(71)(C), as amended by Dodd-Frank § 761(a).

304. Exchange Act § 3(a)(71)(D), as amended by Dodd-Frank § 761(a).

305. Exchange Act § 3(a)(71)(B), as amended by Dodd-Frank § 761(a).

- (II) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- (III) that is a financial entity that—
 - (aa) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and
 - (bb) maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission.³⁰⁶

As with SBS dealers, an entity may be designated a SBS MSP for one or more categories of SBS without being classified as a SBS MSP for all classes of SBS.³⁰⁷

Dodd-Frank requires the SEC to adopt rules, within one year of enactment of the Act (July 21, 2011), providing for the registration of SBS Dealers and SBS MSPs.³⁰⁸ These registration requirements apply regardless of whether the person is also registered with the CFTC as a Swap Dealer or MSP.³⁰⁹ Upon registration as a SBS Dealer or SBS MSP, an entity will become subject to a number of regulatory requirements, including:

- (i) clearing and exchange trading of formerly over-the-counter derivatives,
- (ii) trade reporting,
- (iii) minimum capital and margin requirements,
- (iv) segregation of customers' collateral,
- (v) new business conduct standards, and
- (vi) position limits.

Certain of these requirements also apply to those entities that trade in SBS but are not themselves SBS dealers or MSPs. The CFTC's regime for regulation of swap dealers and MSPs is largely, though not entirely, parallel.

There is no exception from the definition of "SBS dealer" or "SBS MSP," or the registration requirements for SBS dealers or SBS MSPs,

306. Exchange Act § 3(a)(67)(A), as amended by Dodd-Frank § 761(a).

307. Exchange Act § 3(a)(67)(C), as amended by Dodd-Frank § 761(a).

308. Exchange Act § 15F(d), as amended by Dodd-Frank § 764(a).

309. Exchange Act § 15F(c), as amended by Dodd-Frank § 764(a).

for banks.³¹⁰ In addition, there is no concept in Dodd-Frank of a regime parallel to Rule 15a-6 whereby foreign persons can avoid registration as a SBS dealer or SBS MSP through intermediation by a registered SBS dealer or SBS MSP.³¹¹

As noted above, Dodd-Frank introduces a regime for the clearing and exchange trading of certain swaps and SBS. The exchange trading requirement may be satisfied by executing a trade on a SBS SEF.³¹² SBS SEF is defined as:

a trading system or platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that—

- (A) facilitates the execution of security-based swaps between persons; and
- (B) is not a national securities exchange.³¹³

To be registered and maintain registration, a SBS SEF must comply with certain core principles and other SEC requirements. These core principles include, among others,

- (i) establishing and enforcing compliance;
- (ii) only trading SBS not readily susceptible to manipulation and monitoring trading;
- (iii) establishing and enforcing rules that will allow the facility to obtain information, ensure financial integrity of the traded SBS and exercise emergency authority;
- (iv) publishing trading information and maintaining required records;
- (v) establishing conflicts of interests rules;
- (vi) having adequate financial, operational and managerial resources; and
- (vii) establishing and maintaining a program of risk analysis and oversight and designating a chief compliance officer.³¹⁴

310. For a discussion of exclusions from the definition of “broker” and “dealer” for banks, see *infra* section 1A:7.4.

311. For a discussion of Rule 15a-6, see *infra* section 1A:7.2.

312. Exchange Act § 3C(h), as amended by Dodd-Frank § 763(a).

313. Exchange Act § 3(a)(77), as amended by Dodd-Frank § 761(a).

314. Exchange Act § 3D(d), as amended by Dodd-Frank § 763(c).

[C][1][c] Broker-Dealer Registration Issues

Dodd-Frank also alters the first two paragraphs in the definition of the term “dealer” in the Securities Act and Exchange Act to clarify that a dealer in SBS with ECPs is not required to register as a broker-dealer. In particular, Dodd-Frank adds the following underlined text to the first two paragraphs of the “dealer” definition:

- (A) In general. The term “dealer” means any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise.
- (B) Exception for person not engaged in the business of dealing. The term “dealer” does not include a person that buys or sells securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.³¹⁵

No similar change is made to the definition of the term “broker” in the Exchange Act. Therefore, persons who engage in “broker” activities with respect to SBS may need to register as broker-dealers. Since SBS SEFs may perform functions similar to brokers in respect of SBS, this raises the possibility that SBS SEFs could become subject to broker-dealer registration, absent relief. SBS SEFs may also be exchanges or alternative trading systems.

[C][2] The Volcker Rule and Swaps Pushout Rule

While a full description of Dodd-Frank is beyond the scope of this chapter, it is worth mentioning two provisions of the Act of particular import due to the activities restrictions they impose on financial entities. Section 619 of Dodd-Frank, the so-called “Volcker Rule,” prohibits proprietary trading and sponsoring and investing in hedge funds and private equity funds by an insured depository institution, any company that controls an insured depository institution, a company that is treated as a bank holding company for purposes of section 8 of the International Banking Act and any affiliate or subsidiary of any such entity, subject to exceptions for permitted activities and a transition period. The exact contours of the exceptions will remain unknown for some time. However, the impact of the Volcker Rule and proprietary trading activities in derivatives by affected institutions will likely be significant.

315. Exchange Act § 3(a)(5), as amended by Dodd-Frank § 761(a).

Also, section 716 of Dodd-Frank, the so-called “Swaps Pushout Rule,” prohibits “Federal assistance,” including FDIC insurance and access to the Federal Reserve’s discount window other than as part of broad-based programs, to “swaps entities,” which include SBS dealers and SBS MSPs. Insured depository institution MSPs are not subject to the Swaps Pushout Rule. In addition, insured depository institutions are not subject to the Swaps Pushout Rule if they limit their swaps activities to hedging or mitigating the risk of their activities or to swaps on reference assets permissible for investment by a national bank under 12 U.S.C. § 24 (Seventh).

The Swaps Pushout Rule explicitly allows an insured depository institution to have or establish a swaps entity affiliate. Thus, certain activities previously permitted to be conducted in a bank may now need to be conducted in a separate affiliate. This affiliate will likely be required to be separately capitalized.

For those activities that are not required to be ceased or pushed out of the bank by virtue of the Volcker Rule and the Swaps Pushout Rule, however, the bank exceptions for identified banking products, as defined in Section 206(b) of the Gramm-Leach-Bliley Act, from the definitions of “broker” and “dealer” (and, therefore, the exemption from broker-dealer registration) remain.³¹⁶

§ 1A:4.5 Security Futures

The CFMA amended the Exchange Act to permit futures on single stocks and expand the definition of “security” to include certain security futures.³¹⁷ Both the Commodity Exchange Act and the Exchange Act define a “security future” as “a contract of sale for future delivery of a single security or of a narrow-based security index . . . except an exempted security under section 3(a)(12) of the [Exchange Act]. . . .”³¹⁸ The term “security future” includes only futures contracts on a single security (often called single stock futures) or those on a narrow-based security index, and does not include futures contracts on broad-based security indices and exempted securities.³¹⁹ A “security futures product” refers to a

316. For certain exceptions from the definitions of “broker” and “dealer” for banks, see *infra* section 1A:7.4.

317. See Exchange Act §§ 3(a)(10) and 3(a)(11) as amended by section 201 of the CFMA.

318. Exchange Act § 3(a)(55); 7 U.S.C. § 1a(31). Section 1a(31) expressly excludes from the definition of “security future” any agreement, contract, or transaction excluded from this chapter under sections 2(c), 2(d), 2(f), or 2(g) of the CEA (as in effect on December 21, 2000) or sections 27 to 27f of the CEA.

319. CEA § 1a(31).

security future or any put, call, straddle, option, or privilege on any security future.³²⁰

Under the regulatory framework established by the CFMA, futures contracts on exempted securities or on broad-based security indices³²¹ are subject to the sole jurisdiction of the CFTC, and security futures (including futures contracts on individual securities or narrow-based security indices) are jointly regulated by the CFTC and the SEC.³²² Broker-dealers who transact security futures must register with both the SEC and the CFTC.³²³

§ 1A:5 Exempted Securities

§ 1A:5.1 Generally

“Exempted securities” under the Exchange Act, as defined in section 3(a)(12), include, among others, government securities and municipal securities.³²⁴ However, section 3(a)(12)(B)(ii) provides that for purposes of section 15 of the Exchange Act, which requires registration of “brokers” and “dealers,” municipal securities are not “exempted securities.”

Broker-dealers transacting exclusively in exempted securities are exempted from some provisions of the Exchange Act, but they are still subject to the anti-fraud and anti-manipulation provisions of the Exchange Act.³²⁵

320. See Exchange Act § 3(a)(56); CEA § 1a(32).

321. The term “broad-based security index” is not defined in either the CEA or the Exchange Act. The term refers to a security index that is not a narrow-based security index. See SEC Release No. 34-44288 n.8 (May 10, 2001).

322. See *id.*

323. Federal law permits firms already registered with either the SEC or the CFTC to register with the other agency, for the limited purpose of trading security futures, by filing a notice. SEC Guide to Broker-Dealer Registration, *supra* note 72; see CEA § 6f(a)(2); Exchange Act § 15(b)(11); Rule 15b11-1; SEC Release No. 34-44731 (Aug. 21, 2001); SEC Release No. 34-44730 (effective Aug. 27, 2001); 66 Fed. Reg. 43,080 (Aug. 17, 2001).

324. See Exchange Act § 3(a)(12). Exempted securities under the Exchange Act should not be confused with those exempted securities under the Securities Act. “Exempted securities” under the Securities Act are defined in Securities Act § 3(a). Brokers or dealers who engage exclusively in transactions with respect to securities exempted from registration under the Securities Act that are not also exempted securities under the Exchange Act would be required to register as such under Section 15 of the Exchange Act, absent some applicable exemption. See O. Wertheim, SEC Denial of No-Action Letter (Feb. 12, 1973).

325. See, e.g., Exchange Act §§ 15(c)(1) and (2), 10(b). Anti-fraud provisions under Exchange Act § 9(a), however, do not apply to exempted securities. See Exchange Act § 9(f).

§ 1A:5.2 Government Securities

[A] Definition

Section 3(a)(42) of the Exchange Act defines “government securities” to include securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States and/or by other federal government entities among others.

[B] Regulation of Government Securities Brokers and Dealers

“Government securities broker” and “government securities dealer” are defined in Exchange Act §§ 3(a)(43) and 3(a)(44), respectively. Brokers and Dealers that engage exclusively in government securities transactions are not subject to the registration requirement under section 15.³²⁶ However, since 1986, government securities brokers and dealers, other than Registered Broker-Dealers, are subject to requirements under section 15C, which requires government securities brokers and dealers to register with the SEC and comply with other requirements set forth under section 15C.³²⁷

§ 1A:5.3 Municipal Securities

[A] Definition

Section 3(a)(29) of the Exchange Act defines “municipal securities” to include securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, among others. As noted above, municipal securities are not “exempted securities” for the purposes of section 15.³²⁸

[B] Regulation of Municipal Securities Dealers

“Municipal securities dealer” and “municipal securities broker” are defined in Exchange Act §§ 3(a)(30) and 3(a)(31), respectively. However, as noted above, “municipal securities” are not exempted securities for the purpose of section 15.³²⁹ Section 15B requires that

326. Exchange Act § 15(a)(1).

327. See Exchange Act § 15C. Section 15C was inserted into the Exchange Act by the Government Securities Act of 1986; Pub. L. No. 99-571, 100 Stat. 3208 (1986).

328. Exchange Act § 3(a)(12)(B).

329. Prior to the Securities Reform Act of 1975, municipal securities were exempted securities for the purposes of section 15, and were exempted from the registration requirement of that section.

municipal securities dealers be registered pursuant to section 15B unless they are already Registered Broker-Dealers. This has the effect of requiring registration of banks (or, in some cases, separate municipal securities divisions of banks) as municipal securities dealers even though they are exempt from registration as broker-dealers.³³⁰

§ 1A:5.4 Other Exempted Securities

Besides government securities and municipal securities, there are five other categories of exempted securities under section 3(a)(12).³³¹ In addition, securities issued by the International Bank for Reconstruction and Development are deemed to be exempted securities under the Exchange Act.³³² The SEC has also exercised its rule-making authority under section 15(a)(2) to promulgate rules and issue orders exempting securities from the registration requirements of section 15(a).³³³

§ 1A:6 Intra-State Broker-Dealers

Section 15(a)(1) of the Exchange Act provides an exemption from broker-dealer registration for a broker-dealer whose business is “exclusively intrastate and who does not make use of any facility of a national securities exchange” (the “Intrastate Exemption”).³³⁴ This is an extremely narrow exemption, and the SEC has construed the term “exclusively intrastate” strictly.³³⁵ The Intrastate Exemption merely exempts intrastate broker-dealers from the registration requirements of section 15, not other provisions that apply to persons acting as brokers or dealers, whether or not they are registered with the SEC,³³⁶ nor from applicable state requirements.

330. See Exchange Act § 15B.

331. See Exchange Act § 3(a)(12)(A)(iii-vii).

332. 22 U.S.C. § 286k-1.

333. For example, in 1989, the SEC permitted an SEC-registered government securities dealer to treat certain obligations of Israel as exempt for purposes of Section 15(a). See Shearson Lehman Government Securities, Inc., SEC Exemptive Letter (Aug. 22, 1989).

334. Exchange Act § 15(a)(1). There is an “Intrastate Exemption” under the Securities Act § 3(a)(11), which exempts securities under the section 5 registration requirement of the Securities Act. See Securities Act § 3(a)(11).

335. See Heritage Homes and Investment of Palo Alto, SEC No-Action Letter (Aug. 10, 1979); Legacy Motors, Inc., SEC Denial of No-Action Letter (July 31, 1991); Don Chamberlin, SEC No-Action Letter (Aug. 10, 1979).

336. See Vorys, Sater, Seymour and Pease, SEC No-Action Letter (Sept. 3, 1991). That is, section 15(c) anti-fraud provisions do not limit themselves to registered brokers or dealers, but apply to brokers or dealers who make use of the instrumentality of interstate commerce. Section 3(a)(17) of the

The determination of whether a broker-dealer is engaged in an exclusively intrastate business turns principally on the location and residence of the broker-dealer's customers, including the issuer of any securities being distributed.³³⁷ The issuer must be a resident of and doing business within the state of the broker-dealer's own residence, where the offer and sale of the securities are to take place.³³⁸

The Securities Act also contains an intrastate exemption from that Act's registration requirements and the application of this exemption is sometimes considered by the Division of Trading and Markets staff in interpreting the Exchange Act's Intrastate Exemption. Section 3(a)(11)³³⁹ of the Securities Act and Rule 147³⁴⁰ promulgated under it provide guidance in ascertaining when the issuer is deemed to be a "resident" of and "doing business" within a state.³⁴¹ Also, all of the persons being offered and sold securities must be residents of and located within the same state.³⁴² Rule 147 also aids in determining the residence of offerees and purchasers.³⁴³

Exchange Act defines "interstate commerce" to include "the intrastate use" of "an interstate instrumentality." Thus, section 15(c) applies to broker-dealers operating under the "exclusively intrastate" exemption of section 15(a).

337. See Don Chamberlin, SEC No-Action Letter (Aug. 10, 1979); Heritage Homes and Investment of Palo Alto, SEC No-Action Letter (Aug. 10, 1979).
338. See CMS Financial Group, Inc., SEC Denial of No-Action Letter (Apr. 2, 1990); Heritage Homes and Investment of Palo Alto, SEC No-Action Letter (Aug. 10, 1979); Don Chamberlin, SEC No-Action Letter (Aug. 10, 1979); In the Matter of Professional Investors, Inc., SEC Release No. 5315, 37 S.E.C. 173 (May 25, 1956).
339. Securities Act § 3(a). A security is exempted from registration under section 5 of the Securities Act if it "is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."
340. See Rule 147(c).
341. See Heritage Homes and Investment of Palo Alto, SEC No-Action Letter (Aug. 10, 1979); Don Chamberlin, SEC No-Action Letter (Aug. 10, 1979). While the Intrastate Exemption in section 3(a)(11) of the Securities Act and Rule 147 aid in determining the meaning of intrastate activity, it is not the sole basis for determining the meaning of "exclusively intrastate" as it appears in section 15(a) of the Exchange Act. See Legacy Motors, Inc., SEC No-Action Letter (July 31, 1991). Also, the fact that an issuer chooses not to rely on the Interstate Exemption provided by section 3(a)(11) of the Securities Act does not preclude a person from claiming the Intrastate Exemption under the Exchange Act if the person is qualified under the Exchange Act "Intrastate Exemption." See Corporate Investment Co., SEC No-Action Letter (July 17, 1974).
342. See Arizona Property Investors, Ltd. (Nov. 17, 1979); Don Chamberlin, SEC No-Action Letter (Aug. 10, 1979); Allied Real Estate Securities, Inc., SEC Denial of No-Action Letter (Jan. 15, 1977); In the Matter of Capital Funds, Inc., Admin Proc. File No. 8-10968 (Sept. 19, 1963).
343. See Securities Act Rule 147(d).

The SEC's no-action guidance has provided that, for the Intrastate Exemption to be available, the broker-dealer and its associated persons must be residents of the state, registered under the law of the state, and have experience limited to the business of selling securities in the state.³⁴⁴ In other words, in considering no-action relief, the SEC staff has taken the view that the broker-dealer and its associated persons could not have previously engaged in the securities business in another state.³⁴⁵

The securities being underwritten or transacted by the broker-dealer cannot be traded on an interstate basis in order for the broker-dealer to utilize the exemption.³⁴⁶ All aspects of the transaction must be exclusively within the state, and the broker-dealer cannot otherwise engage in securities activities having interstate implications.³⁴⁷

§ 1A:7 Other Exemptions from Registration

§ 1A:7.1 Commercial Paper Dealers

Exchange Act § 15(a)(1) expressly exempts from broker-dealer registration any person who engages exclusively in the purchase or sale of commercial paper.³⁴⁸ Moreover, as noted above, section 3(a)(10) of the Exchange Act excludes from the definition of "security" "any note . . . which has a maturity at the time of issuance of not exceeding nine months. . . ."³⁴⁹ However, the commercial paper exclusion in the Exchange Act's definition of security has been construed as

344. Arizona Property Investors, Ltd., SEC No-Action Letter (Nov. 17, 1979); American Liberty Financial Corp., SEC Denial of No-Action Letter (Dec. 21, 1975).

345. See American Liberty Financial Corp., SEC Denial of No-Action Letter (Dec. 21, 1975).

346. CMS Financial Group, Inc., SEC Denial of No-Action Letter (Apr. 2, 1990); In the Matter of Professional Investors, Inc., SEC Release No. 34-5315 (May 25, 1956); Buy Blue Chip Stocks Direct, SEC Denial of No-Action Letter (Jan. 24, 1996).

347. See Corporate Investment Co., SEC No-Action Letter (July 17, 1974). See also CMS Financial Group, Inc., SEC Denial of No-Action Letter (Apr. 2, 1990); Buy Blue Chip Stocks Direct, SEC Denial of No-Action Letter (Jan. 24, 1996). In *Guon v. United States*, 285 F.2d 140 (8th Cir. 1960), a broker could not take advantage of the Intrastate Exemption because, while the sale of securities were negotiated and agreed upon within one state, the broker transferred certificates of the securities and received payment in a second state.

348. Exchange Act § 15(a)(1).

349. Exchange Act § 3(a)(10). In *Reves v. Ernest Young*, 110 S. Ct. 945, 951 n.3 (1990), the Court explicitly left open the question whether the presumption that every note is a security applies to such short-term notes.

coextensive with the commercial paper exemption in section 3(a)(3) of the Securities Act.³⁵⁰

The term “commercial paper” is not defined in either the Exchange Act or the Securities Act. The commercial paper exemption under the Securities Act has been interpreted to apply only to “prime quality negotiable commercial paper.”³⁵¹ The SEC has relied on several factors to determine whether commercial paper is of “prime quality,” including: (i) the financial strength of the issuer; (ii) support of the commercial paper by a form of credit enhancement; or (iii) rating of the commercial paper by a rating agency.³⁵²

§ 1A:7.2 Foreign Broker-Dealers Operating under Rule 15a-6

[A] Background

[A][1] Pre-Rule 15a-6 Precedents

Section 15(a)(1) of the Exchange Act requires registration of any broker or dealer who makes use of means or instrumentality of interstate commerce to effect securities transactions.³⁵³ The definitions of “broker” and “dealer” include “any person” regardless of their citizenship or location.³⁵⁴ The term “interstate commerce” is defined in section 3(a)(17) of the Exchange Act as “trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof.”³⁵⁵ Therefore, virtually any transaction-oriented contact between a foreign broker-dealer and an investor in the United States involves interstate commerce and could provide the jurisdictional basis for broker-dealer registration.³⁵⁶

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350. Compare 15 U.S.C. § 77c(a)(3), with 15 U.S.C. 78c(a)(10). See *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d. Cir. 1973); *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); see also SEC Release No. 33-4412 (Sept. 20, 1961).
351. See SEC Release No. 33-4412; *UBS Asset Mgmt. (New York) Inc. and The Chase Manhattan Bank v. Wood Gundy Corp.*, 914 F. Supp. 66 (S.D.N.Y., 1996); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079 (7th Cir.), cert. denied, 409 U.S. 1009 (1972).
352. See *Mercury Finance Company*, SEC No-Action Letter (Feb. 21, 1989); *Russell Corp.*, SEC No-Action Letter (Sept. 22, 1988); *Imperial Savs. Assn.*, SEC No-Action Letter (Sept. 21, 1988).
353. Exchange Act § 15(a)(1).
354. Exchange Act §§ 3(a)(4)(A) and 3(a)(5)(A).
355. Exchange Act § 3(a)(17).
356. See Rule 15a-6 Adopting Release, *supra* note 28, at n.20.

Exchange Act Rule 15a-6, which was adopted in 1989, provides the principal basis upon which non-U.S. broker-dealers having contact with specified persons in the United States operate without registration under the Exchange Act. However, prior to adopting Rule 15a-6, the SEC issued a number of no-action letters and other guidance covering various fact patterns that can still be viewed as useful precedents.

In 1964, the SEC provided an exemption to foreign broker-dealers who perform limited functions as underwriters in foreign jurisdictions in a distribution of U.S. securities being made both abroad and in the United States.³⁵⁷ In 1976, the SEC gave no-action relief to a foreign broker-dealer who executed its customers' orders for U.S. securities through a Registered Broker-Dealer and had no other contacts with the U.S. customers.³⁵⁸ In 1981, the SEC permitted a foreign broker-dealer to prepare research for distribution into the United States through a Registered Broker-Dealer who disseminated research under its own name and had the primary relationship with U.S. customers on transactions of the researched securities.³⁵⁹ In 1985, the SEC provided no-action relief to a Canadian broker-dealer that proposed to execute unsolicited orders for U.S. broker-dealers and investment advisers acting on behalf of their U.S. customers.³⁶⁰ In 1987, the SEC staff issued no-action relief to foreign broker-dealers that were members of the Citicorp financial organization that effectively would have let the foreign broker-dealer act as a market maker on Nasdaq through the use of a company that was a Registered Broker-Dealer.³⁶¹ The SEC also issued several no-action letters to exempt foreign affiliates of U.S.

357. The condition for the exemption was that the foreign broker-dealer limited its activities to (i) taking down securities which he sold outside the jurisdiction of the United States to persons other than American nationals, and (ii) participating solely through his membership in the underwriting syndicate in activities of the syndicate in the United States, such as sales to selling group members, stabilizing, over-allotment, and group sales, which activities were carried out for the syndicate by a managing underwriter or underwriters who were registered with the SEC. *See* Registration of Foreign Offerings by Domestic Issuers; Registration of Underwriters of Foreign Offerings as Broker-Dealers, SEC Release Nos. 33-4708, 34-7366 (July 9, 1964).

358. Bear Stearns & Company, SEC No-Action Letter (Feb. 6, 1976). The letter was silent on U.S. customer orders for foreign securities.

359. Scrimgeour, Kemp-Gee & Company, SEC No-Action Letter (June 25, 1981).

360. Wood Gundy, Inc., SEC No-Action Letter (Dec. 9, 1985).

361. *See* Debevoise & Plimpton, SEC No-Action Letter (Aug. 13, 1986); Debevoise & Plimpton, SEC No-Action Letter (Aug. 17, 1987).

banks or U.S. branches of foreign banks that proposed to execute transactions through, or on behalf of, a U.S. broker-dealer affiliate.³⁶²

The Rule 15a-6 Adopting Release states that the SEC's interpretative advice issued prior to the adoption of Rule 15a-6 remains valid unless specifically withdrawn.³⁶³ Accordingly, these no-action letters continue to provide guidance on the registration requirements on foreign broker-dealers.

[A][2] Jurisdictional Language in Section 15 and Section 30

Section 30(b) of the Exchange Act on its face exempts from the Exchange Act, and therefore from the broker-dealer registration requirements under section 15, "any person insofar as he transacts business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate to prevent evasion of this title."³⁶⁴ Before the adoption of Rule 15a-6, the SEC had not recognized any exemptions under this provision.³⁶⁵ By contrast, courts held that the section 30(b) exemption is unavailable under three circumstances:³⁶⁶

- (i) if transactions occurred in a U.S. securities market;³⁶⁷
- (ii) if offers and sales were made abroad to U.S. persons or in the United States to facilitate sales of securities abroad;³⁶⁸ or
- (iii) if the United States was used as a base for securities fraud perpetrated on foreigners.³⁶⁹

The SEC stated its position on the application of section 30(b) in its Rule 15a-6 Adopting Release. The release provided that the phrase

362. See *The Bank of Montreal*, SEC No-Action Letter (June 20, 1989); *National Westminster Bank PLC*, SEC No-Action Letter (July 7, 1988); *Chase Manhattan Corp.*, SEC No-Action Letter (July 28, 1987).

363. See Rule 15a-6 Adopting Release, *supra* note 28 at 32.

364. Exchange Act § 30(b).

365. See *Kook v. Crang*, 182 F. Supp. 388 (S.D.N.Y. 1960).

366. See Rule 15a-6 Adopting Release, *supra* note 28.

367. *Roth v. Fund of Funds, Ltd.*, 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975, *reh'g denied*, 395 U.S. 941 (1969); *Selzer v. The Bank of Bermuda, Ltd.*, 385 F. Supp. 415 (S.D.N.Y. 1974).

368. *SEC v. United Fin. Group, Inc.*, 474 F.2d 354 (9th Cir. 1973); *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1336 n.6 (2d Cir. 1972).

369. *Arthur Lipper Corp. v. SEC*, 547 F.2d 171 (2d Cir. 1976), *reh'g denied*, 551 F.2d 915 (2d Cir. 1977), *cert. denied*, 434 U.S. 1009 (1978).

“without the jurisdiction of the United States” in section 30(b) does not refer to territorial limits of this country, and a broker-dealer operating outside the physical boundaries of the United States, but using the U.S. mails, wires, or telephone lines to trade securities with U.S. persons located in this country, would not be, in the words of section 30(b), transacting a business in securities without the jurisdiction of the United States.³⁷⁰

The SEC also takes the view that, in the absence of some available registration exemption, solicitation of securities business from within the United States is an activity requiring broker-dealer registration, even if the investors being solicited are exclusively foreign persons physically located outside the United States.³⁷¹

The U.S. Supreme Court recently held that the antifraud provisions under section 10(b) of the Exchange Act apply only with respect to (i) the purchase or sale of a security listed on a U.S. stock exchange, or (ii) the purchase or sale of any other security in the United States.³⁷² It is unclear at present how the holding in this case might be extended to the broker-dealer registration context.

Finally, it should be noted that the derivatives title of Dodd-Frank amends section 30 of the Exchange Act to add the following:

(c) No provision of this title that was added by the Wall Street Transparency and Accountability Act of 2010, or any rule or regulation thereunder, shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of any provision of this title that was added by the Wall Street Transparency and Accountability Act of 2010. This subsection shall not be construed to limit the jurisdiction of the Commission under any provision of this title, as in effect prior to the date of enactment of the Wall Street Transparency and Accountability Act of 2010.³⁷³

At the present time, the full extraterritorial reach of Dodd-Frank remains unclear.

370. See Rule 15a-6 Adopting Release, *supra* note 28, at 13.

371. See, e.g., Dilworth Capital Management LLC, SEC Denial of No-Action Request (Dec. 9, 2004).

372. *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. ___, slip op. No. 08-1191 (June 24, 2010).

373. Exchange Act § 30, as amended by Dodd-Frank § 772.

[B] Rule 15a-6**[B][1] Generally**

The SEC adopted Rule 15a-6 in 1989 in response to a growing interest of U.S. investors in foreign securities.³⁷⁴ Rule 15a-6 provides conditional exemptions from broker-dealer registration for foreign broker-dealers³⁷⁵ that have indirect contacts with U.S. persons through unsolicited transactions, distribute research reports, solicit or effect transactions with certain U.S. institutional investors through Registered Broker-Dealers, or solicit or effect securities transactions with certain defined classes of persons without intermediaries.³⁷⁶

[B][2] Unsolicited Transactions

Rule 15a-6(a)(1) permits foreign broker-dealers to effect unsolicited securities transactions without registration under sections 15(a)(1) or 15B(a)(1).³⁷⁷ The term “solicitation” is not defined, but has been interpreted broadly by the SEC to include any affirmative effort by a broker-dealer to induce transactional business for the broker-dealer or its affiliates.³⁷⁸ Thus, an individual securities transaction by a client

374. Rule 15a-6 Adopting Release, *supra* note 28, at 5.

375. “Foreign broker-dealer” is defined in Rule 15a-6(b)(3) as “any non-U.S. resident person (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by this rule) that is not an office or branch of, or a natural person associated with, a registered broker or dealer, whose securities activities, if conducted in the United States, would be described by the definition of “broker” or dealer” in sections 3(a)(4) or 3(a)(5) of the [Exchange] Act.” *See* Rule 15a-6(b)(3). This definition also includes foreign banks to the extent that they operate from outside the U.S., but not their U.S. branches or agencies. Rule 15a-6 Adopting Release, *supra* note 28, at 35.

376. *See* Rule 15a-6 Adopting Release, *supra* note 28, at 29–30.

377. Rule 15a-6(a)(1).

378. Solicitation includes efforts to induce a single transaction or to develop an ongoing securities business relationship. Conduct deemed to be solicitation includes telephone calls from a broker-dealer to a customer encouraging use of the broker-dealer to effect transactions, as well as advertising one’s function as a broker or a market maker in newspapers or periodicals of general circulation in the United States or on any radio or television station whose broadcasting is directed into the United States. Similarly, conducting investment seminars for U.S. investors, whether or not the seminars are hosted by a registered U.S. broker-dealer, would constitute solicitation. A broker-dealer also would solicit customers by, among other things, recommending the purchase or sale of particular securities, with the anticipation that the customer will execute the recommended trade through the broker-dealer. Rule 15a-6 Adopting Release, *supra* note 28, at 21.

on its own initiative generally would not be regarded as unsolicited if the client had been the subject of marketing efforts by a foreign broker-dealer or its affiliates. In practice, this exemption is relatively limited in its utility.

[B][3] Research

The distribution of securities research in the United States may be a form of solicitation and is therefore an activity that should generally be done by or in conjunction with a Registered Broker-Dealer, unless an exemption applies. Rule 15a-6(a)(2) provides an exemption for foreign broker-dealers who furnish research reports³⁷⁹ directly to major U.S. institutional investors³⁸⁰ and effect transactions in the securities discussed in the research reports with or for those major U.S. institutional investors, subject to certain conditions. The conditions include:

- (i) the research reports do not recommend the use of the foreign broker-dealer to effect trades in any security;³⁸¹

379. Rule 15a-6(a)(2) does not distinguish between research reports provided in written or electronic form. *See* Rule 15a-6 Adopting Release, *supra* note 28, at n.106.

380. Rule 15a-6(b)(4) defines “major U.S. institutional investor” as “a person that is (i) [a] U.S. institutional investor that has, or has under management, total assets in excess of \$100 million; provided, however, that for purposes of determining the total assets of an investment company under this rule, the investment company may include the assets of any family of investment companies of which it is a part; or (ii) [a]n investment adviser registered with the Commission under Section 203 of the Investment Advisers Act of 1940 that has total assets under management in excess of \$100 million.” Rule 15a-6(b)(4). Rule 15a-6(b)(7) defines “U.S. institutional investor” as “a person that is (i) [a]n investment company registered with the Commission under Section 8 of the Investment Company Act of 1940; or (ii) [a] bank, savings and loan association, insurance company, business development company, small business investment company, or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act of 1933; a private business development company defined in Rule 501(a)(2); an organization described in Section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3); or a trust defined in Rule 501(a)(7).” Rule 15a-6(b)(7). As noted in *infra* note 385, the definition of “major U.S. institutional investor” was effectively extended in a subsequent no-action letter to include any entity, including any investment adviser (whether or not registered under the Investment Advisers Act), that owns or controls (or, in the case of an investment adviser, has under management) in excess of \$100 million in aggregate financial assets.

381. Rule 15a-6(a)(2)(i). The SEC would not consider disclosure in the research report that the foreign broker-dealer is a market maker in a security discussed in the report to violate this requirement. *See* Rule 15a-6 Adopting Release, *supra* note 28, at 100–101.

- (ii) the foreign broker-dealer does not initiate contact with those major U.S. institutional investors to follow up on the research reports or otherwise induce or attempt to induce purchase or sale of any security by those major U.S. institutional investors;³⁸²
- (iii) the foreign broker-dealer effects transactions in the securities discussed in the research through a Registered Broker-Dealer pursuant to Rule 15a-6(a)(3);³⁸³ and
- (iv) the foreign broker-dealer does not provide research to U.S. persons pursuant to any express or implied understanding that those U.S. persons will direct commission income to the foreign broker-dealer.³⁸⁴

In practice, Rule 15a-6(a)(2) provides limited relief to global investment banks.

[B][4] Rule 15a-6(a)(3) Arrangements

Rule 15a-6(a)(3) permits foreign broker-dealers to solicit U.S. institutional investors and major U.S. institutional investors (but not other entities or natural persons)³⁸⁵ through a Registered

382. Rule 15a-6(a)(2)(ii). If a foreign broker-dealer wished to initiate direct contact with U.S. persons, it could do so using the direct contact exemption in Rule 15a-6(a)(3). See Rule 15a-6 Adopting Release, *supra* note 28, at 47. In its no-action letter on April 9, 1997, the SEC confirmed that Rule 15a-6(a)(2)(ii) would not prohibit a foreign broker-dealer from initiating follow-up contacts with major U.S. institutional investors to which it has furnished research reports, if such follow-up contacts occur in the context of a relationship between the foreign broker-dealer and a U.S. intermediary broker-dealer as permitted under Rule 15a-6(a)(3). See Cleary, Gottlieb, Steen & Hamilton, SEC No-Action Letter (Apr. 9, 1997) [hereinafter *Nine Firms Letter*].

383. Rule 15a-6(a)(2)(iii).

384. Rule 15a-6(a)(2)(iv).

385. The definitions of "U.S. institutional investor" and "major U.S. institutional investor" do not include U.S. business corporations and partnerships, nor do they permit investment funds to qualify as major U.S. institutional investors if they are advised by investment managers that are exempt from registration under the Investment Advisers Act. The SEC, in the U.S. Affiliates Letter, expanded the class of U.S. investors that a foreign broker-dealer may contact. It granted no-action relief that would permit, on the same basis as permitted for transactions with "major U.S. institutional investors" under Rule 15a-6, a U.S.-affiliated foreign broker-dealer to enter into transactions with any entity, including any investment adviser (whether or not registered under the Investment Advisers Act), that owns or controls (or, in the case of an investment adviser, has under

Broker-Dealer (an “(a)(3) Arrangement”).³⁸⁶ Under an (a)(3) Arrangement, the Registered Broker-Dealer is responsible for all aspects of “effecting” transactions with U.S. investors other than the negotiation of terms and (in the case of foreign securities) execution.

The Registered Broker-Dealer must:

- (i) issue all required confirmations in compliance with Rule 10b-10 and periodic account statements to the U.S. institutional investor or the major U.S. institutional investor;
- (ii) extend or arrange for the extension of any credit to investors in connection with the purchase of securities;
- (iii) maintain records in accordance with U.S. requirements, including those required by Exchange Act Rules 17a-3 and 17a-4;
- (iv) take all required capital charges in compliance of Exchange Act Rule 15c3-1;
- (v) receive, deliver and safeguard funds and securities in connection with the transactions in compliance with Exchange Act Rule 15c3-3;³⁸⁷
- (vi) review trades executed by the foreign broker-dealer for indications of possible violations of the federal securities laws;³⁸⁸ and

management) in excess of \$100 million in aggregate financial assets (i.e., cash, money-market instruments, securities of unaffiliated issuers, futures and options on futures and other derivative instruments). *See* Nine Firms Letter, *supra* note 382.

386. The registered broker-dealer who acts as an intermediary does not have to be affiliated with the foreign broker-dealer through ownership or control. *See* Rule 15a-6 Adopting Release, *supra* note 28, at 57.

387. The SEC, permits direct settlement of transactions between foreign broker-dealers acting in reliance on Rule 15a-6(a)(3) and U.S. institutional investors, provided: (i) the transactions involve foreign securities or U.S. government securities; (ii) the foreign broker-dealer agrees to make available to the U.S. broker-dealer responsible for intermediating the transaction all clearance and settlement information; (iii) the foreign broker-dealer is not acting as a custodian of the funds or securities of the U.S. investor; and (iv) the foreign broker-dealer is not in default to any counterparty on any material financial market transaction (which is not defined in the letter). *See* Nine Firms Letter, *supra* note 382.

388. This requirement is not explicit in Rule 15a-6, but it is expressed in the Rule 15a-6 Adopting Release, *supra* note 28.

- (vii) obtain consents to service of process from the foreign broker-dealer and its foreign associated persons³⁸⁹ who participate in the solicitation of U.S. investors under Rule 15a-6(a)(3) and procure certain other information and ensure that such persons are not subject to “statutory disqualifications.”³⁹⁰

Rule 15a-6(a)(3) requires that all activities of the foreign broker-dealer be conducted from outside the United States (though it permits U.S. visits up to thirty days per year, subject to certain conditions), and that certain contacts between personnel of the foreign broker-dealer and U.S. investors be “chaperoned” by associated persons of a Registered Broker-Dealer.³⁹¹ In addition, the foreign broker-dealer must provide the SEC (upon request or pursuant to agreements between the SEC and the foreign securities authority) with any information or documents within its possession, subject to exceptions.³⁹²

[B][5] Rule 15a-6(a)(4)

Rule 15a-6(a)(4) allows foreign broker-dealers to solicit and otherwise deal with certain persons without the involvement of a Registered Broker-Dealer. These persons include:

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389. Rule 15a-6 Adopting Release, *supra* note 28, at 87; “Foreign associated person” is defined in Rule 15a-6(b)(2) to mean “any natural person domiciled outside the United States who is an associated person, as defined in Section 3(a)(18) of the [Exchange] Act, of the foreign broker or dealer, and who participates in the solicitation of a U.S. institutional investor or a major U.S. institutional investor under paragraph (a)(3) of this section.” Rule 15a-6(b)(2).
390. Rule 15a-6(a)(3)(ii).
391. Associated persons of the registered broker-dealer must participate in (“chaperone”) all oral communications between the foreign broker-dealer and the U.S. institutional investor. Communications with a major U.S. institutional investor do not have to be chaperoned. In 1997, the SEC liberalized the “chaperoning” requirements by granting no-action relief that would permit foreign associated persons of a U.S.-affiliated foreign broker-dealer, without the participation of an associated person of a registered broker-dealer, to (i) engage in oral communications from outside the U.S. with U.S. institutional investors (that do not qualify as major U.S. institutional investors) where such communications take place outside of the trading hours of the New York Stock Exchange, as long as the foreign associated persons do not accept orders to effect transactions other than those involving foreign securities, and (ii) have in-person contacts during visits to the United States with major U.S. institutional investors (as such definition is expanded by the letter), so long as the number of days on which such in-person contacts occur does not exceed 30 per year and the foreign associated persons engaged in such in-person contacts do not accept orders to effect securities transactions while in the United States. See Nine Firms Letter, *supra* note 382.
392. Rule 15a-6(a)(3)(i)(B).

- (i) a Registered Broker-Dealer, whether acting as principal or agent;
- (ii) a U.S. bank (including a licensed branch or agency of a non-U.S. bank) acting pursuant to specified exemptions from the Exchange Act's broker-dealer registration requirements that apply to bank securities activities;
- (iii) the United Nations and certain other organizations and their pension funds;
- (iv) foreign persons temporarily present in the United States, subject to conditions;
- (v) non-U.S. branches or agencies of U.S. persons outside the United States, provided that transactions occur outside the U.S.; and
- (vi) with certain exceptions, U.S. citizens resident outside the United States.³⁹³

For purposes of both the broker-dealer registration provisions of the Exchange Act and Rule 15a-6, persons resident in the United States are among the persons deemed to be U.S. persons. A U.S. resident fiduciary, therefore, is considered to be a U.S. person for these purposes, regardless of the residence of the owners of the underlying accounts. Thus, absent the no-action relief discussed below, when a foreign broker-dealer—such as a U.S.-affiliated foreign broker-dealer—solicits discretionary or similar accounts of non-U.S. persons held by a U.S. resident fiduciary (including a U.S. registered investment adviser), it must either register with the SEC or effect such transactions in accordance with Rule 15a-6(a)(3).³⁹⁴

The SEC, in a 1996 no-action letter, permitted U.S.-affiliated foreign broker-dealers to effect transactions in foreign securities³⁹⁵

393. The exemption includes U.S. citizens resident outside the United States, provided that the foreign broker-dealer does not direct its selling efforts toward identifiable groups of U.S. citizens resident abroad. All transactions must occur outside the United States. *See* Rule 15a-6(a)(4) and Rule 15a-6 Adopting Release, *supra* note 28, at 97.

394. *See* Letter re: Regulation S Transactions during Distributions of Foreign Securities to Qualified Institutional Buyers (Feb. 22, 1994). This position does not apply to a U.S. registered broker or dealer or a bank acting in a broker or dealer capacity as permitted by U.S. law. *See* Rule 15a-6(a)(4).

395. The letter defines a "foreign security" as (i) a security issued by an issuer not organized or incorporated under the laws of the United States when the transaction in such security is not effected on a U.S. exchange or through the Nasdaq system, or (ii) a debt security (including a convertible debt security) issued by an issuer organized or incorporated in the

with U.S. resident fiduciaries³⁹⁶ for “offshore clients”³⁹⁷ without the U.S.-affiliated foreign broker-dealers either registering as broker-dealers or effecting the transactions under Rule 15a-6, provided that:

- (i) the U.S.-affiliated foreign broker-dealers will obtain written assurance from the U.S. resident fiduciary that the account is managed for an “offshore client”;
- (ii) transactions with U.S. resident fiduciaries for offshore clients, other than transactions in foreign securities, will be effected in compliance with the requirements of either section 15(a) of the Exchange Act or Rule 15a-6 thereunder; and
- (iii) transactions effected with U.S. resident fiduciaries, other than transactions for offshore clients, will be effected in compliance with the requirements of either section 15(a) of the Exchange Act or Rule 15a-6 thereunder.³⁹⁸

[C] Other Cross-Border Issues

In 2000, the SEC published guidance on the use of electric media by issuers of all types, including operating companies, investment

United States in connection with a distribution conducted outside the United States. For purposes of this definition, the status of OTC derivatives that are securities would be determined by reference to the underlying instrument. A distribution would not be considered to be conducted “outside the United States” if it involved a registration statement filed under the Securities Act, but may be considered conducted outside the United States, notwithstanding U.S. sales pursuant to Section 4(2) of the Securities Act or a resale exemption from the Securities Act registration requirement, including the exemption provided by Rule 144A. *See* Cleary, Gottlieb, Steen & Hamilton, SEC No-Action Letter (Jan. 30, 1996) [hereinafter *Offshore Client Letter*].

396. A “U.S. resident fiduciary” cannot be a registered broker-dealer or a bank acting in a broker-dealer capacity within the meaning of Rule 15a-6(a)(4)(i). A U.S. resident fiduciary may, but need not, be (i) affiliated with a U.S. or foreign broker-dealer, or (ii) registered under the Investment Advisers Act. *See* *Offshore Client Letter*, *supra* note 395.

397. “Offshore client” is defined in the letter as (i) any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for U.S. federal income tax purposes, (ii) any natural person who is neither a U.S. citizen nor a U.S. resident, (iii) a natural person who is a U.S. citizen residing in a foreign country who (1) has \$500,000 or more under the management of the U.S. resident fiduciary or (2) has, together with the person’s spouse, a net worth in excess of one million dollars, or (iv) an entity not organized or incorporated under the laws of the United States substantially all of the outstanding voting securities of which are beneficially owned by the foregoing persons. *See* *Offshore Client Letter*, *supra* note 395.

398. *See* *Offshore Client Letter*, *supra* note 395.

companies and municipal securities issuers, as well as market intermediaries to ensure full and fair disclosure.³⁹⁹ Among other things, the SEC outlined the basic legal principles that issuers, underwriters and other offering participants should consider in conducting online offerings. The Internet Release also notes that third-party service providers that act as brokers in connection with securities offerings may be required to register as broker-dealers, even if the securities are exempt from registration under the Securities Act.⁴⁰⁰

[D] SEC 2008 Proposal to Amend Rule 15a-6

Rule 15a-6 contains procedural requirements—particularly the conditions specified in Rule 15a-6(a)(3)—that broker-dealers have found difficult or impractical to comply with, and that are believed by many to unnecessarily restrict business and raise the cost of cross-border securities transactions. On June 27, 2008, the SEC proposed to amend Rule 15a-6.⁴⁰¹ The proposal would have lowered the asset threshold for investors under the rule, and in certain circumstances allow foreign broker-dealers to effect transactions and custody securities and funds.

The SEC has shown little interest in pursuing this proposal.

§ 1A:7.3 Mutual Recognition of Foreign Broker-Dealers

Foreign broker-dealers seeking access to U.S. investors currently are required to register under Exchange Act §§ 15(a) and 5 respectively, with limited exemptions provided by Rule 15a-6.⁴⁰² As the need of U.S. investors to access foreign securities increases, the SEC has considered expanding access of U.S. investors to foreign broker-dealers.

In 1989, 1997 and 2008, the SEC solicited comments on a possible alternative approach to regulating foreign broker-dealers known as “mutual recognition.”⁴⁰³ Under this approach, foreign broker-dealers

399. SEC Release Nos. 33-7856 and 34-42728 (Apr. 28, 2000) [hereinafter Internet Release].

400. *Id.*

401. SEC Release No. 34-58047 (June 27, 2008).

402. *See* Exchange Act §§ 5, 15(a); Rule 15a-6.

403. In a 1989 concept release, the SEC solicited comments on a conceptual approach that would exempt from U.S. broker-dealer registration certain comparably regulated foreign broker-dealers who conduct a limited business from outside the U.S. with major U.S. institutional investors. *See* Recognition of Foreign Broker-Dealer Regulation, SEC Release No. 34-27018; International Series, Release No. 106 (July 11, 1989). Later in a concept release in 1997, the SEC again solicited comments on the mutual recognition approach—relying on a foreign market’s primary regulatory authority—in regulating foreign markets’ activities in the U.S. *See* Regulation of Exchanges, SEC Release No. 34-38672; International Series Release No. IS-1085 (May 23, 1997).

(and foreign securities exchanges) would be permitted to do business in the United States on the basis of home country rules, rather than the U.S. regulatory regime. On March 24, 2008, the SEC announced that, among other measures, it would explore the possibility of a limited mutual recognition arrangement with one or more foreign regulatory counterparts, and that those arrangements could provide the basis for the development of a more general approach to mutual recognition through rulemaking.⁴⁰⁴ Since then, the SEC has held discussions with Canada, Australia and the European Union. On May 29, 2008, the SEC and its Canadian counterpart announced the schedule for completion of a U.S.-Canadian mutual recognition process agreement.⁴⁰⁵ On August 26, 2008, the SEC and its Australian counterpart signed a mutual recognition agreement.⁴⁰⁶

The Dodd-Frank Act requires that “security-based swap dealers” register with the SEC and remain subject to a host of regulatory requirements. There is no exemption in Dodd-Frank similar to Rule 15a-6 that would allow foreign security-based swap dealers to avoid registration under the Act.

§ 1A:7.4 Banks

[A] Pre-GLBA Background

Prior to the adoption and implementation of the GLBA, banks had a blanket exemption from the Exchange Act’s definitions of “broker” and “dealer.” Thus, banks could conduct any securities activity permissible under the banking laws without having to register as brokers or dealers. Among other things, the GLBA amended sections (a)(4) and (a)(5) of the Exchange Act by replacing the blanket exemption for banks from broker-dealer registration requirements with specific exemptions for designated traditional bank securities activities. These are colloquially referred to as the “push-out” provisions.⁴⁰⁷ The SEC later adopted rules implementing the “push-out” provisions.

404. Press Release, SEC, SEC Announces Next Steps for Implementation of Mutual Recognition Concept (Mar. 24, 2008), *available at* www.sec.gov/news/press/2008/2008-49.htm.

405. Press Release, SEC, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement (May 29, 2008), *available at* www.sec.gov/news/press/2008/2008-98.htm.

406. Press Release, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 26, 2008), *available at* www.sec.gov/news/press/2008/2008-182.htm.

407. The origin of this term relates to the fact that, upon the GLBA’s elimination of banks’ historic exemption from regulation as broker-dealers, it would have been impractical for a bank itself to register as a broker-dealer. Therefore, many of the securities activities traditionally conducted by banks would be “pushed-out” into an affiliated securities firm.

[B] Bank Brokerage Activities**[B][1] Section 3(a)(4)(B)**

Section 3(a)(4)(B) provides that a bank will not be considered to be a broker if it engages in the following activities, including:

- (i) third-party brokerage arrangements;
- (ii) trust activities;
- (iii) permissible securities transactions;
- (iv) certain stock purchase plans;
- (v) sweep accounts transactions;
- (vi) affiliate transactions;
- (vii) private securities offerings;
- (viii) safekeeping and custody activities;
- (ix) transactions in identified banking products as defined in section 206 of the GLBA;⁴⁰⁸ and
- (x) transactions in municipal securities.⁴⁰⁹

408. For purposes of Exchange Act §§ 3(a)(4) and (5), the term “identified banking product” means: (i) a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank; (ii) a banker’s acceptance; (iii) a letter of credit issued or loan made by a bank; (iv) a debit account at a bank arising from a credit card or similar arrangement; (v) a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold—(A) to qualified investors; or (B) to other persons that—(1) have the opportunity to review and assess any material information, including information regarding the borrower’s credit-worthiness; and (2) based on such factors as financial sophistication, net worth, and knowledge and experience in financial matters, have the capacity to evaluate the information available, as determined under generally applicable banking standards or guidelines; or (vi) any swap agreement, including credit and equity swaps, except that an equity swap that is sold directly to any person other than a qualified investor (as defined in section 3(a)(54) of the Exchange Act) shall not be treated as an identified banking product. Pub. L. 106-102, title II, § 206, Nov. 12, 1999, 113 Stat. 1393; 15 U.S.C.A. § 78c note. Section 206(b) of the GLBA defines “swap agreement” for purposes of section 206(a)(6) to include any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product, as defined in sections 206(a)(1) through (5). This definition allows banks to engage in a broad range of derivative activities without registering as broker-dealers.

409. Exchange Act § 3(a)(4)(B)(i) to (x).

Section 3(a)(4)(B)(xi) provides a *de minimis* exception from broker-dealer registration for a bank that effects, other than in transactions referred to in (i) through (x) above, not more than 500 transactions in securities in any calendar year, and if such transactions are not effected by an employee of the bank who is also an employee of a broker or dealer.⁴¹⁰ The availability of these exemptions is subject to various conditions.

[B][2] Regulation R

On September 24, 2007, the SEC and the Board of Governors of the Federal Reserve System jointly adopted Regulation R, which among other things, provides interpretive guidance for the exemptions provided for banks listed in section 3(a)(4).⁴¹¹ Regulation R addresses four major types of exempted activities:

- (i) third-party networking arrangements;
- (ii) trust and fiduciary activities;
- (iii) sweep account transactions; and
- (iv) safekeeping and custody activities.⁴¹²

[B][3] Networking Arrangements

The “push-out” provisions permit banks to enter into arrangements with Registered Broker-Dealers, under which the broker-dealers offer brokerage services on or off the premises of the bank (“networking arrangements”) if certain conditions are met.⁴¹³ One such condition is that unregistered bank employees may not receive “incentive compensation” for brokerage transactions, except that such employees may receive a nominal one-time cash referral fee of a fixed dollar amount that is not contingent on whether the referral results in a transaction.⁴¹⁴ The GLBA does not, however, define the key terms “incentive compensation,” “nominal” or “contingent.” Regulation R provides definitions for these and other terms used in the statute, and contains an exemption from the statutory definition of a “broker” for bank employee referrals involving “institutional customers” or “high

410. This joint rulemaking was required by the Financial Services Regulatory Relief Act of 2006. *See* SEC Release 34-56501 (Sept. 24, 2007).

411. Regulation R Adopting Release, *supra* note 87. Regulation R uses the same definition of “bank” as that in Exchange Act § 3(a)(6), which includes U.S. branches and agencies of foreign banks.

412. Rules 700, 721, 740 and 760; *see* Regulation R Adopting Release, *supra* note 87, at 10.

413. *See* Exchange Act § 3(a)(4)(B)(i).

414. *See* Exchange Act § 3(a)(4)(B)(i)(VI).

net worth customers.”⁴¹⁵ Regulation R also provides that if a bank acts in good faith and has reasonable policies and procedures, the bank will not be subject to registration as a broker-dealer for failing to comply with the provisions of the exemption so long as the bank takes prompt corrective action and attempts to reclaim any non-compliant referral fee.⁴¹⁶

[B][4] Trust and Fiduciary Activities

The “push-out” provisions allow a bank to effect securities transactions as a trustee or fiduciary from a trust department (or other department of the bank regularly examined for compliance with fiduciary principles and standards).⁴¹⁷ To qualify for the statutory exception, however, the bank must be “chiefly compensated” in one of three enumerated ways (or a combination thereof), generally referred to as “relationship compensation,” and abide by certain advertising restrictions.⁴¹⁸ Regulation R provides criteria for determining “relationship compensation” and a bank’s compliance with the trust and fiduciary activities exception.⁴¹⁹

Section 3(a)(4)(C) conditions the exception (and certain of the other GLB exceptions) to being considered a broker for a bank on transactions for publicly traded securities in the United States being executed by a registered broker-dealer, among other requirements, or the trade, subject to certain conditions, being a cross-trade.

[B][5] Sweep Accounts and Money Market Funds

Under section 3(a)(4)(B)(v) of the Exchange Act, a bank may effect transactions as part of a program for the investment or reinvestment of deposit funds into any no-load, open-end management investment company that holds itself out as a money market fund.⁴²⁰ Regulation R provides definitions for “money market fund,” “no-load” and other terms,⁴²¹ and a conditional exemption for banks effecting transactions in money market funds.⁴²²

415. Regulation R, at 59, provides a conditional exemption that allows a bank employee to receive otherwise prohibited contingent and greater-than-nominal referral fees if the customer referred to the broker-dealer is either an “institutional customer” or a “high net worth customer.” *See* Rule 701.

416. Rule 701(iv).

417. *See* Exchange Act § 3(a)(4)(B)(ii). There is a separate exception in Exchange Act § 3(a)(4)(B)(iv) for bank transfer agent activities.

418. *See* Exchange Act § 3(a)(4)(B)(ii).

419. *See* Rules 721 and 722.

420. Exchange Act § 3(a)(4)(B)(v).

421. Rule 740.

422. Rule 741.

[B][6] Safekeeping and Custody

The “push-out” provisions permit banks to engage in certain customary safekeeping and custody activities, including

- (i) providing safekeeping or custody services,
- (ii) facilitating the transfer of funds or securities, as custodian or clearing agent,
- (iii) effecting securities lending or borrowing transactions with or on behalf of customers as part of custodial services or cash collateral investment pledged as part of such services,
- (iv) investing related cash collateral and holding securities pledged by customers, or
- (v) providing custodial or other related administrative services to individual retirement, pension or similar accounts.⁴²³

Regulation R adds two additional exemptions under this exception: (i) broker activities as an accommodation to customers, and (ii) broker activities in relation to certain employee benefit plan, individual retirement and similar accounts.⁴²⁴ Regulation R also clarifies that banks are exempt under the above Regulation R custody and safekeeping exception only if the bank is not acting in a trust or fiduciary capacity and the bank complies with the trade execution and carrying broker requirements of the Exchange Act.⁴²⁵ The trade execution limitation in section 3(a)(4)(C) referred to in d. above also applies to transactions executed under the safekeeping and custody exception.

Regulation R also includes several additional conditional exemptions for banks’ brokerage activities, including exemptions for:

- (i) certain agency transactions involving securities offered and sold outside the United States in accordance with Regulation S under the Securities Act (“Regulation S”);
- (ii) securities lending transactions;
- (iii) transactions in certain investment company securities;

423. Exchange Act § 3(a)(4)(B)(viii). A bank may not act as a “carrying broker” (as such term and different formulations are used in Exchange Act § 15(c)(3)), except with regard to “government securities” (as defined in Exchange Act § 3(a)(42)) under this exception.

424. Rule 760.

425. Rule 760(d).

- (iv) certain transactions involving a company's securities for its employee benefit plans and participants; and
- (v) contracts entered into by banks from being considered void or voidable.⁴²⁶

While Regulation R does not include all the exceptions provided in Exchange Act § 3(a)(4)(B) as listed above, these exceptions remain in force and available to banks.⁴²⁷

[C] Bank Dealer Activities

[C][1] Section 3(a)(5)(C)

The GLBA also amended Exchange Act § 3(a)(5) and provided exemptions from the definition of "dealer" for certain bank activities. As discussed above, section 3(a)(5)(A) defines a "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."⁴²⁸ Section 3(a)(5)(C) exempts a bank from the definition of a "dealer" subject to conditions when it engages in certain activities, including:

- (i) transactions in commercial paper, bankers acceptances, commercial bills, exempted securities, qualified Canadian government or North American Development Bank obligations, or standardized, credit-enhanced debt security issued by a foreign government;
- (ii) securities transactions for investment purposes for the bank, or for accounts for which the bank acts as a trustee or fiduciary;
- (iii) certain asset-backed transactions; and
- (iv) transactions in identified banking products.⁴²⁹

426. Rules 771, 772, 775, 776 and 780.

427. See Regulation R: Exceptions for Banks from the Definition of Broker in the Securities Exchange Act of 1934—A Small Entity Compliance Guide, available at www.sec.gov/divisions/marketreg/tmcompliance/regulation_r_secg.htm.

428. Exchange Act § 3(a)(5)(A). Section 3(a)(5)(B) excludes from the term "dealer" "a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." Such a person is usually called a "trader." For dealer/trader distinction, see *supra* section 1A:3.2.

429. Exchange Act § 3(a)(5)(C). Three of the four exceptions are also exceptions from the "broker" definition, except for the exception for engaging in certain asset-backed transactions. See Exchange Act §§ 3(a)(4)(B)(ii), (iii), and (ix).

[C][2] Bank Riskless Principal Activities—Rule 3a5-1

Exchange Act Rule 3a5-1 exempts from the definition of “dealer” a bank engaging in or effecting riskless principal transactions.⁴³⁰ However, the number of such riskless principle transactions during a calendar year combined with transactions in which the bank is acting as an agent for a customer pursuant to section 3(a)(4)(B)(xi) of the Exchange Act during that same year cannot exceed 500.⁴³¹

[C][3] Bank Regulation S Transactions—Rule 3a5-2

Ordinarily, persons in the United States may not act as a broker-dealer in securities without registration unless an exception applies, even if the selling activity occurs outside of the United States. Regulation R provides an exemption for banks that, as agents, effect transactions with non-U.S. persons in securities issued pursuant to Regulation S.⁴³² Rule 3a5-2 provides a similar exemption for banks that effect riskless principal transactions⁴³³ with non-U.S. persons involving Regulation S Securities.⁴³⁴

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430. Rule 3a5-1. For purposes of this section, the term “riskless principal transaction” means a transaction in which, after having received an order to buy from a customer, the bank purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the bank sold the security to another person to offset a contemporaneous purchase from such customer. *See* Rule 3a5-1(b). Under the securities laws, riskless principal transactions are dealer activity. *See* SEC Release No. 34-44291 (2001). Exchange Act § 3(a)(4)(B)(xi) excepts a bank from the definition of broker if it effects no more than 500 securities transactions per calendar year, other than transactions that qualify for one of the other statutory exceptions. A transaction in which a bank is acting as an agent for a customer would count as one transaction toward the 500-transaction limit. The GLBA provisions did not extend this *de minimis* exception to dealer transactions. In the Interim Final Rules adopted by the SEC in 2001, the SEC adopted Rule 3a5-1 to exempt banks from the definition of “dealer” provided that the number of “riskless” principal transactions and agency transactions engaged in by a bank does not exceed 500 transactions per year. *See* Rule 3a5-1; SEC Release No. 34-44291 (2001).
431. Rule 3a5-1. Under Rule 3a5-1, a riskless principal transaction, even if it involves two separate counterparties, would count as only one transaction against the annual 500-transaction limit. However, if a bank acts as an intermediary between one counterparty and multiple counterparties by arranging multiple transactions, the bank must count each of the transactions on the side of the intermediation that involves the largest number of transactions as a separate transaction against the annual 500-transaction-limit. *See* SEC Release No. 34-47364 (2003).
432. The Regulation R Adopting Release, *supra* note 87.
433. “Riskless principal transaction” is defined in Rule 3a5-2(b)(4) and has the same meaning as that in Rule 3a5-1(b).
434. *See* Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules, SEC Release No. 34-56502 (Sept. 24, 2007).

Under Rule 3a5-2, a bank is not considered a dealer when, in a riskless principal transaction, it:

- (i) purchases an eligible security⁴³⁵ from an issuer or a broker-dealer and sells that security in compliance with the requirements of Rule 903 of Regulation S to a purchaser⁴³⁶ who is not in the United States;
- (ii) purchases from a person who is not a U.S. person (as defined in Regulation S) an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with the requirements of Rule 903 of Regulation S, and resells that security to a purchaser who is not in the United States or to a registered broker or dealer;⁴³⁷ or
- (iii) purchases from a registered broker or dealer an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with the requirements of Rule 903 of Regulation S, and resells that security to a purchaser who is not in the United States.⁴³⁸

[C][4] Bank Securities Lending—Rule 3a5-3

Rule 772 of Regulation R exempts from the definition of “broker” banks engaging in certain bank lending activities, as agents.⁴³⁹ Rule 3a5-3 provides an exemption from the definition of “dealer” for banks engaging in certain securities lending transactions, as conduit lenders.⁴⁴⁰

435. “Eligible security” is defined in Rule 3a5-2(b)(2) as a security that (i) is not being sold from the inventory of the bank or an affiliate of the bank; and (ii) is not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank. The definition of “eligible security” in Rule 3a5-2 is the same as that in Rule 771 of Regulation R.

436. For the purposes of Rule 3a5-2, a “purchaser” is a person who purchases an eligible security and who is not a U.S. person under Rule 902(k).

437. See Rule 3a5-2(a)(2).

438. See Rule 3a5-2(a)(3).

439. See Rule 772; SEC Release No. 34-56501, at 127 (Sept. 24, 2007).

440. See Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules, SEC Release No. 34-56502, at 12 (Sept. 24, 2007).

Under Rule 3a5-3, a bank is exempt from the definition of “dealer” to the extent that, as a conduit lender,⁴⁴¹ it engages in or effects securities lending transactions, and any securities lending services⁴⁴² in connection with such transactions.⁴⁴³ The exemption applies only to securities lending transactions with or on behalf of a person that the bank reasonably believes to be (i) a qualified investor,⁴⁴⁴ or (ii) any employee benefit plan that owns and invests, on a discretionary basis, not less than \$25,000,000 in investments.⁴⁴⁵

§ 1A:7.5 Charitable Exemption—Section 3(e)

Exchange Act § 3(e) provides an exemption from the broker-dealer registration requirements in sections 15(a), 15B(a), and 15C(a) for a charitable organization,⁴⁴⁶ or any person⁴⁴⁷ of such a charitable organization acting within the scope of such person’s employment or duties with such organization, buys, holds, sells, or trades in securities for its own account in its capacity as trustee or administrator of, or otherwise on behalf of or for the account of: (i) such a charitable organization; (ii) a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment

441. For purposes of this rule, “conduit lender” means a bank that borrows or loans securities, as principal, for its own account, and contemporaneously loans or borrows the same securities, as principal, for its own account. A bank that qualifies under this definition as a conduit lender at the commencement of a transaction will continue to qualify, notwithstanding whether (i) the lending or borrowing transaction terminates and so long as the transaction is replaced within one business day by another lending or borrowing transaction involving the same securities, and (ii) any substitutions of collateral occur. *See* Rule 3a5-3(d).

442. “Securities lending services” means: (i) selecting and negotiating with a borrower and executing or directing the execution of the loan with the borrower; (ii) receiving, delivering, or directing the receipt or delivery of loaned securities; (iii) receiving, delivering, or directing the receipt or delivery of collateral; (iv) providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; (v) investing, or directing the investment of, cash collateral; or (vi) indemnifying the lender of securities with respect to various matters. *See* Rule 3a5-3(c).

443. Rule 3a5-3; SEC Release No. 34-56502 (Sept. 24, 2007).

444. A “qualified investor” is defined in Exchange Act § 3(a)(54)(A). In part, this definition encompasses corporations and partnerships with at least \$25 million in investments.

445. Rule 3a5-3; SEC Release No. 34-56502 (Sept. 24, 2007).

446. “Charitable organization” is defined in Section 3(c)(10)(D)(iii) of the Investment Company Act.

447. Such person includes any trustee, director, officer, employee, or volunteer of such a charitable organization. *See* Exchange Act § 3(e)(1).

Company Act; or (iii) a trust or other donative instrument or the settlors (or potential settlors) or beneficiaries of such a trust or other instrument.⁴⁴⁸ This exemption is not available to any charitable organization, or any trustee, director, officer, employee, or volunteer of such a charitable organization, unless each person who solicits donations on behalf of such charitable organization from any donor to a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act, is either a volunteer or is engaged in the overall fund-raising activities of a charitable organization and receives no commission or other special compensation based on the number or the value of donations collected for the fund.⁴⁴⁹

§ 1A:7.6 Associated Persons of Registered Broker-Dealers

[A] Section 15(a)(1)

Absent an exemption, a person engaged in broker or dealer activities has to register with the SEC in accordance with section 15(b). Section 15(a), however, does not require a natural person who is associated with a Registered Broker-Dealer to register when he or she engages in securities transactions as a broker-dealer.⁴⁵⁰ A “person associated with a broker or dealer” or “associated person of a broker or dealer” includes any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker-dealer whose functions are solely clerical or ministerial.⁴⁵¹ While exempted from registering with the SEC, with certain exceptions associated persons must register with an SRO via the firm with which they are associated and be subject to the supervision and control of such firm.⁴⁵² Of course, the broker-dealer with whom the natural person is associated must register with the SEC, absent an exemption.

448. Exchange Act § 3(e)(1).

449. Exchange Act § 3(e)(2).

450. Exchange Act § 15(a)(1). A natural person who is not associated with a registered broker-dealer will still have to register pursuant to Section 15(b).

451. Exchange Act § 3(a)(18).

452. *See, e.g.*, NASD Rule 1032 (concerning registration of representatives) and NASD Rule 3010 (concerning supervision).

**[B] Retired Brokers—SEC and FINRA Guidance
Concerning Trailing Commissions**

Subject to certain exceptions, a retired broker is generally not allowed to conduct securities transactions or receive commissions for securities transactions upon retirement without being a Registered Broker-Dealer or an associated person of a registered securities firm. Under New York Stock Exchange (NYSE) Rule 353(b), no member, principal executive, registered representative or officer shall be compensated for business done by or through his employer after the termination of his employment except as may be permitted by the Exchange.⁴⁵³ NASD, IM-2420-2, permits contracts entered into in good faith between employers and employees at the time the employees are registered representatives of the employing members, which vests in an employee the right to receive continuing compensation on business done in the event the employee retires and the right to designate such payments to his widow or other beneficiary.⁴⁵⁴

The SEC has, through no-action letters, allowed retiring representatives of a registered securities firm to share in commissions generated by former clients without the retiring representative maintaining his or her status as a registered associated persons upon retirement.⁴⁵⁵ In each case, there has to be a bona fide contract between the securities firm and the retiring representative, which provides for the payment of compensation to the retiring representative by the firm. The contract must contain several terms and conditions, including that:

- (i) the retiring representative must have been continuously associated with the securities firm for at least three years;
- (ii) the retiring representative must have demonstrated appropriate professional and ethical conduct;
- (iii) the retiring representative must not have been subject to a statutory disqualification during the three years prior to the retirement;
- (iv) the securities firm may pay the retiring representative commissions for no longer than five years after retirement, and a pre-determined percentage scale between the retiring representative and the receiving registered representative;

453. Incorporated NYSE Rule 353(b).

454. NASD Rule 2420, IM-2420-2.

455. Securities Industry and Financial Markets Ass'n, SEC No-Action Letter (Nov. 20, 2008); Gruntal & Co., SEC No-Action Letter (Oct. 14, 1998); Prudential Securities Incorporated, SEC No-Action Letter (Oct. 11, 1994); Shearson Lehman Brothers Inc., SEC No-Action Letter (Mar. 25, 1993) [collectively hereinafter Retiring Representative No-Action Letters].

- (v) the retiring representative must cease contacting former clients for solicitation or provision of securities related services or advice;
- (vi) the retiring representative must comply with all applicable securities laws and regulations and SRO rules;
- (vii) the retiring representative must cease association with the securities firm, other broker-dealers or investment adviser or investment company during the term of the agreement, or become associated with any bank, insurance company or insurance agency during the term of the agreement if the retiring representative's activities relate to effecting transactions in securities;
- (viii) the retiring representative must certify at least annually to the securities firm that he/she has adhered to the requirements and conditions of the agreement; and
- (ix) the securities firm must contact a representative sample of the account holders at least annually to ensure that the retiring representative has not provided investment advice or solicited trades in securities in any way.⁴⁵⁶

In addition, the securities firm must approve the receiving representative, who must meet certain eligibility criteria.⁴⁵⁷ Prior to the retirement date, the securities firm must inform the account holders of the applicable accounts in writing of the retiring representative's departure and of the transfer of the applicable accounts to the receiving representative.⁴⁵⁸

On December 2, 2009, FINRA proposed to establish new FINRA Rule 2040, which codifies existing FINRA staff guidance on the payment by members of continuing commissions to retiring registered representatives.⁴⁵⁹ The proposal would permit members to pay continuing commissions to retiring registered representatives of the

456. See Retiring Representative No-Action Letters, *supra* note 455.

457. A receiving representative is the registered representative of the securities firm who will service, and may receive compensation related to, the client accounts of the retiring representative. The receiving representative must meet certain eligibility criteria, including continuous employment with the firm for a minimum of one year, employment in the securities industry in a registered capacity for a minimum of three years, and not being subject to statutory disqualification in the three years prior to the retirement date. *See id.*

458. *See id.*

459. FINRA Regulatory Notice 09-69, Payments to Unregistered Persons (Dec. 2009) [hereinafter Regulatory Notice 09-69], available at www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120480.pdf.

member, after they cease to be employed by the member, that are derived from accounts held for continuing customers of the retiring registered representative regardless of whether customer funds or securities are added to the accounts during the period of retirement, provided that (i) a bona fide contract between the member and the retiring registered representative calling for the payments was entered into in good faith while the person was a registered representative of the employing member and such contract, among other things, prohibits the retiring registered representative from soliciting new business, opening new accounts or servicing the accounts generating the continuing commission payments, and (ii) the arrangement complies with applicable SEC rules, regulations and published guidance by the SEC or its staff.

§ 1A:7.7 *Miscellaneous Exemptions—Rule 15a-2 and 15a-5*

The SEC has also provided exemptions from registration for certain securities of cooperative apartment houses and certain non-bank lenders participating in the guaranteed loan program of the Small Business Administration (SBA). Under section 15a-2, shares of cooperative apartment houses are exempted from section 15(a), when such shares are sold by or through a locally licensed real estate broker.⁴⁶⁰ Rule 15a-5 exempts certain lenders participating in the SBA's guaranteed loan program to sell guaranteed notes, provided that the sale is made through or to a Registered Broker-Dealer, or to a bank, a savings institution, an insurance company, or an account over which an investment adviser registered pursuant to the Investment Advisers Act exercises investment discretion.⁴⁶¹ The rule is intended to facilitate participation by qualified lending institutions in the SBA's guaranteed loan program.⁴⁶²

§ 1A:7.8 *General Exemptive Authority*

Section 15(a)(2) and section 36 of the Exchange Act provide the SEC with general exemptive authority from, with respect to section 15(a)(2), the broker-dealer registration requirement and, with respect to section 36, any section of the Exchange Act. The SEC must find that any such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.⁴⁶³

460. Rule 15a-2.

461. Rule 15a-5; Exemption of Certain Non-Bank Lenders, SEC Release No. 34-12967 (Nov. 11, 1976) [hereinafter Rule 15a-5 Adopting Release].

462. *Id.*

463. *See, e.g.*, SEC Release No. 34-61662 (Mar. 5, 2010) (granting exemptions to ICE Trust U.S. LLC for certain credit default swap clearing activities).

§ 1A:8 Doing Business As an Unregistered Broker-Dealer

§ 1A:8.1 SEC and State Enforcement

Absent an exemption, a broker-dealer who engages in securities transactions without proper registration may be subject to enforcement actions by the SEC, relevant state regulators, as well as investor actions for rescission. The SEC and the state regulators have authority to enforce respective federal and state securities laws through administrative proceedings, civil court proceedings, and referrals for criminal prosecutions.

Exchange Act § 21(a)(1) grants the SEC the authority to make investigations to detect securities laws violations.⁴⁶⁴ Once it determines that there is a violation, the SEC can enter a cease-and-desist order which may, in addition to requiring a person to cease and desist from committing a violation, require such person to comply with a rule upon such terms and within such time as the SEC may specify.⁴⁶⁵ The SEC can also impose civil penalties and require accounting and disgorgement.⁴⁶⁶

The SEC can also bring an action in court and seek permanent or temporary injunction or a restraining order against an unregistered broker-dealer.⁴⁶⁷ In addition to an injunction, the SEC may also seek civil penalties and equitable relief for such violation.⁴⁶⁸ In addition,

See also SEC Release No. 34-61884 (Apr. 9, 2010) (granting exemptions to the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 in connection with restructuring of debt instruments acquired by the Federal Reserve Bank of New York when it facilitated the acquisition of the Bear Stearns Companies Inc. by JP Morgan Chase & Co., including permitting receipt of compensation that is calculated by reference to underwriting fees received by other parties to the restructuring).

464. Exchange Act § 21(a)(1).

465. Exchange Act § 21C. *See, e.g.*, In the Matter of CentreInvest, Inc., SEC Release No. 34-60450 (Aug. 5, 2009); In the Matter of Warrior Fund LLC, SEC Release 34-61625 (Mar. 2, 2010).

466. Exchange Act § 21B.

467. Exchange Act § 21(d)(1). *See, e.g.*, SEC v. Martino and CMA Noel, Ltd., 255 F. Supp. 2d 268 (Apr. 2, 2003); SEC v. Dowdell, 2002 U.S. Dist. LEXIS 4522, Fed. Sec. L. Rep. (CCH) ¶ 91,728 (Mar. 14, 2002); SEC v. ProVision Operation Systems, Inc., Civil Action Number SACV 07-1139 (SEC Release No. 34-60171); SEC v. Jarrod McMillin, Civil Action Number 07cv2636-REB-MEH (SEC Release No. 34-59263); SEC v. Rabinovich & Associates, L.P., Civil Action Number 07 Civ. 10547 (SEC Release No. 34-59190); SEC v. Viktor Novosselov, Civil Action Number 3:05-CV-951; SEC v. Century Investment Transfer Corp., et al., Fed. Sec. L. Rep. (CCH) ¶ 93,232 (Oct. 5, 1971).

468. Exchange Act §§ 21(d)(3) and (5).

the SEC may transmit such evidence of securities laws violations to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under the Exchange Act.⁴⁶⁹

In addition to SEC actions, an unregistered broker-dealer may also be subject to state enforcement actions under respective state blue sky laws. As discussed in section 1A:1, most states have their own registration requirements. Under both the 1956 Uniform Act and the 2002 Uniform Act, as adopted by most states, a state regulator can initiate a civil action in court for a temporary or permanent injunction to enjoin a person's act in violation of the registration requirement.⁴⁷⁰ The state regulator may also, under the 2002 Uniform Act, issue a cease-and-desist order or impose civil penalties on the unregistered broker-dealer.⁴⁷¹ Under the 1956 Uniform Act, the state regulator can refer evidence to the attorney general or appropriate district attorney who may institute criminal proceedings against the unregistered broker-dealer.⁴⁷² States have brought numerous enforcement actions against unregistered broker-dealers.⁴⁷³ In cases where fraud is involved, states have brought criminal charges against such broker-dealers.⁴⁷⁴

§ 1A:8.2 Private Actions—Exchange Act § 29(b)

Exchange Act § 29(b) provides that contracts made in violation of any provision of the Exchange Act or any rule thereunder are “void” (though, in reality, courts treat such contracts as being voidable rather than void *ab initio*).⁴⁷⁵ The Supreme Court has recognized a private

469. Exchange Act § 21(d)(1).

470. 1956 Act § 408; 2002 Act § 603.

471. 2002 Uniform Act § 604. *See* California Desist and Refrain Order against Markow Tsai on May 15, 1998; Alabama Cease and Desist Order against Markow Tsai on March 3, 2000.

472. 1956 Act § 409. *See, e.g., Kahn v. State*, 493 N.E.2d 790, 1986 Ind. App. LEXIS 2616 (1986).

473. *See, e.g., State of W. Va. v. Fairchild*; *State of W. Va. v. Roger*, 171 W. Va. 137, 298 S.E.2d 110 (Nov. 18, 1982); *People of the State of Colo. v. Milne*, 690 P.2d 829 (Nov. 5, 1984).

474. *See, e.g., State v. Milne*, 690 P.2d 829 (Nov. 5, 1984).

475. Exchange Act § 29(b). While the language of the statute provides that such contracts “shall be void,” courts have interpreted the statute to mean that such contracts are void as regards the rights of the violating party and “voidable” at the option of the innocent injured party. *See Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357 (5th Cir.), cert. denied, 393 U.S. 913 (1968); *Schneberger v. Wheeler*, 859 F.2d 1477, 1481–82 (11th Cir., 1988), cert. denied *sub nom.* *Schneberger v. United States Trust Co. of N.Y.*, 490 U.S. 1091 (discussing *Mills v. Electric Auto-Lite Co.* 396 U.S. 375).

right of rescission under this section.⁴⁷⁶ Section 29(b) renders void not only those contracts that “by their terms” violate the Exchange Act, but also those that involve a violation when made or as in fact performed.⁴⁷⁷ Although a contract engaging an unregistered broker-dealer in a securities transaction may not be illegal by its terms, the performance of it may involve a violation of section 15(a) of the Exchange Act.⁴⁷⁸ In such cases, some courts have found the contract to be void and have allowed rescission under section 29(b).⁴⁷⁹

Courts have held that, under section 29(b), a contract is only voidable at the option of the innocent party, not the unregistered broker-dealer,⁴⁸⁰ and that the unregistered broker-dealer is not entitled to any fees as yet unpaid.⁴⁸¹ However, when the services contracted for have been performed by an unregistered broker-dealer, courts have been unwilling to grant restitution of payments made for such services, except for those by which the defendant unregistered broker-dealer has been unjustly enriched.⁴⁸²

A plaintiff in a section 29(b) action does not have to prove a causal connection between its harm and the defendant’s violation of the broker-dealer registration requirements.⁴⁸³ A plaintiff can avoid a contract by showing that:

- (i) the contract involved a “prohibited transaction;”
- (ii) he or she is in contractual privity with the defendant; and

476. *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979); *Royal Air Props., Inc. v. Smith*, 312 F.2d 210, 213 (9th Cir. 1962).

477. *Reg'l Props., Inc. v. Fin. and Real Estate Consulting Co.*, 678 F.2d 552 (5th Cir. 1982).

478. See *id.*

479. See *id.*; *Eastside Church of Christ*, 391 F.2d 357 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968); *Western Fed. Corp. v. Erickson*, 739 F.2d 1439, 1443–44 n.5 (9th Cir. 1984); *Boguslavsky v. Kaplan*, 159 F.3d 715, 722 n.6 (2d Cir. 1998).

480. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 387–88 (1970); *Berkeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195 (3d Cir. 2006); *Schneberger v. Wheeler*, 859 F.2d 1477, 1481–82 (11th Cir. 1988), *cert. denied sub nom.*; *SEC v. Levine*, 881 F.2d 1165, 1176 (2d Cir. 1989); *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715, 726 (8th Cir. 1974); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 792 (8th Cir. 1967).

481. *Regional Props.*, 678 F.2d 552.

482. *Id.*; *Prudential-Bache Secs., Inc. v. Cullather*, 678 F. Supp. 601, 607 (E.D. Va. 1987); *Energytec, Inc. v. Proctor*, 516 F. Supp. 2d 660 (N.D. Texas 2007).

483. *Regional Props.*, 678 F.2d 552; *Eastside Church of Christ*, 391 F.2d 357 (5th Cir. 1968).

- (iii) he or she is in the class of persons the Exchange Act was designed to protect.⁴⁸⁴

The plaintiff must demonstrate a direct relationship between the violation at issue and the performance of the contract; that is, the violation must be inseparable from the performance of the contract rather than collateral or tangential to the contract.⁴⁸⁵ If an agreement cannot be performed without violating the securities laws, that agreement is subject to rescission under section 29(b).⁴⁸⁶

As discussed in *supra* section 1A:1, states have their own registration requirements for broker-dealers doing business within the state. Many states' securities laws have provisions modeled on section 29 of the Exchange Act, which allow parties to rescind contracts with unregistered broker-dealers.⁴⁸⁷

§ 1A:8.3 Concerns for Controlling Persons

Section 20 of the Exchange Act imposes liabilities on controlling persons and persons who aid and abet anyone in violation of the Exchange Act. Under section 20(a), every person who, directly or indirectly, controls any person liable under any provision of the Exchange Act or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. Under section 20(e), any person that knowingly provides substantial assistance to another person in violation of the Exchange Act, or of any rule or regulation thereunder, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

Pursuant to sections 21(d)(1), (3) and (5) of the Exchange Act, the SEC can bring enforcement actions against such controlling persons

484. *Regional Props.*, 678 F.2d 552; *Berkeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195 (3d Cir. 2006).

485. *Berkeley Inv. Group*, 455 F.3d 195; *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 201 (3d Cir. 2001); *Salamon v. Teleplus Enters.*, Fed. Sec. L. Rep. (CCH) ¶ 94,742.

486. *Berkeley Inv. Group*, 455 F.3d 195.

487. *See, e.g.*, CAL. CORP. CODE § 25501.5 (2009); CONN. GEN. STAT. § 36b-29 (2008); FLA. STAT. § 517.211 (2009); 815 ILCS 5/13 (2009); N.J.S.A. 49:3-71 (a)(2) (2001); TEX. REV. CIV. STAT. art. 581-33 (2009); *cf.* N.Y. GEN. BUS. § 353 (2010) (providing the New York Attorney General with a right to order restitution of any money or property, but not providing a private right of action).

and seek injunction or restraining order, money penalties or equitable relief. The SEC has filed numerous complaints against controlling persons who aided and abetted violations of Exchange Act § 15(a) and sought injunction or restraining order, disgorgement and prejudgment interest, or civil penalties.⁴⁸⁸ Some state laws impose liabilities on controlling persons who materially aid in the acts or transactions constituting violations of the state securities laws.⁴⁸⁹

§ 1A:8.4 Concerns for Registered Broker-Dealers

[A] Compensation Sharing

FINRA rules also prohibit FINRA members from engaging in any compensation sharing arrangements with non-members. The form of compensation is not limited to commissions, and can be in the form of concession, discount and allowances. Under NASD Rule 2410, no member shall offer a concession, discount, or other allowances to any person not actually engaged in the investment banking or securities business.⁴⁹⁰ NASD Rule 2740 provides the same restrictions in connection with the sale of securities which are part of a fixed price offering.⁴⁹¹ NASD Rule 2420⁴⁹² prohibits members from dealing with any non-member broker-dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.⁴⁹³ Members are not

488. *See, e.g.,* SEC v. Big Apple Consulting USA, Inc. et al., Civil Action No. 09-cv-1963 (M.D. Fla. Nov. 18, 2009); SEC v. FTC Capital Markets, Inc. et al., Civil Action No. 09-cv-4755 (S.D.N.Y. May 20, 2009); SEC v. Clean Care Techs., Inc., et al., 08 CIV 01719 (S.D.N.Y. Feb. 21, 2008); SEC v. American Growth Capital Corp., et al., Civil Action No. 97-5993 (C.D. Cal. Aug. 12, 1997); SEC v. Johnston and Fiduciary Planning, Inc., Civil Action No. 93-73541 DT (E.D. Mich. Aug. 23, 1993); SEC v. Black, 90 Civ. 1988 (E.D.N.Y. June 13, 1990); SEC v. Forma, 85 Civ. 3820 (S.D.N.Y. May 4, 1989).

489. *See, e.g.,* CAL. CORP. CODE § 25403 (2009); CONN. GEN. STAT. § 36b-29 (2008).

490. NASD Rule 2410.

491. NASD Rule 2740. For the definition of “fixed price offering,” see NASD Rule 0120(h).

492. Rule 2420 has been interpreted to apply equally to any Registered Broker-Dealer that is a non-member of the NASD and entities that are not registered, but are required to be registered under the Exchange Act. Rule 2420 does not apply to entities that are not registered and are not required to be registered under the Exchange Act. *See* FINRA Interpretive Letter to Daniel Schloendorn, Willkie Farr & Gallagher (June 18, 1998).

493. NASD Rule 2420.

allowed to grant selling concession, discount or other allowances to non-members as they are allowed to grant to members.⁴⁹⁴ Rule 2420(d) provides restrictions on payments by or to persons that have been suspended or expelled.⁴⁹⁵ NASD Rule 2420(b)(2) also prohibits FINRA members from joining with any non-member broker-dealer in any syndicate or group for the distribution of securities.⁴⁹⁶ However, Rule 2420(c) allows members to pay concessions and fees to a non-member broker-dealer in a foreign country who is not eligible for membership subject to certain conditions.⁴⁹⁷

On December 2, 2009, FINRA proposed for public comment FINRA Rule 2040 which would replace several NASD rules including NASD Rules 2410 and 2420.⁴⁹⁸ Proposed Rule 2040 would prohibit members or associated persons from paying or offering to pay, directly or indirectly, any compensation, fees, concessions, discounts, commissions or other allowances to any person that is not registered with the SEC as a broker-dealer but, by reason of receipt of any such payments, would be required to be so registered. The proposed rule would be consistent with FINRA staff interpretations under NASD Rule 2420 and SEC rules and regulations under section 15(a) of the Exchange Act. Under the proposal, persons would look to SEC rules and regulations to determine whether the activities in question require registration as a broker-dealer under section 15(a) of the Exchange Act.

[B] Participating in Syndicates with Unregistered Persons

FINRA prohibits its members from participating in underwriting syndicates with unregistered persons. FINRA Rule 5110(f)(2)(L) forbids FINRA members from participating in underwriting syndicates with unregistered persons hired by the issuer primarily to assist in the public distributions of non-underwritten offerings except associated persons of the issuer who are exempt from broker-dealer registration under Rule 3a4-1 and applicable state law.⁴⁹⁹

494. NASD Rule 2420(b)(1).

495. NASD Rule 2420, IM-2420-1(d).

496. NASD Rule 2420(b)(2).

497. NASD Rule 2420(c).

498. See Regulatory Notice 09-69, *supra* note 459.

499. FINRA Rule 5110(f)(2)(L). This limitation should not be read to prohibit certain otherwise permissible syndicate activities, such as participating in underwriting syndicates with foreign persons that are not FINRA members, subject to conditions. See NASD Rules 2740(c) and 2420(c).

[C] Aiding and Abetting

Registered Broker-Dealers are liable for aiding and abetting operations of unregistered broker-dealers. Exchange Act § 20(e) provides that any person that knowingly provides substantial assistance to another person in violation of a provision of the Exchange Act, or of any rule or regulation issued thereunder, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.⁵⁰⁰ Pursuant to Exchange Act §§ 21(d)(1), (3) or (5), the SEC has brought enforcement actions against Registered Broker-Dealers for aiding and abetting unregistered broker-dealers in their securities transactions.⁵⁰¹ Some state laws impose liabilities on Registered Broker-Dealers who materially aid in the acts or transactions constituting violations of the state securities laws.⁵⁰²

§ 1A:8.5 Concerns for Issuers**[A] Liability for Aiding and Abetting**

Issuers can face liability for knowingly aiding and abetting an unregistered broker-dealer. Exchange Act § 20 imposes liabilities on persons who aid and abet another person in violation of the Exchange Act and the SEC has brought enforcement actions against such issuers.⁵⁰³ Some state laws also have provisions that impose liabilities on persons who with knowledge assist another person in violation of state securities laws.⁵⁰⁴

[B] State Liability for Engaging Unlicensed Agents

Besides liabilities from aiding and abetting, an issuer who engages unregistered broker-dealers can face private actions for rescission from investors. Some states have provided a private right of rescission for

500. Exchange Act § 20(e).

501. *See, e.g.*, SEC v. Vladimir Chekholko, Civil Action No. 09-cv-6937 (S.D.N.Y. Aug. 6, 2009); SEC v. FTC Capital Markets, Inc. et al., Civil Action No. 09-cv-4755 (S.D.N.Y. May 20, 2009); SEC v. Black, 90 Civ. 1988 (E.D.N.Y. June 13, 1990).

502. *See, e.g.*, CAL. CORP. CODE § 25403 (2009); CONN. GEN. STAT. § 36b-29 (2008).

503. Exchange Act § 20; *see, e.g.*, SEC v. Jason Smith Petroleum Corp., et al., Civil Action No. CV 86-4419-TJH (C.D. Cal. July 8, 1986); SEC v. Jones and Skinner, Civil Action No. N81-396 (D. Conn. Sept. 9, 1981).

504. *See, e.g.*, CAL. CORP. CODE § 25403 (2009); CONN. GEN. STAT. § 36b-29(c) (2008).

innocent parties who buy securities through unregistered broker-dealers.⁵⁰⁵

[C] Section 29

As discussed above, section 29(b) of the Exchange Act renders contracts involving a violation of section 15(a) void and provides for a private right of rescission for innocent parties.⁵⁰⁶

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505. *See, e.g.*, CAL. CORP. CODE § 25501.5 (2009); CONN. GEN. STAT. § 36b-29 (2008); FLA. STAT. § 517.211 (2009); 815 ILCS 5/13 (2009); Tex. Sec. Act § 33; N.J.S.A. 49:3-71(a)(2); *Bramblewood Investors, Ltd. v. C&G Assocs.*, 262 N.J. Super. 96, 619 A.2d 1332 (June 26, 1992); *Carrousel N., Inc. v. Chelsea Moore Co.*, 9 Ohio App. 3d 344, 460 N.E.2d 316 (1983); *Brandenburg v. Miley Petroleum Exploration Co.*, 16 F.2d 933 (N.D.S.D. 1926).
506. *See, e.g.*, *DeHuff v. Digital, et al.*, Civil Action No. 3:08CV327TSL-JCS (S.D. Miss. Dec. 11, 2009); *Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968).

