

Chapter 2

What Is a Broker-Dealer?

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§ 2:1 Exchange Act Registration Requirement

§ 2:1.1 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 (the “Exchange Act”) is the primary federal legislation governing “brokers” and “dealers” in securities.¹ With certain exceptions, section 15 of the Exchange Act requires

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.”

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 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Section 15, as originally enacted in 1934 (“Original Section 15”),³ did not impose specific registration requirements on broker-dealers.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.⁴ 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.⁵ 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.⁶ To strengthen the authority of the SEC as part of a regulatory reform following the paperwork crisis of 1968–1970, Congress passed the

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2. Exchange Act § 3(a)(12) defines “exempted security” to include: (i) government securities; (ii) municipal securities; (iii) interest in a common trust fund that is not an investment company under section 3(c)(3) of the Investment Company Act of 1940 (the “Investment Company Act”); (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) a security issued by any pooled income fund, collective trust fund, collective investment fund, or similar fund that is not an investment company under section 3(c)(10)(B) of the Investment Company Act; (vi) a security issued in any church plan, company or account that is not an investment company under section 3(c)(14) of the Investment Company Act; and (vii) other securities exempted by the SEC by rules and regulations. However, section 3(a)(12) provides that “municipal securities” are not deemed exempted securities for the purposes of the section 15 registration requirement.
 3. Pub. L. No. 73-291, 48 Stat. 881 (1934).
 4. Original Section 15.
 5. See Exchange Act § 15(a), (b), and (c), enacted by Pub. L. No. 621, 49 Stat. 1375, 1377 (1936).
 6. See H.R. REP. NO. 94-123, 94th Cong., 1st Sess.; H.R. 4111 (1975).

Securities Acts Amendments of 1975,⁷ which eliminated that exclusion and enacted section 15(a) in its current form.⁸

The underlying policy for the broker-dealer registration requirement and associated regulatory framework is to provide important safeguards to investors.⁹ 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.¹⁰

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.¹¹ The registration requirement extends not just to entities, but also to natural persons (other than natural persons who are associated with a broker-dealer).¹²

Sections 2:2 and 2:3 below discuss the definitions of "broker" and "dealer," respectively.

Section 2:4 below discusses the definition of "security" for purposes of the Exchange Act's registration requirements, and section 2:5 discusses "exempted securities."

Section 2:6 explores the extent to which broker-dealers engaged in purely intrastate activities enjoy an exemption from federal registration requirements, and section 2:7 discusses various other exemptions (including for banks and foreign broker-dealers), and the SEC's exemptive authority with respect to broker-dealer registration generally.

Finally, section 2:8 discusses the possible regulatory enforcement and private investor actions that may be brought against a person who conducts business as, or engages, an unregistered broker-dealer.

§ 2:1.2 Consequences of Registration

Once registered, a Registered Broker-Dealer is subject to numerous compliance requirements and obligations under the Exchange Act,

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7. Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97.
 8. See H.R. REP. NO. 94-123, 94th Cong., 1st Sess.; H.R. 4111 (1975).
 9. See Persons Deemed Not to Be Brokers, SEC Release No. 34-20943 (May 9, 1984) [hereinafter Rule 3a4-1 Proposing Release].
 10. *Id.*; *Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357, 382 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968).
 11. See Exchange Act § 15(a)(1).
 12. "Person associated with a broker or dealer" is defined in Exchange Act § 3(a)(18).

as well as rules and regulations promulgated thereunder. The compliance requirements include: being subject to investigations,¹³ inspections,¹⁴ and disciplinary actions¹⁵ by the SEC; and complying with minimum net capital requirements,¹⁶ customer protection rules,¹⁷ specific recordkeeping, financial compliance, and financial reporting requirements.¹⁸ Registered Broker-Dealers are also subject to the general antifraud and anti-manipulation provisions of the federal securities laws and implementing rules, as well as specific antifraud requirements.¹⁹ Registered Broker-Dealers must also establish, maintain, and enforce policies and procedures reasonably designed to prevent insider trading,²⁰ and comply with rules limiting extensions of securities-related credit to customers under certain circumstances.²¹ Registered Broker-Dealers are also subject to anti-money laundering regulations²² and many other requirements and obligations under the securities laws, rules, and regulations thereunder.²³

One of the most important requirements for broker-dealers, however, may be the obligation to be a member of an SRO,²⁴ which

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13. Exchange Act § 21.
 14. Exchange Act § 15(b)(2)(C); Rules 15b2-2, 17d-1.
 15. Exchange Act § 15(b)(4), (5) and (6).
 16. Exchange Act § 15(c)(3); Rules 15c3-1, 15c3-3, and 17a-11.
 17. See Rules 15c3-3, 15c2-1, and 8c-1.
 18. See Rules 17a-3, 17a-4, 17a-5, 17a-11, 17h-1T, and 13h-1.
 19. See Securities Act § 17(a); Exchange Act §§ 9(a), 10(b), and 15(c)(1) and (2). As noted in *infra* section 2:1.3, these requirements also apply to unregistered broker-dealers.
 20. Exchange Act § 15(g).
 21. See, e.g., Exchange Act § 11(d); Regulation T of the Board of Governors of the Federal Reserve System; FINRA Rule 4210.
 22. Broker-dealers have broad obligations under the Bank Secrecy Act (BSA) to guard against money laundering and terrorist financing. See, e.g., Department of the Treasury, Financial Crimes Enforcement Network, Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398 (May 11, 2016). In addition to obligations under the BSA, Rule 17a-8 requires broker-dealers subject to the Currency and Foreign Transactions Reporting Act of 1970 to comply with certain reporting and record-keeping requirements. SRO rules (e.g., FINRA Rule 3310) also require broker-dealers to establish anti-money laundering compliance programs.
 23. For example, the SEC and the federal banking agencies have proposed rules (i) prohibiting incentive-based payment arrangements that would encourage inappropriate risks by certain financial institutions, including Registered Broker-Dealers with total consolidated assets of \$1 billion or greater, by providing excessive compensation or that could lead to material financial loss and (ii) requiring those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate federal regulator. Incentive-based Compensation Arrangements, SEC Release No. 34-77776 (May 6, 2016).
 24. Exchange Act § 15(b)(8).

includes national securities exchanges and registered securities associations. The Financial Industry Regulatory Authority (FINRA)²⁵ is currently the only registered national securities association. A broker-dealer must join FINRA, unless it:

- (i) is a member of a national securities exchange;
- (ii) carries no customer accounts; and
- (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, subject to certain exceptions.²⁶

In addition, the Securities Investor Protection Act of 1970 (codified at 15 U.S.C. § 78aaa through § 78lll) requires that a Registered Broker-Dealer become a member of the Securities Investor Protection Corporation (SIPC),²⁷ with limited exceptions.

Membership in a national securities exchange, FINRA or other self-regulatory organization subjects a broker-dealer to the rules and requirements of that organization,²⁸ including, among others, qualification and training standards for natural persons considered to be

25. FINRA was formed in July 2007 through the merger of the National Association of Securities Dealers, Inc. (NASD) with the member regulation function of the New York Stock Exchange (NYSE).

26. *See* Exchange Act § 15(b)(8) and Rule 15b9-1. The \$1,000 gross income limitation does not, however, apply to income derived from transactions for a dealer's own account, either with or through another Registered Broker-Dealer. *See* Rule 15b9-1(b). The SEC has proposed to narrow this exception in light of the many proprietary trading firms that have relied on the exception to engage in unlimited levels of off-exchange trading without being subject to FINRA membership. The proposal would eliminate the \$1,000 income threshold and replace it with more targeted exemptions from FINRA membership for a dealer that effects transactions off the exchange of which it is a member either (i) solely for the purpose of hedging the risks of its floor-based activities, or (ii) as a result of orders that are routed by an exchange to prevent trade-throughs on the exchange, consistent with the provisions of Rule 611 of Regulation NMS. *See* Exemption for Certain Exchange Members, SEC Release No. 34-74581 (Mar. 25, 2015).

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

28. Although a broker-dealer that is a FINRA member must generally comply with all applicable FINRA rules, the SEC has recently approved a FINRA proposal to establish a new limited membership category that would be available to broker-dealers engaged solely in certain corporate financing advisory and capital raising activities, referred to as "capital acquisition brokers" or "CABs." Once these rules become effective, a firm that engages only in these limited activities could elect to be regulated as a CAB, subject to a reduced and streamlined set of FINRA rules. *See* Order Approving Rule Change as modified by Amendment Nos. 1 and 2 to Adopt FINRA

“associated persons” of the broker-dealer.²⁹ FINRA and national securities exchanges also have enforcement powers and examination authority over their members and their members’ associated persons.

§ 2:1.3 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 prohibitions³⁰ under the federal securities laws, if it transacts in securities.³¹ Section 17(a) of the Securities Act of 1933 (the “Securities Act”) prohibits any person from committing fraud in securities transactions.³² 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.³³ Exchange Act § 10(b) outlaws the use of any manipulative or deceptive device or contrivance in securities transactions.³⁴ 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 contrivance, or fictitious quotations.³⁵ Exchange Act § 15(c)(7) makes it unlawful for government securities broker-dealers, and bidders for or purchasers of securities, from knowingly or willfully making any false or misleading written statement.³⁶

Capital Acquisition Broker Rules, SEC Release No. 34-78617 (Aug. 18, 2016).

29. Exchange Act § 15(b)(7); Rule 15b7-1; *see also* SEC, Staff Study on Investment Advisers and Broker-Dealers at 46 (Jan. 2011), <http://www.sec.gov/news/studies/2011/913studyfinal.pdf> [hereinafter Study on Investment Advisers and Broker-Dealers].
30. *See* Securities Act § 17(a); Exchange Act §§ 9(a), 10(b), and 15(c)(1) and (2).
31. *See* SEC v. Clean Care Tech., Inc., 08 CIV 01719 (S.D.N.Y. Feb. 21, 2008); SEC v. Braintree Energy, Inc., No. 100:07-cv-10307 (D. Mass. Feb. 21, 2007); SEC v. Corp. Relations Grp., Inc., No. 99-1222-CV-22-A (M.D. Fla. Sept. 27, 1999); SEC v. Staples, No. 98-1061-CV-22c (M.D. Fla. Sept. 24, 1998); Vorys, Sater, Seymour and Pease, 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]; Letter from Kenneth S. Spirer, Special Counsel, SEC, to Robert J. Delambo, Supervisor of Registrations, Ohio Division of Securities, Department of Commerce (Sept. 27, 1973).
32. Securities Act § 17(a).
33. Exchange Act § 9(a).
34. *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.
35. Exchange Act § 15(c).
36. Exchange Act § 15(c)(7).

§ 2:1.4 State Registration Requirements

In addition to the federal regulatory system, broker-dealers are subject to state securities laws, known as the “Blue Sky Laws.”³⁷

Most states have adopted either the Uniform Securities Act of 1956 (the “1956 Act”) or 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 agent³⁸

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37. The state laws were given the name “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).
38. “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 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 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 employee’s stock purchase, savings, pension, profit-sharing, or similar benefit plan if the Administrator is notified in writing 30 days before the inception of the plan or, with respect to plans which are in effect on the effective date of this act, within 60 days thereafter (or within 30 days before they are reopened if they are closed on the effective date of this act).

unless registered with the state's securities regulatory authority, subject to certain exemptions.³⁹

In the National Securities Markets Improvement Act of 1996 (NSMIA), Congress preempted certain aspects of state regulation of broker-dealer operations.⁴⁰ NSMIA added section 15(h) to the 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.

§ 2:1.5 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

In addition, "agent" does not include, among other things, an individual (i) 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 the 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 or she otherwise comes within this definition.

"Agent" is defined in section 102 of the 2002 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]."

39. See 1956 Act § 201; 2002 Act § 401. Section 401 of the 2002 Act provides two exemptions from the registration requirement: (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 are with certain defined categories of persons; and (ii) a person that deals solely in 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. In addition, the 2002 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 (2013); CONN. GEN. STAT. § 36B-6 (2013); FLA. STAT. § 517.12 (2013).
40. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

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 2:8.

§ 2:2 What Is a Broker?

§ 2:2.1 Generally

Section 3(a)(4)(A) of the Exchange Act defines a “broker” as “any person⁴¹ engaged in the business of effecting transactions in securities for the account of others.”⁴² The definition focuses on three elements. A broker must:

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

These three terms 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. Often, courts apply a “facts and circumstances” analysis in evaluating whether a person has acted as a broker, with no single element being dispositive.⁴³

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

42. Exchange Act § 3(a)(4)(A).

43. See, e.g., Study on Investment Advisers and Broker-Dealers, *supra* note 29, at 9 (listing examples of brokerage services and products); Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P., II, LLC, No. 09–2521–BLS1, 2011 Mass. Super. LEXIS 86, at *12 (Mass. May 31, 2011); SEC v. Kramer, 778 F. Supp. 2d 1320, 1334 (M.D. Fla. 2011); DeHuff v. Dig. Ally, Inc., No. 3:08CV327TSL–JCS, 2009 U.S. Dist. LEXIS 116328, at *10–11 (S.D. Miss. Dec. 11, 2009).

§ 2:2.2 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.”⁴⁴ 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;⁴⁵
- (iii) screening potential participants in a transaction for creditworthiness;
- (iv) soliciting securities transactions (including advertising);⁴⁶
- (v) negotiating between the issuer and the investor;⁴⁷
- (vi) making valuations as to the merits of an investment or giving advice;⁴⁸
- (vii) taking, routing or matching orders, or facilitating the execution of a securities transaction;

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- 44. *See* Mass. Fin. Servs., Inc. v. Sec. Inv'r 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 Exec. Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); Transfer Online, SEC Denial of No-Action Request (May 3, 2000). Distributions facilitated in an unconventional manner have also been found to give rise to broker-dealer status. *See, e.g., In re International Capital Grp., LLC*, SEC Release No. 34-74172 (Jan. 29, 2015) (instituting proceedings for unregistered broker-dealer activity against person purporting to provide loans against microcap securities collateral, but raising cash for the loan through the sale of the collateral into the market).
 - 45. *See, e.g.,* David W. Blass, Chief Counsel, Division of Trading and Markets, SEC, Remarks to American Bar Association, Trading and Markets Subcommittee (Apr. 5, 2013); *see also* Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 34-47265, at n.82 (Jan. 28, 2003) (noting that an accounting firm that helps an issuer identify potential purchasers of securities may be “effecting transactions” and acting as a broker).
 - 46. *See* SEC v. Margolin, No. 93-7309, 1992 U.S. Dist. LEXIS 14872, at *15-16 (S.D.N.Y. Sept. 30, 1992); *In re Ireeco, LLC*, SEC Release No. 34-75268 (June 23, 2015) (finding firm that solicited foreign nationals to invest in particular project in connection with obtaining an EB-5 visa was an unregistered broker).
 - 47. *See* SEC v. Martino, 255 F. Supp. 2d 268, 270 (S.D.N.Y. Apr. 2, 2003); SEC v. Hansen, No. 83 Civ. 3692, 1984 U.S. Dist. LEXIS 17835, at *26 (S.D.N.Y. Apr. 6, 1984).
 - 48. *Id.*

- (viii) handling customer funds or securities;⁴⁹ and
- (ix) preparing and sending transaction confirmations (other than on behalf of a broker-dealer that executes the trades).⁵⁰

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 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 addition, structuring issuances, soliciting transactions negotiating with investors and taking and executing orders are strong indicators of broker activity. Each of these factors is substantially heightened when combined with transaction-based compensation.

49. See The Investment Archive, LLC, SEC No-Action Letter (May 14, 2010). Handling customer funds may also include handling customer's digital currencies, such as bitcoin, in connection with bitcoin-denominated securities transactions. See *In re* BTC Trading, Corp., SEC Release No. 34-73783 (Dec. 8, 2014).

50. 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); Transfer Online, SEC Denial of No-Action Request (May 3, 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 U.S. Dist. LEXIS 17835 (S.D.N.Y. Apr. 6, 1984); SEC v. Art Intellect, Inc., No. 2:11-CV-357, 3572013 U.S. Dist. LEXIS 32132, at *63 (D. Utah Mar. 6, 2013). Depending on additional circumstances, engaging in certain of these activities could also trigger registration requirements under other regulatory regimes, for example, as an investment adviser under the Investment Advisers Act of 1940 or as a municipal advisor under the Exchange Act. See, e.g., Registration of Municipal Advisors, SEC Release No. 34-70462 (Sept. 20, 2013). In addition, the SEC or a court may also look to other contexts where the meaning of the term "effecting transactions" has been considered for guidance on the meaning of this term under section 3(a)(4). See, e.g., Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, SEC Release No. 34-75611 (Aug. 5, 2015) (discussing the meaning of "effecting" transactions in security-based swaps, and citing various authorities interpreting the term "effecting" for purposes of other rules under the Exchange Act).

§ 2:2.3 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.”⁵¹ 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.⁵²

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 section 2:2.7 below.

§ 2:2.4 “In the Business”

Courts have read “engaged in the business” as connoting a certain regularity of participation in purchasing and selling activities rather than a few isolated transactions.⁵³ Two factors are important in determining whether there is “regularity of business”: (i) the number of

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51. See SEC Denial of No-Action Request, *Financial Surveys, Inc.* (Aug. 29, 1973).
 52. See Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Harold J. Smotkin, *Clearing Service, Inc.* (Jan. 3, 1972) (Clearing Service was required to register as broker-dealer, inasmuch as the services it performed went beyond those of a purely clerical or ministerial nature); Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to William F. Clare, *ESE Stock Transfer Corp.* (Oct. 21, 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); *cf.* *Universal Pensions, Inc.*, SEC No-Action Letter (Jan. 30, 1998) (granting no-action relief to a pension plan administrator performing recordkeeping and other administrative services, subject to conditions); *Applied Financial Systems, Inc.*, SEC No-Action Letter (Sept. 25, 1971) (granting no-action relief to entity providing certain shareholder servicing and recordkeeping functions as clerical and ministerial).
 53. *SEC v. Am. Inst. Counselors, Fed. Sec. L. Rep. (CCH) ¶ 95,388* (D.D.C. 1975); *see also SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1 (D.D.C. 1998); *SEC v. Margolin*, 1992 U.S. Dist. LEXIS 14872 (S.D.N.Y. Sept. 30, 1992); *SEC v. Hansen*, 1984 U.S. Dist. LEXIS 17835 (S.D.N.Y. Apr. 6, 1984); *SEC v. Nat'l Exec. Planners, Ltd.*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); *Mass.*

transactions and clients,⁵⁴ and (ii) the dollar amount of securities sold, as well as the extent to which advertisement and investor solicitation were used.⁵⁵ 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 threshold.⁵⁶ While the 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.⁵⁷ The SEC has stated that:

[N]othing . . . 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 person’s business, he will be deemed to be “engaged in the business.”⁵⁸

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- Fin. Servs., Inc. v. Sec. Inv’r 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); Landegger v. Cohen, No. 11-cv-01760-WJM-CBS (D. Colo. Sept. 30, 2013); SEC v. Collyard, No. 11-cv-3656 (D. Minn. Dec. 9, 2015).
54. SEC v. Margolin, 1992 U.S. Dist. LEXIS 14872 (S.D.N.Y. Sept. 30, 1992); Landegger v. Cohen, No. 11-cv-01760-WJM-CBS (D. Colo. Sept. 30, 2013) (declining to find that participating in seven transactions could not be sufficient regularity to constitute acting as a broker). 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).
55. *Nat’l Exec. 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 at 13. (citing SEC v. Deyon, 977 F. Supp. 510, 518 (D. Me. 1997), and *Nat’l Exec. Planners*, 503 F. Supp. at 1066, 1073).
56. *Kenton Capital, Ltd.*, 69 F. Supp. 2d at 13 (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).
57. See *UFITEC v. Carter*, 20 Cal. 3d 238, 254 (1977); see also *Kenton Capital, Ltd.*, 69 F. Supp. 2d at 13 (a corporation could be a broker even though securities transactions are only a small part of its business activity).
58. InTouch Global, LLC, SEC No-Action Letter (Nov. 14, 1995).

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;⁵⁹
- (ii) holding oneself out as a broker, as executing trades, or as assisting others in settling securities transactions;⁶⁰ and
- (iii) soliciting securities transactions.⁶¹

§ 2:2.5 “For the Account of Others”

In order to be considered a “broker,” a person must be effecting transactions in securities for others, not itself. As a result, a firm effecting transactions solely on its own behalf is generally not considered to be acting as a “broker.”⁶² Nonetheless, the SEC has taken the position that a firm may be acting as a broker where it effects transactions in securities nominally on its own behalf, but where those transactions are at the direction of individual traders that hold membership interests in the firm, effectively acting as the firm’s customers.⁶³

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- 59. See SEC v. Martino, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003); SEC v. Margolin, 1992 U.S. Dist. LEXIS 14872, at *16 (S.D.N.Y. Sept. 30, 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); Transfer Online, SEC Denial of No-Action Request (May 3, 2000); Strengthening the Commission’s Requirements Regarding Auditor Independence, SEC Release No. 34-47265, at n.82 (Jan. 28, 2003); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation to Myles C.S. Harrington, President, MuniAuction, Inc. (Mar. 13, 2000).
 - 60. See SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 13 (D.D.C. 1998); 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); Transfer Online, SEC Denial of No-Action Request (May 3, 2000); Strengthening the Commission’s Requirements Regarding Auditor Independence, SEC Release No. 34-47265 (Jan. 28, 2003) at n.82; Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Myles C.S. Harrington, President, MuniAuction, Inc. (Mar. 13, 2000).
 - 61. See, e.g., SEC v. Deyon, 977 F. Supp. 510 (D. Me. 1997), *aff’d*, 201 F.3d 428 (1st Cir. 1998) (both defendants solicited investors by phone and in person); SEC v. Century Inv. Transfer Corp., 1971 U.S. Dist. LEXIS 11364, at *13 (S.D.N.Y. Oct. 5, 1971) (defendant “engaged in the brokerage business” by soliciting customers through ads in the *Wall Street Journal*).
 - 62. Such activities may, however, constitute acting as a “dealer,” depending on various factors. See *infra* section 2:3.
 - 63. In a number of recent SEC enforcement actions against trading firms for acting as unregistered broker-dealers, the firms opened master accounts through a registered broker-dealer and then provided day traders access

§ 2:2.6 *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.⁶⁴ Transaction-related compensation refers to compensation based, directly or indirectly, on the size, value or completion of any securities transactions.⁶⁵ The receipt of transaction-based compensation often indicates that a person is engaged in the business of effecting transactions in securities.⁶⁶ As a policy consideration, transaction-related compensation can induce high pressure sales tactics and other

to the securities markets through sub-accounts established by the trading firms. The SEC characterized these day traders as customers of the trading firm—even though the day traders contributed funds to the trading firm and were required to sign an operating agreement, which deemed them to be members of the trading firm. *See, e.g., In re Brickman*, SEC Release No. 34-75113 (June 5, 2015); *SEC v. Tucu Trading, LLC, et al.*, No. CV-08-400-DMS, 2008 U.S. Dist. LEXIS 112727 (S.D. Cal. Mar. 17, 2008); *In re Warrior Fund, LLC*, SEC Release No. 34-61625 (Mar. 2, 2010); *In re GLB Trading, Inc. and Robert A. Lechman*, SEC Release No. 34-60764 (Oct. 1, 2009); *see also* National Exam Risk Alert by the Office of Compliance Inspections and Examinations, vol. I, iss. 1 (Sept. 29, 2011) (“[t]he staff is concerned that broker-dealers offering master/sub-account arrangements may provide an avenue for unregistered broker-dealer activity . . .”).

64. *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 Mkts., Inc.*, No. 09-cv-4755, 2010 U.S. Dist. LEXIS 65417 (S.D.N.Y. May 20, 2009); *SEC v. UBS AG*, No. 100:09-CV-00316, 2009 U.S. Dist. LEXIS 123034 (D.D.C. Feb. 18, 2009); *SEC v. Milken*, 98 Civ. 1398 (S.D.N.Y. Feb. 26, 1998); *see also* Study on Investment Advisers and Broker-Dealers, *supra* note 29, at 10–11 (“Generally, the compensation in a broker-dealer relationship is transaction-based and is earned through commissions, mark-ups, mark-downs, sales loads or similar fees on specific transactions. . .”).
65. *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).
66. *See* *SEC v. Margolin*, 1992 U.S. Dist. LEXIS 14872 (S.D.N.Y. Sept. 30, 1992); *BondGlobe, Inc.*, SEC Denial of No-Action Request (Feb. 6, 2001);

problems of investor protection often associated with unregulated and unsupervised brokerage activities.⁶⁷

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.⁶⁸ 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 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.⁶⁹

Progressive Technology Inc., SEC Denial of No-Action Request (Oct. 11, 2000); BD Advantage, Inc., SEC Denial of No-Action Request (Oct. 11, 2000); Transfer Online, SEC Denial of No-Action Request (May 3, 2000); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Myles C.S. Harrington, President, MuniAuction, Inc. (Mar. 13, 2000).

67. Persons Deemed Not to Be Brokers, SEC Release No. 34-20943 (May 9, 1984); *see also* Study on Investment Advisers and Broker-Dealers, *supra* note 29, at 50. The SEC may also find transaction-based compensation to be present in structures other than ordinary commission payments, such as profit-sharing arrangements. *See, e.g.*, In re Global Fixed Income, LLC, SEC Release No. 34-74586 (Mar. 26, 2015) (finding that participants in a scheme to increase a trading firm’s allocation of new issue securities through purchases of additional new issue securities by the participants on behalf of the trading firm in return for a portion of any profits resulted in the participants receiving transaction-based compensation, causing them to be subject to broker-dealer registration).
68. *See* SEC v. FTC Capital Mkts., Inc., No. 09-cv-4755, 2010 U.S. Dist. LEXIS 65417 (S.D.N.Y. May 20, 2009); SEC v. UBS AG, 100:09-CV-00316, 2009 U.S. Dist. LEXIS 123034 (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). *But see* SEC v. Kramer, 778 F. Supp. 2d 1320 (M.D. Fla. 2011) (finding that a person’s receipt of transaction-based compensation, without engaging in certain other activities, did not constitute acting as a broker).
69. 1st Global, Inc., No-Action Letter (May 7, 2001); *see also* Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the

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 bringing 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.⁷⁰ At the same time, the SEC has granted no-action relief to companies providing payroll processing services to broker-dealers for a flat, predetermined administrative fee not related to commissions earned by the employees of the broker-dealer.⁷¹

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]."⁷² The SEC has granted no-action relief to investment advisers that did not receive transaction-based compensation for their activity of assisting securities transactions,⁷³ but denied no-action relief to investment advisers

Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration, SEC Release No. 34-61884 (Apr. 9, 2010) [granting exemptions 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).

70. *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).
71. *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., SEC No-Action Letter (Sept. 26, 2003).
72. *See* e-Media, LLC, SEC No-Action Letter (Dec. 14, 2000); *see also* Roadshow Broadcast, LLC, SEC No-Action Letter (May 6, 2011).
73. *See* McGovern Advisory Group, Inc., SEC No-Action Letter (Aug. 7, 1984) (company received compensation for assisting in securities transactions by transmitting orders for securities to registered broker-dealers, but the compensation was based solely on the value of assets under management and not on a transactional basis or otherwise based on the volume of transactions in securities).

that proposed to receive transaction-related compensation.⁷⁴ 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.⁷⁵ Although the SEC has previously granted no-action relief under limited circumstances in which a celebrity acting as finder “sold his rolodex,”⁷⁶ and would receive a success-based fee, it has since publicly distanced itself from that precedent.⁷⁷ 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.⁷⁸ Nonetheless, courts have found that receipt of transaction-based compensation in connection with securities transactions alone—without the presence of other factors—may not be sufficient to be considered engaging in the business of effecting transactions in securities.⁷⁹

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74. See Boston Advisory Group, SEC Denial of No-Action Request (Sept. 2, 1980).
75. See King & Spalding, SEC No-Action Letter (Nov. 17, 1992); National Royalty Exchange, SEC Denial of No-Action Request (Dec. 21, 1988).
76. 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* section 2:2.7[A].
77. See Paul Anka, SEC No-Action Letter (July 24, 1991), in which the SEC staff 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 regarding compensation arrangements today. See 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). Further, in the enforcement litigation context, the SEC has recently argued that “there is no ‘finder’ exception.” Brief for Appellee Securities and Exchange Commission at 28, SEC v. Collyard et al. (8th Cir. June 3, 2016) (No. 16-1405). See also Brumberg, Mackey & Wall, P.L.C., SEC Denial of No-Action Request (May 17, 2010); John W. Loofbourrow Associates, Inc., SEC Denial of No-Action Request (June 29, 2006).
78. *In re* Blackstreet Capital Management, LLC, SEC Release No. 34-77959 (June 1, 2016) (adviser that received transaction-based compensation found to be acting as a broker); *In re* Havanich et al., Initial Decision Release No. 935 (Jan. 4, 2016); *In re* Visionary Trading LLC et al., SEC Release No. 34-71871 (Apr. 4, 2014); SEC v. Christopher A.T. Pedras et al., No. CV 13-07932 (Oct. 28, 2013); SEC v. FTC Capital Mkts., Inc., No. 09-CV-4755, 2010 U.S. Dist. LEXIS 65417 (S.D.N.Y. May 20, 2009); SEC v. UBS AG, No. 100:09-CV-00316, 2009 U.S. Dist. LEXIS 123034 (D.D.C. Feb. 18, 2009); SEC v. Clean Care Tech., Inc., 08 CIV 01719 (S.D.N.Y. Feb. 21, 2008); SEC v. Black, No. 8:00 CV383-T-26B (M.D. Fla. Feb. 25, 2000); SEC v. Milken, 98 Civ. 1398 (S.D.N.Y. Feb. 26, 1998).
79. See SEC v. Kramer, 778 F. Supp. 2d 1320 (M.D. Fla. 2011); SEC v. M&A West, No. 01-3376 VRW, 2005 U.S. Dist. LEXIS 22358 (N.D. Cal. 2005)

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 broker-dealer registration to an investment adviser that proposed to locate issuers, solicit new clients, and act as a customers' agent in structuring or negotiating transactions.⁸⁰ 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.⁸¹

§ 2:2.7 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."⁸² 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.⁸³ The SEC's decision to grant no-action treatment in some cases to permit finders to

(denying SEC motion for summary judgment where unregistered person received transaction-based compensation for facilitating securities transactions among others where certain other factors were not present); *Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P., II, LLC*, No. CIV.A. 09-2521-BLS1, 2011 Mass. Super. LEXIS 86 (Mass. May 31, 2011). Some courts and SEC administrative law judges have also distinguished between "active" and "passive" finders, finding active finders to be acting as brokers. *In re Havanich et al.*, Initial Decision Release No. 935 (Jan. 4, 2016) (citing *SEC v. Zubkis*, No. 97-cv-8086, 200 U.S. Dist. LEXIS 1865 (S.D.N.Y. Feb. 23, 2000)).

80. *See* PRA Securities Advisers, L.P., SEC Denial of No-Action Request (Mar. 3, 1993).
81. *See* *SEC v. Am. Energy Res. Corp.*, No. 08-CV-01847-REB-BNB (D. Colo. Aug. 28, 2008); *SEC v. Harbour Bay Fin. Co.*, No. 90-3580 (E.D.PA. May 25, 1990).
82. *See, e.g.*, Paul Anka, SEC No-Action Letter (July 24, 1991). *But see supra* note 77 (noting more recent SEC and SEC staff statements regarding existence of a finder exception.)
83. Courts too have acknowledged the potential availability of the finder exception based on SEC no-action letters in the context of private litigation under Exchange Act § 29, in which a party seeks rescission of a contract with a party they allege acted as an unregistered broker-dealer. *See, e.g.*, *Cornhusker Energy Lexington, LLC v. Prospect St. Ventures*, 2006 U.S.

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.⁸⁴

[B] Private Placement Agents

Private placements agents generally must register as broker-dealers under the Exchange Act. Effecting transactions in a security sold in a transaction that is exempt under the Securities Act does not necessarily benefit from an exemption from the broker-dealer registration requirement under the Exchange Act.⁸⁵ For example, 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

Dist. LEXIS 68959 (D. Neb. Sept. 12, 2006) (citing SEC no-action letters); *Apex Glob. Partners, Inc. v. Kaye/Bassman Int'l Corp.*, 2009 U.S. Dist. LEXIS 77679 (N.D. Tex. Aug. 31, 2009) (“Merely bringing together the parties to transactions, even those involving the purchase and sale of securities, is not enough [to require registration]”); *DeHuff v. Dig. Ally, Inc.*, 2009 U.S. Dist. LEXIS 116328 (S.D. Miss. Dec. 11, 2009); *Salamon v. Teleplus Enters., Inc.*, 2008 U.S. Dist. LEXIS 43112 (D.N.J. June 2, 2008). In addition, although FINRA rules generally prohibit the sharing of securities transaction-related compensation with a person not registered as a broker-dealer, an exception permits such a payment to a “foreign finder” that makes an initial introduction to a non-U.S. customer, if, among other things, the foreign finder is not required to register as a broker-dealer. *See* FINRA Rule 2040(c).

84. The SEC’s Advisory Committee on Small and Emerging Companies has recently recommended that finders that solely provide names of or introductions to prospective investors should not be subject to broker-dealer registration, even if they receive transaction-based compensation. *See* SEC Advisory Committee on Small and Emerging Companies, *Recommendations Regarding the Regulation of Finders and Other Intermediaries in Small Business Capital Formation Transactions* (Sept. 23, 2015), <http://www.sec.gov/info/smallbus/acsec/acsec-recommendations-regulation-of-finders.pdf>.
85. *See* SEC Division of Trading and Markets, *Guide to Broker-Dealer Registration* (Apr. 2008) [hereinafter *SEC Guide to Broker-Dealer Registration*], <http://www.sec.gov/divisions/marketreg/bdguide.htm>. The SEC has recently brought several unregistered broker-dealer actions against immigration service providers that facilitated EB-5 visa applications by arranging private securities transactions between foreign nationals and U.S. issuers. *See, e.g.*, *SEC v. Feng*, No. 2:15-cv-09420 (C.D. Cal. Dec. 7, 2015); *SEC v. Luca Int’l Grp., LLC*, No. 3:15-cv-03101 (N.D. Cal. July 6, 2015); *In re Irecco, LLC*, SEC Release No. 34-75268 (June 23, 2015); *In re Yoo*, SEC Release No. 34-77459 (Mar. 28, 2016).

falls within the finder exception or within some registration exemption.⁸⁶ In addition, broker-dealers, including those acting as placement agents, may face sanction under state law if they do not possess the required state registrations.⁸⁷

The Jumpstart Our Business Startups Act (the “JOBS Act”), signed by President Obama on April 5, 2012, created a new limited exception for private placement brokers facilitating transactions in compliance with Rule 506 of Regulation D under the Securities Act (a “Rule 506 Offering”), where certain conditions are met.⁸⁸ The JOBS Act required the SEC to revise Rule 506 to permit general solicitation and general advertising of offerings, without Securities Act registration, so long as the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors.⁸⁹ In connection with that modified securities registration exemption, the JOBS Act also created an

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86. *See id.*; *see also In re Wegener*, SEC Release No. 34-62529 (July 19, 2010) (complaint alleged that Wegener acted as an unregistered broker and investment adviser when he raised at least \$6.5 million from at least twenty investors by falsely representing that he would invest their funds in securities through companies that he owned and issued false statements to investors); *In re Keating*, SEC Release No. 34-62456 (July 6, 2010) (complaint alleged that Keating fraudulently conducted an unregistered offering of securities, raising over \$17.6 million from over 100 investors for an investment in a company that he formed and acted as an unregistered broker-dealer); *In re Yurkin*, SEC Release No. 34-58768 (Oct. 10, 2008) (complaint alleged Yurkin acted as an unregistered broker-dealer); *In re Ferona, Jr.*, SEC Release No. 34-57729 (Apr. 28, 2008) (complaint alleged that Ferona acted as an unregistered broker-dealer by offering and selling securities in an unregistered investment company managed by an unregistered investment adviser); John W. Loofbourrow Associates, Inc., SEC Denial of No-Action Request (June 29, 2006).
87. *See, e.g., In re Manatt*, Phelps & Phillips, LLP, Assurance of Discontinuance, Investigation No. 10-127 (Oct. 12, 2010) (Manatt entered into an Assurance of Discontinuance to settle the New York State Attorney General’s allegations that it acted as a placement agent by soliciting, albeit unsuccessfully, investments from public pension funds in New York, although it did not have a license to act as a placement agent or securities broker under either federal or state law. Manatt agreed to a ban prohibiting it from appearing before New York public pension funds until 2015. It must also ensure that its relevant partners and employees obtain the required federal and state broker licenses “prior to engaging in any business effecting securities transactions.”).
88. Jumpstart Our Business Startups Act, Pub. L. No. 112-106 (2012), § 201(a).
89. The SEC adopted rules implementing this mandate by adding Rule 506(c) to Regulation D. *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, SEC Release No. 34-69959 (July 10, 2013).

exemption from broker-dealer registration for any person who, in connection with a compliant Rule 506 Offering, maintains a “platform” or “mechanism” that “permits the offer, sale, purchase or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar related activities by issuers of such securities, whether online, in person, or through any other means.” To be eligible for this exemption, the person and its associated persons must:

- (i) receive no compensation in connection with a purchase or sale in the Rule 506 Offering,
- (ii) not have possession of customer funds or securities in connection with the Rule 506 Offering, and
- (iii) not be subject to statutory disqualification.⁹⁰

While this exemption could be read to allow a person to conduct a range of private placement intermediation activities without broker-dealer registration, the SEC staff has interpreted it very narrowly. In particular, the SEC staff has indicated that it reads the prohibition on receipt of “compensation in connection with a purchase or sale” broadly, to prohibit a person from relying on the exemption if there is “any direct or indirect economic benefit to the person or any of its associated persons”—not merely transaction-based compensation.⁹¹

The SEC staff has issued two no-action letters to allow certain web-based platforms operated by investment advisers to match accredited investors with issuers seeking capital, without broker-dealer registration, where certain conditions are met.⁹² These no-action letters were conditioned on, among other things, the advisers and their employees not receiving any transaction-based compensation for these activities, although the advisers would be permitted to receive compensation in the form of traditional advisory fees, such as carried interest.⁹³

90. Securities Act § 4(b) [second] (added by JOBS Act § 201(b)). Where these conditions are met, this provision would also exempt any person from registration as a broker-dealer that would otherwise be required solely because (i) the person or its associated person co-invests in the Rule 506 Offering, or (ii) the person or its associated person provides ancillary services, such as due diligence and documentation, in connection with the Rule 506 Offering.

91. See SEC Division of Trading and Markets, Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act (Feb. 5, 2013), at Question 5.

92. See AngelList LLC and AngelList Advisors, SEC No-Action Letter (Mar. 28, 2013); FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar. 26, 2013).

93. See *id.* In addition, the no-action letters required that advisers not come into possession of investor funds or securities.

A number of web-based platforms have sought to rely on these letters to facilitate “crowdfunding” of investments from accredited investors in early stage companies in transactions under Rule 506 of Regulation D.⁹⁴ As required by the JOBS Act, the SEC has also recently adopted rules to implement a separate limited exemption from broker-dealer registration for “funding portals” that act as intermediaries in crowdfunding transactions open to retail investors under section 4(a)(6) of the Securities Act.⁹⁵

[C] M&A Brokers

Persons engaged in merger and acquisition advisory and business brokerage activities (generally, “M&A Brokers”) may be subject to the broker registration requirements when these activities involve, for example, a sale or exchange of securities.⁹⁶ Whether an intermediary in an M&A transaction would be considered to be a broker depends on the precise nature of the services performed.⁹⁷ 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.⁹⁸ On the other hand, persons (other than professionals such as lawyers or accountants acting as such) who provide advice or otherwise participate in or facilitate negotiations in effecting mergers or acquisitions involving securities, and receive transaction-based compensation, are generally required to register as

94. In November 2014, the SEC brought an enforcement action against an entity operating a non-U.S. online crowdfunding platform that accepted investments from U.S. investors without complying with Regulation D or registering as a broker-dealer. *In re Eureeca Capital SPC*, SEC Release No. 34-73569 (Nov. 10, 2014).

95. *See infra* section 2:7.6.

96. Garrett/Kushell/Assocs., SEC No-Action Letter (Sept. 7, 1980); *see also* Ernst & Young Corporate Finance (Canada) Inc., SEC No-Action Letter (July 12, 2012).

97. 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).

98. Garrett/Kushell/Assocs., SEC No-Action Letter (Sept. 7, 1980); IMF Corp., SEC No-Action Letter (May 15, 1978); Henry C. Coppelt d/b/a May Pac Management Co., SEC No-Action Letter (June 2, 1974).

broker-dealers⁹⁹—subject to a limited no-action letter for certain private M&A activities, described below.¹⁰⁰

M&A Brokers have developed as a special case because for many years there was an open question as to whether the sale of a business through the conveyance of all of 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.¹⁰¹ An M&A Broker usually receives a commission in connection with locating a buyer and facilitating the sale of a commercial firm.¹⁰² While an M&A Broker does not have to register as a broker-dealer if there is no distribution, sale, or exchange of securities,¹⁰³ if the sale of the company includes a transfer of securities, then the M&A Broker may have to register as a broker-dealer.¹⁰⁴

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99. 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, 1978); Equity Development Corp., SEC No-Action Letter (Dec. 10, 1976); *see also* SEC v. Milken, 98 Civ. 1398 (S.D.N.Y. Feb. 26, 1998). *See also* Henry C. Coppelt d/b/a May Pac Management Co., SEC No-Action Letter (June 2, 1974) (noting that 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). *See also* David W. Blass, Chief Counsel, SEC Division of Trading and Markets, Remarks to American Bar Association, Trading and Markets Subcommittee (Apr. 5, 2013) (noting that a private equity fund manager that receives additional special fees in connection with the sale of a portfolio company may be required to register as a broker-dealer); *In re* Blackstreet Capital Management, LLC, SEC Release No. 34-77959 (June 1, 2016) (finding private equity fund adviser acted as unregistered broker where it held itself out as performing investment banking services for funds and received transaction-based fees from its advised funds in connection with the funds' acquisition and disposition of portfolio companies).
100. *See infra* section 2:2.7[C][1]; M&A Brokers, SEC No-Action Letter (Jan. 31, 2014).
101. *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% of the outstanding stock by current shareholders to the purchasers.
102. *See* Pleger, Gary L., Esq./Pleger, Duderwicz & Prince, SEC No-Action Letter (Oct. 11, 1977).
103. *See id.*; Hallmark Capital Corp., SEC No-Action Letter (June 11, 2007).
104. *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

The analysis under section 15 for an M&A Broker is, therefore, similar to that for a finder. An M&A Broker, 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, receiving only a flat fee), may not have to register as a broker.¹⁰⁵ However, if the M&A Broker solicits potential investors or participates in the negotiation of the issuance or exchange of securities and receives a transaction-based fee, the person may have to register as a broker-dealer.¹⁰⁶ A key factor is whether the M&A Broker receives transaction-based compensation.¹⁰⁷ Naturally, if the transaction involves only a sale of

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); *see also* Nemzoff & Company LLC, SEC Denial of No-Action Request (Nov. 30, 2010) (rejecting business broker’s request for relief from registration under section 3(e) of the Exchange Act as it advises and assists non-profit hospital clients buy and sell membership interests in other hospitals, and participates in negotiations of joint ventures and business combinations of such clients).

105. 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).

106. Dominion Resources, Inc., SEC Revocation of No-Action Letter (Mar. 7, 2000) (withdrawing a prior letter dated August 22, 1985, granting no-action relief to Dominion Resources, Inc. for the same activities; the staff clarified its position consistent with 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). In addition, questions sometimes arise regarding whether advisory services in connection with securities transactions requires registration under other regulatory regimes, such as the Investment Advisers Act of 1940.

107. *See* Hallmark Capital Corp., SEC No-Action Letter (June 11, 2007).

non-securities assets and/or assumption of liabilities, no broker-dealer registration issue would be presented.

[C][1] Private Company M&A Broker No-Action Letter

Responding to calls for the SEC to promulgate an exemption to the broker-dealer registration requirement for M&A Brokers,¹⁰⁸ the SEC staff recently issued a no-action letter, effectively creating a new limited exemption from broker-dealer registration for certain limited private company M&A brokerage activities where certain conditions are met (the “Private M&A Broker Letter”).¹⁰⁹ Specifically, the Private M&A Broker Letter permits M&A Brokers to facilitate mergers, acquisitions, business sales, and business combinations (“M&A Transactions”) in connection with the purchase or sale of privately held companies without registering as broker dealers, subject to conditions described below. The relief does not restrict either the types of compensation that eligible M&A Brokers can receive or the size of the privately held company that is the subject of the transaction.

For purposes of the Private M&A Broker Letter, an “M&A Broker” is defined as a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately held company (but not a public company) through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company. The relief is subject to the following conditions:

108. See, e.g., Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2014, H.R. 2274, 113th Cong. (as passed by the U.S. House of Representatives, Jan. 14, 2014) (proposed legislation to exempt certain M&A Brokers from broker-dealer registration requirements); 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), <http://www.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), <http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf>. FINRA has also proposed to create a special limited membership category for “capital acquisition brokers” that limit their activities to certain M&A and other investment banking activities. Firms electing this limited membership category would be subject to a new more limited set of rules, rather than the complete FINRA rulebook that otherwise applies to full FINRA members. See *supra* note 29.

109. See M&A Brokers, SEC No-Action Letter (Jan. 31, 2014).

- the M&A Broker does not have the ability to bind any party to the M&A Transaction;
- the M&A Broker does not directly, or indirectly through any of its affiliates, provide financing for the M&A Transaction (though the M&A Broker may arrange financing, subject to certain conditions);
- the M&A Broker does not have custody, control, or possession of or otherwise handle funds or securities issued or exchanged in connection with the M&A Transaction or other securities transaction for the account of others;
- the M&A Transaction does not involve a public offering;
- if the M&A Broker represents both buyers and sellers, it provides clear written disclosure as to the parties it represents and obtains written consent from both parties to the joint representation;
- the M&A Broker will facilitate the M&A Transaction with a group of buyers only if the group is formed without the assistance of the M&A Broker;
- the buyer, or group of buyers, in the M&A Transaction will, upon completion of the M&A Transaction, control and actively operate the company or the business conducted with the assets of the business;¹¹⁰
- the M&A Transaction will not result in the transfer of interests to a passive buyer or group of passive buyers;
- any securities received by the buyer or M&A Broker in the M&A Transaction will be restricted securities within the meaning of Rule 144(a)(3) under the Securities Act of 1933, because the securities would have been issued in a transaction not involving a public offering; and
- the M&A Broker, its officers, directors, and employees have not been barred or suspended from association with a broker-dealer.

110. A buyer, or group of buyers collectively, would have the necessary control if it has the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. The necessary control will be presumed to exist if, upon completion of the transaction, the buyer or group of buyers has the right to vote 25% or more of a class of voting securities, has the power to sell or direct the sale of 25% or more of a class of voting securities, or in the case of a partnership or limited liability company, has the right to receive upon dissolution or has contributed 25% or more of the capital. In addition, the buyer, or group of buyers, must actively operate the company or the business conducted with the assets of the company. *See id.*

[C][2] Foreign M&A Brokers

In general, a person soliciting a person in the United States, even from outside of the United States, to potentially engage in a securities transaction may be required to register as a broker-dealer.¹¹¹ The application of this general principal can have particularly challenging consequences for a foreign M&A Broker representing a foreign client, where the client is interested in engaging in an M&A transaction with a U.S. company. Absent registration or an exemption therefrom,¹¹² the foreign M&A Broker may be unable to contact persons in the United States concerning the securities transaction.

The SEC staff has, however, issued no-action relief that allows a foreign M&A Broker to contact U.S. persons, without registration, under certain circumstances.¹¹³ Specifically, where a foreign M&A Broker is retained outside of the United States by a non-U.S. client considering the acquisition or sale of a company or business, the no-action relief would permit the foreign M&A broker, without registering as a broker-dealer, to contact potential U.S.-based buyers or sellers (“U.S. Targets”) and to conduct certain activities to facilitate the potential transaction¹¹⁴ and receive transaction-based compensation for its services. The no-action relief is subject to certain conditions, including that:

- the foreign M&A Broker would only approach U.S. Targets that own, control, or manage (in the case of an investment adviser) in excess of \$100 million in aggregate financial assets;
- the foreign M&A Broker would only interact either (i) with personnel of the U.S. Target (or its corporate family) with relevant M&A experience that are not associated with a Registered Broker-Dealer, where the foreign M&A Broker has made certain determinations regarding the disciplinary history of its personnel engaging in such communications, or (ii) a U.S. Target that is represented by an external advisor, such as a broker-dealer, attorney or other professional with relevant experience;

111. See generally *infra* section 2:7.2.

112. Potentially, a foreign M&A Broker could structure its activities in the United States to comply with an exemption from registration under Rule 15a-6. See *infra* section 2:7.2[B].

113. Roland Berger Strategy Consultants, SEC No-Action Letter (May 28, 2013).

114. The activities may include, among other things, developing and managing a data room and the information process, conducting negotiations on behalf of the non-U.S. client and advising the non-U.S. client on the terms of the transaction.

- the foreign M&A Broker does not receive, acquire or hold funds or securities in connection with any transaction it engages in with a U.S. Target in reliance on the no-action letter; and
- the foreign M&A Broker does not represent or advise the U.S. Target in any regard with respect to the proposed transaction.

[D] Networking Arrangements

[D][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.¹¹⁵ 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 customers to the broker-dealer.¹¹⁶ These activities may be deemed broker-dealer activities under certain circumstances.

Prior to the adoption of the Gramm-Leach-Bliley Act (GLBA),¹¹⁷ banks¹¹⁸ were excluded altogether from the definitions of “broker” and

115. See Proposed Rule: Regulation B, SEC Release No. 34-49879 (Aug. 2, 2004); 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].

116. *Id.*

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

118. 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. § 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 Rule 15a-6 Adopting Release, *supra* note 31, at n.16. It is important to note that exceptions applicable to banks under the Exchange Act, as amended by the GLBA, are not

“dealer” under the Exchange Act.¹¹⁹ The GLBA replaced this exclusion with eleven conditional exemptions for banks from the statutory definition of “broker,”¹²⁰ including an exemption for banks’ “networking” arrangements.¹²¹

The exception for networking arrangements in section 3(a)(4)(B)(i) sets out nine conditions.¹²² The conditions are designed to ensure that bank employees (other than associated persons of a broker-dealer who

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 85.

119. Before the enactment 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. . . .”
120. *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 2:7.4.
121. *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 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 85.
122. 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

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.¹²³ 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 referral that is not contingent on whether the referral results in a securities transaction.¹²⁴ FINRA rules also address networking arrangements.¹²⁵

[D][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.¹²⁶ This exemption was designed to respond to the unique nature of insurance securities

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).

123. *See* Regulation R Adopting Release, *supra* note 115.

124. *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.

125. FINRA Rule 3160 (Networking Arrangements Between Members and Financial Institutions); FINRA Regulatory Notice 10-21 (Apr. 2010); SEC Release No. 34-61706 (Mar. 22, 2010) (approving FINRA Rule 3160).

126. *See* SEC Guide to Broker-Dealer Registration, *supra* note 85.

and address the difficulties posed by insurance and securities laws applicable to the sale of these products.¹²⁷ 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.¹²⁸

Through networking arrangements, insurance companies and agencies can share in the commissions generated by their referred customers under certain conditions.¹²⁹ Insurance networking arrangements are limited to insurance products that are also securities.¹³⁰ The networking exemption does not apply to arrangements for the sales of mutual funds¹³¹ and other non-insurance securities that do not present the same regulatory difficulties posed by dual state and federal laws applicable to insurance securities.¹³²

[E] Issuers and Their Associated Persons

[E][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.¹³³ Issuers whose activities go beyond selling their

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127. 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 85; Committee of Annuity Insurers, SEC No-Action Letter (Apr. 23, 2013).
128. *See* Insurance Networking Arrangements, SEC No-Action Letter (Apr. 23, 2013); 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).
129. *See* SEC Guide to Broker-Dealer Registration, *supra* note 85.
130. *See id.*
131. *See* The Wolper Ross Corp., SEC No-Action Letter at n.1 (Oct. 16, 1991).
132. *See* Lincoln Financial Advisors Corp., SEC No-Action Letter (Feb. 20, 1998).
133. 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.” Rule 3a4-1 Proposing Release, *supra* note 9.

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.¹³⁴ The SEC has also asserted that an issuer that operates a dividend reinvestment and stock purchase plan (DRSPP)¹³⁵ 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.¹³⁶

[E][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.¹³⁷ 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.¹³⁸ Directors, officers or employees of an issuer, therefore, will have to register under section 15 if they are considered to be brokers.

134. See SEC Guide to Broker-Dealer Registration, *supra* note 85.

135. 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).

136. 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).

137. See Rule 3a4-1 Proposing Release, *supra* note 9. See also SEC v. Small Bus. Capital Corp., 2013 U.S. Dist. LEXIS 116607 (N.D. Cal. Aug. 16, 2013) (finding employees of a fund manager who were paid a salary and commission on sale of fund interests were acting as brokers for the funds); *In re* Clare, SEC Release No. 34-77373 (vice president of finance of issuer acted as unregistered broker in connection with issuer's stock sales where he actively solicited potential investors, recommended investments in the issuer, negotiated and closed the stock sales, and received transaction-based compensation).

138. See Exchange Act § 15(a)(1).

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;¹³⁹ and
- 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.¹⁴⁰

Exchange Act Rule 3a4-1 provides a non-exclusive safe harbor from broker-dealer registration for “associated persons of an issuer.”¹⁴¹ Compliance with the conditions of the safe harbor is not the only means by which associated persons of an issuer may sell that issuer's

139. *See, e.g.*, SEC v. Stratocomm Corp., No. 1:11-CV-1188, 2013 U.S. Dist. LEXIS 96816 (N.D.N.Y. Feb. 19, 2014) (finding an employee of issuer that was paid a discretionary bonus based on performance in selling employer's securities was acting as an unregistered broker).

140. *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, No. 09 12950, 2009 U.S. Dist. LEXIS 64609 (E.D. Mich. July 27, 2009) (quoting SEC v. George, 426 F.3d 786, 797 (6th Cir. 2005)); SEC v. McMillin, 07 CV 2636-REB-MEH, 2008 U.S. Dist. LEXIS 99702 (D. Colo. Jan. 12, 2009); SEC v. Sarad, No. 2:08-cv-02252-GEBDAD (E.D. Cal. Sept. 25, 2008); SEC v. Am. Energy Res. Corp., No. 08-CV-01847 REB BNB (D. Colo. Aug. 28, 2008); SEC v. McDuff, No. 3:08-CV-00526 (N.D. Tex. Mar. 26, 2008); SEC v. Rabinovich & Assocs., LP, 07-CV-10547 (S.D.N.Y. Nov. 26, 2007); SEC v. Martino, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003).

141. *See* Rule 3a4-1; Persons Deemed Not to Be Brokers, SEC Release No. 34-22172 (June 27, 1985) [hereinafter Rule 3a4-1 Adopting Release].

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.¹⁴² However, the scope of permissible activities outside the safe harbor is difficult to judge. The SEC has brought numerous actions against issuer employees and other personnel associated with issuers for broker-dealer registration violations, though generally coupled with other claims, such as violations of the Securities Act or anti-fraud rules.¹⁴³

“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.¹⁴⁴ Under the rule, an associated person of an issuer who participates in the sale of “the securities of such issuer”¹⁴⁵ 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;¹⁴⁶
- (ii) is not compensated, directly or indirectly, by commissions or transaction-based compensation in connection with the sale of the issuer’s securities;¹⁴⁷
- (iii) is not an associated person of a broker or dealer;¹⁴⁸ and

142. Rule 3a4-1.

143. *See, e.g.*, SEC v. Braslau, No. CV-14-01290, 2014 U.S. Dist. LEXIS 161602 (C.D. Cal. Feb. 20, 2014); SEC v. Small Bus. Capital Corp., 2013 U.S. Dist. LEXIS 116607 (N.D. Cal. Aug. 16, 2013); *In re* Lawton, SEC Release No. 34-65270 (Sept. 6, 2011) (alleging that Lawton acted as an unregistered broker when he solicited investors on behalf of the corporation of which he was secretary and in-house counsel and made misrepresentations to defraud investors); *In re* Hertz, SEC Release No. 34-62862 (Sept. 7, 2010) (alleging that Hertz acted as an unregistered broker when he served as president of a purported oil-and-gas equipment leasing joint venture and sold, on a commission basis, unregistered securities issued by the joint venture); *In re* Denigris, SEC Release No. 34-62844 (Sept. 3, 2010) (alleging that Denigris acted as an unregistered broker when he sold, in return for transaction-based compensation, unregistered stock of a corporation of which he was president and sole director and, in connection with the offering, made fraudulent statements to investors about the corporation’s potential IPO and future stock price).

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

145. 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.

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

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

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

- (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, investment companies registered under the Investment Company Act of 1940 (the “Investment Company Act”), and state-regulated insurance companies;¹⁴⁹
 - 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:
 - (a) preparing written materials, which are approved by a partner, officer, or director of the issuer;
 - (b) 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
 - (c) ministerial and clerical work.¹⁵⁰

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.¹⁵¹

**[E][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

149. *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.

150. 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 141; Rule 3a4-1(a)(3).

151. For a discussion of how some private fund managers have chosen to register an affiliated broker-dealer, rather than relying upon the “issuer exemption” in Rule 3a4-1 for the solicitation activities of in-house fundraisers, see Jennifer Harris, *News Analysis: Firms May Emulate TPG’s In-House Broker-Dealer*, PE MANAGER, Jan. 20, 2010.

persons provide assistance, including proxy solicitation,¹⁵² during the process of a company's demutualization, conversion, or 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 they 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.¹⁵³

152. 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).

153. *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).

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 3a4-1.¹⁵⁴

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:

- (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.¹⁵⁵

[F] 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 party¹⁵⁶ for the securities of multiple companies.¹⁵⁷ 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

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- 154. Mortgage Investors of Washington, SEC No-Action Letter (Jan. 31, 1981).
 - 155. 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).
 - 156. *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).
 - 157. *See, e.g.*, Transfer Online, SEC Denial of No-Action Request (May 3, 2000); Investex Investment Exchange Inc., SEC No-Action Letter (Apr. 9, 1990); Petroleum Information Corp., SEC No-Action Letter (Nov. 28, 1989).

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
- (iii) all transactions would be effected only by direct contact between the bulletin board participants.¹⁵⁸

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.¹⁵⁹

158. 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).

159. 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., SEC No-Action Letter (June 8, 2000); Transfer Online, SEC Denial of No-Action Request (May 3, 2000); King & Spalding, SEC No-Action Letter (Nov. 17, 1992).

[G] 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. 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 marketplace 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 facilities¹⁶⁰ maintained by such exchange.”¹⁶¹ 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.¹⁶²

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.¹⁶³ 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 (ATs) 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

160. Exchange operators also often seek to engage in certain traditional broker-dealer functions, such as outbound routing of orders from the exchange to other markets, and have been required to register a broker-dealer entity to perform these activities. Such a broker-dealer is generally considered to be acting as a “facility” of the exchange and, as a result, its activities can be subject to both broker-dealer and exchange regulation. *See, e.g.*, Order Approving Proposed Rule Change by the Pacific Exchange, Inc., SEC Release No. 34-44983 (Oct. 25, 2001) (requiring outbound routing broker to function as exchange facility); SEC Release 34-63241 (Nov. 3, 2010) (“[i]n general, the outbound order routing service provided to exchanges by broker-dealers is regulated as a facility of the exchange, and therefore is subject to direct Commission oversight”).

161. *See* Exchange Act § 3(a)(1).

162. Rule 3b-16(a).

163. Rule 3b-16(b).

activities and trading volume.¹⁶⁴ 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.¹⁶⁵

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.¹⁶⁶

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”),¹⁶⁷ are discussed below in section 2:4.4.

[H] 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.¹⁶⁸ The services provided to broker-dealer clients usually consist of payroll processing

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

165. Regulation ATS, Rule 300(a).

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

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

168. 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).

services, human resources consulting, and employee benefits services, which include the provision of various types of insurance¹⁶⁹ to employees of its broker-dealer clients. Although the employees placed on the service company's payrolls are employees of the service company for purposes of applicable employment laws, they are associated persons¹⁷⁰ of the broker-dealers for purposes of the 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,¹⁷¹ 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.¹⁷² The staff has refused to grant

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

170. 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. 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 re Giordano*, SEC Release No. 34-36742 (Jan. 19, 1996).

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

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

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.¹⁷³ The SEC staff articulated the policy considerations behind its positions in its letter to Investacorp Group:

. . . 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-dealers 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.¹⁷⁴

[I] Personal Service Companies

The SEC has distinguished companies providing employee leasing services from those personal service companies owned by registered representatives of broker-dealers.¹⁷⁵ 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:¹⁷⁶

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). *See also* Moran Asset Management, Inc., SEC No-Action Letter (June 29, 1988) (investment adviser would not have to register as a broker-dealer to act as "paymaster" for registered representatives of its affiliated broker-dealer, where the adviser makes payments at a predetermined amount upon the broker-dealer's direction and invoices the broker-dealer for reimbursement of such payments).

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

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

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

176. *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

- 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; 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 generally 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,¹⁷⁷ 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.¹⁷⁸ However, recent lower court cases have found that although transaction-related compensation is a key factor in determining whether an entity or person is conducting broker activity, it alone is not dispositive of broker activity.¹⁷⁹

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

[J][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.

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).

177. See Brumberg, Mackey & Wall, P.L.C., SEC Denial of No-Action Request (May 17, 2010); 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).

178. See *id.*

179. See *Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P., II, LLC*, 2011 Mass. Super. LEXIS 86 (Mass. May 31, 2011); *SEC v. Kramer*, 778 F. Supp. 2d 1320 (M.D. Fla. 2011).

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;
- (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.¹⁸⁰

[J][2] Confirmation and Other Processors

As discussed above in section 2:2.3, an entity generally does not need to register as a broker-dealer if it performs only clerical or ministerial functions for Registered Broker-Dealers.¹⁸¹ The SEC has granted

180. See, e.g., S3 Matching Technologies LP, SEC No-Action Letter (July 19, 2012) (no-action relief granted to firm proposing to provide a platform to electronically link registered broker-dealers and provide sending broker-dealers an execution quality metrics analytical tool to assist them in determining where to route their order); Roadshow Broadcast, LLC, SEC No-Action Letter (May 6, 2011) (granting no-action relief to firm proposing to produce and stream Internet roadshow presentations and charge only a flat fee); 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 that 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).

181. 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

no-action relief to entities that send out confirmation of securities transactions to investors without being engaged in the effecting of the securities transactions.¹⁸²

The confirmation must be sent out under the supervision of the broker-dealer that executed the transaction.¹⁸³ The broker-dealer must ensure that all applicable provisions of the federal securities laws, including the recordkeeping and confirmation requirements, are complied with in connection with each sale.¹⁸⁴ Absent such responsibility, supervision and recordkeeping by a broker-dealer, the entity

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- 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 a 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).
182. See 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 recordkeeping 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).
183. See Central Federal Savings & Loan Ass’n, SEC No-Action Letter (Jan. 31, 1987); The Woodmoor Corp., SEC No-Action Letter (Mar. 5, 1972). See also SEC Staff 15a-6 FAQ, *infra* note 195, at Question 4 (permitting a Registered Broker-Dealer to rely on a foreign broker-dealer to deliver confirmations that the Registered Broker-Dealer is obligated to deliver pursuant to an arrangement under Rule 15a-6(a)(3)).
184. 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 Inv. Co., SEC No-Action Letter (Jan. 20, 1973); see also Omgeo LLC, SEC No-Action Letter (Nov. 19, 2010) (“[The SEC] has long taken the view that broker-dealers may use electronic media to satisfy their Rule 10b-10 [confirmation] delivery obligations, provided that the medium used to send the information is not so ‘burdensome that the intended recipients cannot effectively access the information provided.’ In this respect, [the SEC] emphasize[s] that broker-dealers relying on a vendor’s electronic platform to fulfill their Rule 10b-10 obligations must ensure that their customers can effectively access all of the information required by Rule 10b-10 in a format that is understandable but not burdensome for the customer to access. To the extent that this is not the case, broker-dealers may not be able to rely on that vendor’s electronic platform to fulfill their Rule 10b-10 obligations.”) (citing Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisers for Delivery of Information, SEC Release No. 34-37182 (May 9, 1996)).

that provides confirmation services may be required to register as a broker-dealer with the SEC.¹⁸⁵

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

The SEC has provided no-action relief to transfer agents¹⁸⁶ that act as intermediaries between issuers and Registered Broker-Dealers without effecting securities transactions.¹⁸⁷ 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.¹⁸⁸ 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. To assist employees in selling 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. Digital would not receive any compensation for these services and would only perform these services as a convenience for its employees. In another no-action letter, the SEC permitted American Transtech to act as transfer agent to its

185. See Benal Beach Corp., S.A., SEC No-Action Letter (Apr. 5, 1974); Scotch Whisky Investment Company, SEC No-Action Letter (Jan. 20, 1973); Woodmoor Corp., SEC No-Action Letter (Mar. 5, 1972).

186. 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.

187. 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).

188. See Digital Equipment Corp., SEC No-Action Letter (Oct. 2, 1978).

shareholders in transmitting the shares they wished to sell to a broker-dealer for execution without registering as a broker-dealer itself.¹⁸⁹

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,¹⁹⁰ 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.¹⁹¹

Subject to certain conditions,¹⁹² 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.¹⁹³ 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 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

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

190. See Stallion Fund, Inc., SEC Denial of No-Action Request (Oct. 13, 1971); Transfer Online, SEC Denial of No-Action Request (May 3, 2000); see also *In re Bankers Pension Services, Inc.*, SEC Release No. 34-37567 (Aug. 14, 1996); *In re Transcorp Pension Services, Inc.*, SEC Release No. 34-37278 (June 4, 1996). See also *supra* note 52 (discussing activities deemed clerical and ministerial).

191. 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); see also *In re Computershare Trust Company of Canada*, SEC Release No. 34-53668 (Apr. 18, 2006); *In re CIBC Mellon Trust Company*, SEC Release No. 34-51297 (Mar. 2, 2005); Transfer Agents Operating Direct Registration System, SEC Release No. 34-35038 (Dec. 1, 1994). See also Transfer Agent Regulations, SEC Release No. 34-76743 (Dec. 22, 2015) at 195-98 (discussing potential broker-dealer registration issues for transfer agents).

192. Conditions set forth by section 3(a)(4)(B)(iv) include that (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 odd-lot holders or plans registered with the Commission. See Exchange Act § 3(a)(4)(B)(iv).

193. *Id.*

agent, subject to certain conditions, including that the entity must maintain its registration as transfer agent with the SEC.¹⁹⁴

The SEC staff has also indicated that a foreign broker-dealer not registered as a broker-dealer with the SEC could, in certain circumstances, provide stock plan services to a foreign issuer with U.S. employees.¹⁹⁵

[J][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.¹⁹⁶ 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.¹⁹⁷ 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)¹⁹⁸

194. 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).

195. See SEC Division of Trading and Markets, Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers (Apr. 21, 2014), <http://www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm>, at Questions 2–2.4 [hereinafter SEC Staff 15a-6 FAQ]. In the transfer agent context, the SEC had indicated that a stock plan service provider may be acting as a broker-dealer where, among other things, it engages in netting participant transactions or receiving transaction-based compensation for its services. See Transfer Agent Regulations, SEC Release No. 34-76743, at 195–96 (Dec. 22, 2015).

196. Capital Institutional Services, Inc., SEC No-Action Letter (Apr. 13, 2007); Goldman Sachs & Co., SEC No-Action Letter (Jan. 17, 2007); Charles Schwab & Co., SEC No-Action Letter (Sept. 18, 1997); Citicorp, SEC No-Action Letter (Aug. 13, 1986).

197. Charles Schwab & Co., 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).

198. 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

of the Exchange Act without registering as broker-dealers.¹⁹⁹ 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.²⁰⁰

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.²⁰¹ 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.²⁰²

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).

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

200. *Id.*

201. Investment Advisers Act § 202(a)(11) (defining an “investment adviser” as, subject to certain exclusions, “any person . . . who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities”); Sterling Research Corp., SEC No-Action Letter (May 20, 1982); Citicorp, SEC No-Action Letter (Aug. 13, 1986); Investment Mgmt. & Research, Inc., SEC No-Action Letter (Jan. 27, 1977).

202. Tax Shelter Advisory Service, Inc., SEC No-Action Letter (Nov. 30, 1973); Citicorp, SEC No-Action Letter (Aug. 13, 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 receive no special compensation for the advisory services); *see also* Investment Advisers Act Rule 206(3)-1 (classifying the provision of certain “publicly distributed written materials or publicly made oral statements” as the provision of investment advisory services); BNY ConvergeX Group, LLC, SEC No-Action Letter (Sept. 21, 2010) (stating that the provision of research services by a research firm that

[J][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 in connection with securities-based activities generally is required to register as a broker-dealer.²⁰³

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.²⁰⁴ 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.²⁰⁵ 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.²⁰⁶ 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.²⁰⁷ 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

is also a registered broker-dealer to an institutional investment manager would not "in and of itself" establish an investment adviser/client relationship under the Investment Advisers Act between the research firm and accounts managed by the investment manager on a discretionary basis).

203. 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).
204. See Flexible Financial Marketing, Inc., SEC Denial of No-Action Request (Sept. 13, 1996).
205. See *id.*
206. See Redmond Associates and John Kendall Redmond, SEC No-Action Letter (Jan. 12, 1985).
207. See *id.*

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.²⁰⁸ 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.”²⁰⁹

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.²¹⁰

[K] Investment Advisers

There is no general exemption for investment advisers from federal broker-dealer registration.²¹¹ 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:

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208. See Joseph K. Bannon, CPA, SEC No-Action Letter (Dec. 9, 1988).
209. See *id.* See also Strengthening the Commission’s Requirements Regarding Auditor Independence, SEC Release No. 34-47265, at n.82 (Jan. 28, 2003) (describing circumstances where an accountant might be acting as an unregistered broker).
210. See 1st Global Inc., SEC No-Action Letter (May 7, 2001).
211. See, e.g., Havanich et al., Initial Decision Release No. 935 (Jan. 4, 2016) (“[a]lthough brokers may be exempt from registering as investment advisers if their advisory activity is ‘solely incidental’ to their brokerage business, investment advisers are not similarly exempt from registering as brokers when, in connection with their advisory business, they act as brokers”); Blackstreet Capital Management, LLC, SEC Release No. 34-77959 (June 1, 2016) (adviser that received transaction-based compensation found to be acting as a broker); *cf.* David W. Blass, Chief Counsel, Division of Trading and Markets, SEC, Remarks to American Bar Association, Trading and Markets Subcommittee (Apr. 5, 2013) (suggesting that adviser that received transaction-based compensation might not be a broker on the basis of such compensation if the otherwise applicable “advisory fee is wholly reduced or offset by the amount of the transaction fee”).

[T]he 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.²¹²

§ 2:3 What Is a Dealer?

§ 2:3.1 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 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.”²¹³

212. 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 a 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)); *see also* Study on Investment Advisers and Broker-Dealers, *supra* note 29, at 12–13 (discussing instances where investment advisers are dually registered as broker-dealers in order to provide a “variety of services not available through entities that are solely registered as investment advisers or broker-dealers.”).

213. *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) [hereinafter Bank Exemptions Adopting Release]. For a detailed

As discussed above,²¹⁴ before the GLBA was enacted in 1999, banks were excluded from the definitions of both “broker” and “dealer.” The GLBA amended sections 3(a)(4) and 3(a)(5) and replaced the blanket exclusion for banks with eleven exemptions from the statutory definition of “broker” and five exemptions from the statutory definition of “dealer.”²¹⁵

The Dodd-Frank Act amended 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 below in section 2:4.4.

[B] Buying and Selling Securities for Own Account

To be a dealer, a person has to both buy and sell securities.²¹⁶ 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.²¹⁷

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.²¹⁸ These transactions also include so-called “riskless principal” transactions,²¹⁹ in which, after receiving an order to buy (or sell) from a customer, the broker-dealer purchases (or sells) the security from (or

review of the SEC’s precedents concerning dealers, see Ignacio A. Sandoval, Steven W. Stone et al., *Challenges in Requiring High-Frequency Traders to Register as Dealers*, NAT’L L.J. (June 10, 2014) [hereinafter Sandoval & Stone].

214. See *supra* section 2:2.7[D][1].

215. See Exchange Act §§ 3(a)(4)(B) and 3(a)(5)(C). For a detailed discussion of these exemptions, see *infra* section 2:7.4.

216. 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.), *cert. denied*, 393 U.S. 913 (1968).

217. See Exchange Act § 3(a)(4); *Mass. Fin. Servs., Inc. v. Sec. Inv’t 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 Exec. Planners, Ltd.*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); Transfer Online, SEC Denial of No-Action Request (May 3, 2000).

218. 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) [hereinafter Bank Exemptions Proposing Release].

219. *Id.*

to) another person in a contemporaneous offsetting transaction.²²⁰ 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 nonexistent.²²¹

The SEC has taken the position that a dealer must buy and sell, or be willing to buy and sell, contemporaneously.²²² 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 added “security-based swaps” to the definition of “security” in section 3(a)(10) of the Exchange Act. In addition, it introduced 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 below in section 2:4.4.

[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.²²³ As discussed in section 2:2.4, courts have read into the term “engaged in the business” a certain regularity of participation in purchasing and selling activities.²²⁴ To be “engaged in the business” of buying and selling securities, a person has to conduct securities transactions as a

220. See *id.* at n.28; see also Rule 10b-10(a)(2)(ii)(A); Confirmation of Transactions, SEC Release No. 34-33743, n.11 (Mar. 9, 1994).

221. See Bank Exemptions Proposing Release, *supra* note 218.

222. 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).

223. See Exchange Act § 3(a)(5)(A).

224. See *SEC v. Am. Inst. Counselors, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.D.C. 1975) (citing Loss, *Securities Regulation* (2d ed. 1961)); see also *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1 (D.D.C. 1998); *SEC v. Margolin*, 1992 U.S. Dist. LEXIS 14872 (S.D.N.Y. Sept. 30, 1992); *SEC v. Hansen*, 1984 U.S. Dist. LEXIS 17835 (S.D.N.Y. Apr. 6, 1984); *SEC v. Nat'l Exec. Planners, Ltd.*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); *Mass. Fin. Servs., Inc. v. Sec. Inv'r 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).

part of a regular business,²²⁵ and more often than on a single isolated basis.²²⁶

§ 2:3.2 “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.”²²⁷ 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.²²⁸ The level of a dealer’s activity in securities transactions is

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225. See *Eastside Church of Christ v. Nat’l Plan, Inc.*, 391 F.2d 357, 361 (5th Cir.), *cert. denied*, 393 U.S. 913 (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). Securities transactions between affiliated entities acting as principal with each other generally are not thought to trigger “dealer” status because such activities do not constitute the conduct of a “regular business” of securities dealing. See *Fenchurch Paget Fund, Ltd.*, SEC No-Action Letter (Aug. 3, 1987). By way of analogy, in the context of security-based swaps, the SEC’s definition of “security-based swap dealer” provides that security-based swap activity between majority-owned affiliates does not constitute “dealing” and therefore does not trigger a security-based swap dealer registration requirement. See *Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,”* SEC Release No. 34-66868 (Apr. 27, 2012) [hereinafter *Swap Entity Definition Release*]; Exchange Act Rule 3a71-1(d). The full text of the final rules defining these terms may be found in their entirety in an online appendix located on the Davis Polk & Wardwell LLP website, <http://net.davispolk.com/swaps/sbsappendix.pdf> [hereinafter *Online Appendix*]. *But cf.* SEC Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules, <http://www.sec.gov/divisions/marketreg/bankdealerguide.htm>, at Question 2 (implying a bank may need an exemption from broker-dealer registration when engaging in securities transactions with affiliates).
226. See Letter from Ezra Weiss, Chief Counsel, Division of Market Regulation, to Joseph McCulley (Aug. 2, 1972); see also *SEC v. Am. Inst. Counselors, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.D.C. 1975) (citing *Loss, Securities Regulation* (2d ed. 1961)); Stephen V. Hart, SEC No-Action Letter (Feb. 5, 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 . . .”).
227. See *Bank Exemptions Proposing Release*, *supra* note 218; *Public Securities Locating Services*, SEC No-Action Letter (Sept. 8, 1973); *Swap Entity Definition Release*, *supra* note 225; *Online Appendix*, *supra* note 225.
228. SEC Guide to Broker-Dealer Registration, *supra* note 85; see also *Testimony of Richard R. Lindsey, Director, Division of Market Regulation, SEC*,

usually more than that of an active trader.²²⁹ 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.”²³⁰ 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.

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

- (i) issuing or originating securities;²³¹
- (ii) having a regular clientele;²³²
- (iii) advertising or otherwise holding itself out as buying or selling securities on a continuous basis or at a regular place of business;²³³

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229. before the House Committee on Banking & Financial Services, Concerning Hedge Fund Activities in the U.S. Financial Markets, at n.2 (Oct. 1, 1998), <http://www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm>. See SEC v. Ridenour, 913 F.2d 515 (8th Cir. 1990). The SEC’s Chair recently implied that the SEC might view some “high frequency trading” firms as dealers, and, in any event, has requested the SEC staff to prepare “a rule to clarify the status of unregistered active proprietary traders to subject them to our rules as dealers.” See, e.g., Mary Jo White, Chair, Securities and Exchange Commission, Remarks at Sandler O’Neill & Partners, L.P. Global Exchange and Brokerage Conference: Enhancing Our Equity Market Structure (June 5, 2014) [hereinafter White Speech]. To this effect, the SEC’s official regulatory agenda indicates that the SEC plans to “propose a new, metrics-based rule to establish that a person engaged in a large volume of intraday trading activity for its own account without holding a significant overnight position is a dealer.” See Office of Management and Budget, Office of Information and Regulatory Affairs, Unified Agenda RIN No. 3235-AL64 (Spring 2015), <http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201504&RIN=3235-AL64>. Some practitioners have expressed a view that such a position is controversial. See Sandoval & Stone, *supra* note 213.
230. 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.’”).
231. See Louis Dreyfus Corp., SEC No-Action Letter (July 23, 1987).
232. See Bank Exemptions Proposing Release, *supra* note 218; see also SEC v. Ridenour, 913 F.2d 515 (8th Cir. 1990).
233. See Bank Exemptions Proposing Release, *supra* note 218; SEC v. Schmidt, Fed. Sec. L. Rep. (CCH) ¶ 93,202 (S.D.N.Y. 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,

- (iv) actively soliciting clients;²³⁴
- (v) having a regular turnover of inventory (or participating in the sale or distribution of new issues, such as by acting as an underwriter);²³⁵
- (vi) acting as a market maker or specialist on an organized exchange or trading system;²³⁶
- (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);²³⁷
- (viii) generally providing liquidity services in transactions with investors (or, in the case of a dealer who is a market maker, for other professionals);²³⁸
- (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

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").

234. *See* SEC v. Nat'l Exec. Planners, Ltd., 503 F. Supp. 1066 (M.D.N.C. 1980).
235. *See* Bank Exemptions Adopting Release, *supra* note 213. 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). The SEC recently instituted an administrative proceeding against Ironridge Global Partners, LLC and an affiliate. According to the SEC, Ironridge would purchase an outstanding claim owed by a microcap issuer to a creditor and then entered into a court-approved settlement agreement with the issuer under which Ironridge would receive unrestricted stock in the issuer in satisfaction of the claim, in a securities issuance exempt from registration under section 3(a)(10) of the Securities Act. Ironridge would then engage in open market sales of the securities received. The SEC alleged that this conduct constituted underwriting activity and that Ironridge had therefore acted as an unregistered dealer. *In re* Ironridge Global Partners, LLC, SEC Release No. 75272 (June 23, 2015).
236. *See* Bank Exemptions Proposing Release, *supra* note 218.
237. *Id.*
238. *See* Bank Exemptions Adopting Release, *supra* note 213. In an enforcement context, the SEC has argued that seeking to profit from markups or spreads rather than from appreciation in the value of securities is also indicative of being a dealer. *See In re* Sodorff, SEC Release No. 34-31134 (Sept. 2, 1992); *In re* OX Trading, LLC, Order on Motion for Partial Summary Disposition, Admin. Proc. Release No. 722 (Sept. 5, 2012).

with transactions in securities, and carrying a securities account;²³⁹

- (x) using an interdealer broker (other than a retail screen broker) to effect securities transactions;²⁴⁰ and
- (xi) running a matched book of repurchase and reverse repurchase agreements.²⁴¹

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;²⁴²
- (ii) engaging in securities activities that are relatively minor measured against its other activities;²⁴³
- (iii) not handling others' money or securities;
- (iv) engaging in securities transactions with registered brokers or dealers only;²⁴⁴
- (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;²⁴⁵ and
- (viii) not furnishing the services that are usually provided by dealers, such as quoting the market in one or more securities, rendering investment advice, extending or arranging for credit, or lending securities.²⁴⁶

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

240. *See id.*

241. *See* Bank Exemptions Adopting Release, *supra* note 213; *see generally* Bank Exemptions Proposing Release, *supra* note 218; 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).

242. *See* Bank Exemptions Proposing Release, *supra* note 218; *see also* Letter from Susan J. Walters, Office of Chief Counsel, to Martin E. Lybecker, National Council of Savings Institutions (July 27, 1986).

243. *See* Stephen V. Hart, SEC No-Action Letter (Feb. 5, 1980).

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

245. *See* Stephen V. Hart, SEC No-Action Letter (Feb. 5, 1980).

246. *See* Bank Exemptions Proposing Release, *supra* note 218; Letter from Susan J. Walters, Office of Chief Counsel, to Martin E. Lybecker, National Council of Savings Institutions (July 27, 1986).

A person does not have to exhibit all or any given number of these above-listed factors in order to be considered a dealer.²⁴⁷ 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.²⁴⁸

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.²⁴⁹

There is no requirement that the purchase and sale of securities be a dealer’s principal business or principal source of income.²⁵⁰ 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.²⁵¹ 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.²⁵²

A dealer can buy and sell securities for its own account through a broker or on its own.²⁵³ 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).²⁵⁴ Therefore, a dealer cannot avoid section 15 registration requirements merely by transacting securities through another Registered Broker-Dealer.²⁵⁵

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247. Conroy v. Andeck Res., 484 N.E.2d 525 (Ill. App. Ct. 1985) (citing LOSS, SECURITIES REGULATIONS (2d ed. 1961)).
248. Letter from Susan J. Walters, Office of Chief Counsel, to Martin E. Lybecker, National Council of Savings Institutions (July 27, 1986); Stephen V. Hart, SEC No-Action Letter (Feb. 5, 1980); Burton Securities, SEC No-Action Letter (Dec. 5, 1977).
249. See, e.g., Acqua Wellington North American Equities Fund, Ltd., SEC No-Action Letter (July 11, 2001) (granting no-action request because, although the offshore investment fund was named as a statutory underwriter in a registration statement for purposes of the Securities Act, it did not possess the other characteristics of a dealer under the circumstances).
250. See Stephen V. Hart, SEC No-Action Letter (Feb. 5, 1980); UFITEC v. Carter, 20 Cal. 3d 238, 571 P.2d 990 (1977).
251. 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).
252. See SEC v. Am. Inst. Counselors, Inc., Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.D.C. 1975).
253. Exchange Act § 3(a)(5).
254. See, e.g., Instant Funds, Inc., SEC No-Action Letter (Mar. 14, 1971); *In re Rafferty Capital Markets, LLC*, SEC Release No. 34-72171 (May 15, 2014).
255. See, e.g., Boetel & Co., SEC No-Action Letter (Sept. 29, 1971). See also *In re OX Trading, LLC*, SEC Release No. 34-66831 (Apr. 19, 2012) (alleging firm conducted a business as an unregistered dealer by acting as a liquidity provider to other customers of affiliated broker-dealer).

Although the role of a securities dealer differs in some respects from the role of a swap dealer or security-based swap dealer, the dealer-versus-trader analysis has many similarities. In adopting joint rules further defining “swap dealer” and “security-based swap dealer,” the Commodity Futures Trading Commission (CFTC) and the SEC stated that, given parallels between the way these terms and the term “dealer” are defined, analogous interpretative positions are warranted.²⁵⁶ It can be anticipated that interpretive and enforcement positions taken in the context of swaps and security-based swaps will therefore become important for analyzing whether analogous activity would trigger securities dealer registration.

[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.²⁵⁷ 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;

256. See Swap Entity Definition Release, *supra* note 225.

257. 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), <http://www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm>.

- (x) issue or originate securities;
- (xi) use an interdealer broker to effect securities transactions; and
- (xii) otherwise engage in other dealer activities.²⁵⁸

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.²⁵⁹ 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.²⁶⁰ 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.²⁶¹

[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.²⁶² However, under certain circumstances, issuers

258. 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); *Bank Exemptions Proposing Release*, *supra* note 218. The SEC, however, is considering whether certain active proprietary traders should be required to register as dealers. See *supra* note 229 and accompanying text.

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

260. See *Bankers Guarantee Title & Trust Co.*, SEC No-Action Letter (Jan. 22, 1991).

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

262. 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." Proposed Rulemaking, SEC Release No. 34-13195 (Jan. 21, 1977).

can be engaged in both purchasing and selling their securities from and to investors, which could require them to register under the Exchange Act.²⁶³

In contrast, a life insurance company that distributed fixed and variable annuity contracts²⁶⁴ through a separate account was determined to be both a “broker” and a “dealer” under the Exchange Act.²⁶⁵ 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.”²⁶⁶

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.²⁶⁷

[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,

263. See SEC Guide to Broker-Dealer Registration, *supra* note 85 (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.).

264. “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); Tcherepnin 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).

265. See *id.*; see also National Integrity Life Ins. Co., SEC No-Action Letter (May 1, 1987).

266. 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).

267. See *id.*

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.²⁶⁸ As noted below, 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.²⁶⁹ 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 bank²⁷⁰ or from offshore entities pursuant to Rule 15a-6 under the Exchange Act.²⁷¹ 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,”²⁷² which include both securities and non-securities OTC derivative instruments.²⁷³ These entities, as affiliates of fully regulated broker-dealers, can register with the SEC under section 15(b) of the Exchange Act as

268. 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 85.

269. Notably, the SEC has proposed net capital rules for security-based swap dealers and to amend the net capital rules for broker-dealers holding security-based swaps and swaps. The proposed rules would clarify, and potentially alleviate, the current onerous net capital treatment applied to security-based swaps and certain other OTC derivatives. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, SEC Release No. 34-68071 (Oct. 18, 2012).

270. For a discussion of the ability of banks to engage in swaps under their authority to deal in “identified banking products” under GLBA push-out rules, see *infra* section 2:7.4, note 480 and accompanying text. For a discussion of the ability of banks to engage in swaps and security-based swaps activities under the Swaps Push-out Rule, see *infra* section 2:4.4[D][2].

271. For a discussion of Rule 15a-6, see *infra* section 2:7.2.

272. “Eligible OTC derivative instrument” is defined in Rule 3b-13.

273. OTC Derivative Dealers Adopting Release, *supra* note 268.

OTC derivatives dealers, subject to specially tailored capital, margin, and various other requirements.²⁷⁴

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

- (i) membership in an 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 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.²⁷⁵

The Dodd-Frank Act will bring under regulation previously unregulated “security-based swaps,” modify the definition of “security” to include “security-based swaps,” and introduce new regimes for “swap dealers,” “security-based swap dealers,” “major swap participants” and “major security-based swap participants.”²⁷⁶ Although the Dodd-Frank Act amended the definition of “security” to include “security-based swaps,” as noted above, the Dodd-Frank Act excludes

274. *Id.*

275. *Id.*

276. *See infra* section 2:4.4[D][1]. As of July 16, 2011, the definition of “security” under the Securities Act and the Exchange Act was expanded to include security-based swaps, but the SEC used its exemptive authority to limit the impact of this change, on a temporary basis, primarily to the anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act. *See* Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, SEC Release No. 34-64795, (July 1, 2011); Exemptions for Security-Based Swaps, SEC Release No. 34-64794 (July 1, 2011). Although this relief was scheduled to expire on the effective date of the final rules defining “security-based swap” and “eligible contract participant,” the SEC has on multiple occasions extended the temporary relief. *See* Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, SEC Release No.

from the definition of “dealer” a person that engages in security-based swap dealing with eligible contract participants only. However, because security-based swaps are securities, a registered broker-dealer’s activities involving security-based swaps are subject to the broker-dealer regulations that apply to securities activities more generally. The SEC and FINRA have temporarily exempted broker-dealers from most such requirements with respect to their security-based swap activities while the SEC considers the impact of applying the various pre-Dodd-Frank Act Exchange Act provisions, SEC rules, and FINRA rules that would otherwise apply to securities to security-based swaps.²⁷⁷ The Dodd-Frank Act is discussed further below in section 2:4.4.

34-67453 (July 18, 2012) (extending the temporary exemptive relief until February 11, 2013); Order Extending Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with the Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, SEC Release No. 34-68864 (Feb. 13, 2013) (extending the temporary exemptive relief until February 11, 2014); Order Extending Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with the Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, SEC Release No. 34-71485 (Feb. 5, 2014) (extending the temporary exemptive relief, depending on the particular rule, until either (i) the earlier of such time as the SEC issues an order or rule determining whether any continuing exemptive relief is appropriate or until three years following the effective date of the release or (ii) the compliance date for related pending security-based swap rulemaking). FINRA similarly adopted and extended a rule that temporarily limits, with certain exceptions, the application of FINRA rules to security-based swaps. *See* Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Extend the Expiration Date of FINRA Rule 0180 (Application of Rule to Security-Based Swaps), SEC Release No. 34-74049 (Jan. 14, 2015) (extending exemptive relief until February 11, 2016); Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Extend the Expiration Date of FINRA Rule 0180 (Application of Rules to Security-Based Swaps), SEC Release No. 34-76850 (Jan. 7, 2016) (extending exemptive relief until February 11, 2017). The SEC has also adopted exemptions from the Securities Act (other than the section 17(a) anti-fraud provisions), the Exchange Act registration requirements and the Trust Indenture Act for security-based swaps issued by certain clearing agencies satisfying certain conditions. *See* Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, SEC Release No. 33-9308 (Mar. 30, 2012).

277. *See* Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, SEC Release No. 34-64795 (July 1, 2011); Exemptions for Security-Based Swaps, SEC Release No. 34-64794 (July 1, 2011). Not all provisions relating to security-based swaps have been temporarily exempted, however. For example, engaging in the sale of security-based swaps to persons other than eligible contract participants either (i) without registration under the Securities Act or (ii) other than on a national securities exchange is prohibited notwithstanding the exemptive orders. *See, e.g., In re Sand Hill*

§ 2:4 What Is a Security?

§ 2:4.1 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:

. . . unless the context otherwise requires . . . any note, stock, treasury stock, security future, security-based swap,²⁷⁸ 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 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.²⁷⁹

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,”²⁸⁰ and courts have interpreted the definition of “security”

Exchange, SEC Release No. 34-75187 (June 17, 2015) (finding website offering trading in contracts tied to the value of private startup companies engaged in unlawful sale of security-based swaps to non-eligible contract participants).

278. The Dodd-Frank Act added “security-based swaps” to the definition of “security.” “Security-based swaps” are discussed further, *infra* section 2:4.4.

279. Exchange Act § 3(a)(10).

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

broadly.²⁸¹ In determining whether an instrument is a security, courts will look at the economic reality and focus on the substance rather than form.²⁸²

§ 2:4.2 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.²⁸³ It is a descriptive term capable of adaptation to meet many different types of investment schemes.²⁸⁴ 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 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.”²⁸⁵ The definition establishes a four-part test in determining whether a particular scheme is an investment contract. Specifically, the test requires that there be:

- (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 “specific consideration in return for a separable financial interest with the characteristics of a security.”²⁸⁶

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

282. 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.

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

284. See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

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

286. *Int’l Bhd. Teamsters v. Daniel*, 439 U.S. 551, 559 (1979). An investment of money need not be in traditional currency. See, e.g., *SEC v. Shavers*, 2013 U.S. Dist. LEXIS 110018 (E.D. Tex. Aug. 6, 2013) (finding that making

[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.²⁸⁷ In horizontal commonality, the fortunes of each investor depend upon the profitability of the enterprise as a whole.²⁸⁸

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.²⁸⁹ 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.²⁹⁰ The approach focuses on the community of interest between the individual investor and the manager of the enterprise.²⁹¹ In vertical commonality, the investors’ fortunes need not rise and fall together, and a pro rata sharing of profits and losses is not required.²⁹² It is also not necessary that the funds of investors be pooled.²⁹³

investments denominated in bitcoin, a form of digital virtual currency, constituted an investment of money subject to federal securities laws); *see also* SEC v. Shavers, No. 4:13-CV-416 (E.D. Tex. Aug. 26, 2014) (upholding on rehearing).

287. 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. Infinity Grp. Co.*, 212 F.3d 180, 188 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001); *Teague v. Bakker*, 35 F.3d 978 n.8 (4th Cir. 1994); *cert. denied*, 513 U.S. 1153 (1995); *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385 (6th Cir. 1989), *cert. denied*, *Trager, Glass & Co. v. Newmyer*, 495 U.S. 930 (1990); *Union Planters Nat’l Bank of Memphis v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174 (6th Cir.), *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 (D.C. Cir. 1996), *reh’g denied*, 102 F.3d 587 (D.C. Cir. 1996).
288. *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)).
289. *Revak*, 18 F.3d 81 (discussing *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974)).
290. *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).
291. *See, e.g., Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989).
292. *Revak*, 18 F.3d 81.
293. *SEC v. Goldfield Deep Mines Co.*, 758 F.2d 459 (9th Cir. 1985).

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.²⁹⁴ 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.”²⁹⁵ Under this approach, the promoter shares in the returns of the investors.²⁹⁶ 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.

[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.²⁹⁷ Profits are income or return that investors seek on their investment, not the profits of the scheme in which they invest.²⁹⁸ Profits include, for example, dividends, other periodic payments, or the increased

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294. 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.
295. SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 n.7 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973) (citations omitted).
296. 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); *Brodts 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, did not amount to a “common enterprise;” since there was no direct correlation on either the success or failure side, the court held that there was no common enterprise between Bache and Brodts).
297. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852, *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. C.M. Joiner Leasing Corp.*, 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).
298. *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

value of the investment.²⁹⁹ 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.³⁰⁰ The analysis should not distinguish between promises of fixed returns and promises of variable returns for purposes of the test.³⁰¹

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.³⁰² The investor may not have been motivated by a desire to use or consume the item purchased.³⁰³ In determining whether an investor was “attracted or led” by the expectation of profits, courts look 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

299. *Id.* See also FINRA Regulatory Notice 16-12 (Apr. 2016) (reminding members to consider whether “pension income stream” products that promise purchasers a share of a pensioner’s income stream in return for an up-front lump sum purchase price, are securities subject to the federal securities laws).

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

301. This is 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.

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

303. 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 (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 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), <http://www.sec.gov/news/studies/2010/lifsettlements-report.pdf>.

to the word “solely,” and have adopted liberal interpretations, emphasizing the economic reality of the transaction.³⁰⁴ 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.”³⁰⁵

§ 2:4.3 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.”³⁰⁶ While the statutory definition of “security” includes “any note,” this is not interpreted literally.³⁰⁷ “Note” is a relatively broad term that

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304. *Liberty Prop. Tr. v. Republic Props. Corp.*, 577 F.3d 335 (D.C. Cir. 2009); *SEC v. SG Ltd.*, 265 F.3d 42, 55 (1st Cir. 2001); *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir. 1984), *cert. denied*, 469 U.S. 831 (1984), *overruled on other grounds*, *Zosky v. Boyer*, 856 F.2d 554 (3d Cir. 1988); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988); *SEC v. Koscot Interplanetary*, 497 F.2d 473 (5th Cir. 1974); *SEC v. Prof'l 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.), *cert. denied*, 414 U.S. 821 (1973); *McCown v. Caldwell*, 527 F.2d 204 (10th Cir. 1975). *See also* *SEC v. Garza*, No. 3:15-cv-01760 (D. Conn. filed Dec. 12, 2015) (alleging that a contract for the purchase of shares of defendant's bitcoin mining computer “hashing power” and resulting profits “relied solely on the efforts” of the promoters and therefore constituted securities as investment contracts); *In re Prosper Marketplace, Inc.*, SEC Release 33-8984 (Nov. 24, 2008) (finding peer-to-peer lending marketplace operator sold investment contract securities to lenders, as “[l]enders rely on the efforts of Prosper . . . [whose] efforts are instrumental to realizing a return.” *In re Flanagan*, No. 14-60019, 2016 WL 1085528 (9th Cir. Mar. 21, 2016) (loan not an investment contract where a guaranteed return was promised, regardless of success of borrower's venture).
305. *Glenn W. Turner Enters.*, 474 F.2d 476. Some circuits have adopted the Ninth Circuit's interpretation, *see SG Ltd.*, 265 F.3d 42; *Glenn W. Turner Enters.*, 474 F.2d 476, *accord Rivanna Trawlers Unlimited*, 840 F.2d at 240 n.4. *Cf. Iguacu, Inc. v. Filho*, 637 F. App'x 407 (9th Cir. 2016) (plaintiff did not act as unregistered broker by selling interests in a joint venture where the purchaser was to have active role in management, rather than rely on promoter's efforts).
306. 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).
307. *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.³⁰⁸ 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.³⁰⁹ 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.”³¹⁰ 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.³¹¹ 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.³¹²

The Supreme Court in *Reves* adopted the list created by the Second Circuit. 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.

308. *See Landreth Timber Co. v. Landreth*, 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.

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

310. *Id.*

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

312. *Id.*

- (vii) a note evidencing loans by commercial banks for current operations.³¹³

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.³¹⁴

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."³¹⁵ 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.³¹⁶

While the SEC and the courts have applied the *Reves* analysis to a variety of different instruments, two areas are particularly significant: (i) bank certificates of deposit (CDs) and other deposit instruments, and (ii) loans and loan participations.

CDs have been analyzed as a type of "note," and 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.³¹⁷ 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

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

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

315. Exchange Act § 3(a)(10).

316. See *In re Minotaur Capital, Inc.*, SEC Release No. 33-4412 (Sept. 20, 1961). See also *infra* section 2:7.1.

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

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.³¹⁸ However, the Court stated that CDs could be securities subject to the Exchange Act in other 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.”³¹⁹ 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.³²⁰

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.”³²¹ Another court, however, found that foreign CDs were securities where the instrument failed the four-factor family resemblance test and were issued by a foreign bank subject to “inadequate” regulation—indicating that the extent to which foreign bank CDs will, or will not, be treated as securities requires case-by-case consideration.³²²

A particularly vexing question is whether and when loans (particularly those that are syndicated to, or otherwise sold to, multiple investors) and loan participations are “notes” subject to the federal securities laws. In the leading case of *Banco Espanol de Credito v. Security Pacific National Bank*,³²³ the Second Circuit held that the

318. *See id.*

319. *Id.*

320. *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).

321. *Wolf v. Banco Nacional de Mexico, S.A.*, 739 F.2d 1458, 1463 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985).

322. *See SEC v. Stanford Int’l Bank*, No. 3:09-cv-0298-N (N.D. Tex. Nov. 30, 2011) (finding CDs issued by an Antigua bank in a Ponzi scheme were securities); *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014) (assuming, without analysis, that the fraudulent CDs issued by Stanford International Bank were securities subject to the federal securities laws).

323. *See, e.g., Banco Espanol de Credito v. Sec. Pac. Nat’l Bank*, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993). *See also* Potential Applicability of MSRB Rules to Certain “Direct Purchases” and “Bank Loans,” MSRB Notice 2011-52 (Sept. 12, 2011) (discussing whether so-called

particular loan participations at issue did not amount to securities under the *Reves* “family resemblance” test, because the participants had commercial rather than investment motivations, the participations were not offered to the general public, the investors had notice in their contracts and discussions that the instruments were loans, and regulatory oversight was provided by the Office of the Comptroller of Currency.

Banco Espanol indicates that the analysis will be a highly fact-specific inquiry, and the cases have not yielded entirely consistent results. In general, loans that are broadly marketed and distributed, or offered and sold to persons other than banks and other customary commercial lenders, are more likely to be treated as securities.³²⁴

The ambiguity and malleability of the four-factor “family resemblance” test is reflected in continued SEC enforcement actions relying on loans as securities to pursue claims against promoters of typically fraudulent investment schemes.³²⁵

The character of these instruments as a security or not may have broad implications beyond broker-dealer registration.³²⁶ For example,

“bank loans” extended to state and local governments constitute municipal securities); Direct Purchases and Bank Loans as Alternatives to Public Financing in the Municipal Securities Market, MSRB Notice 2016-12 (Apr. 4, 2016) (same).

324. *See Battig v. Simon*, 237 F. Supp. 2d 1139 (D. Or. 2001) (emphasizing the nationwide scale of the offering in finding notes to be securities); *SEC v. Chem. Tr.*, No. 00-CIV-8015, 2000 U.S. Dist. LEXIS 19786 (S.D. Fla. Dec. 18, 2000) (notes found to be securities in part due to offerings via a nationwide network of agents who advertised and solicited for a broad segment of the investing public); *SEC v. J.T. Wallenbrock & Assocs.*, 313 F.3d 532 (9th Cir. 2002) (notes held by more than 1,000 investors in 25 states held to be securities). *Cf. Sunset Mgmt., LLC v. Am. Realty Inv’r, Inc.*, No. 4:06-cv-18 (LEAD), 2007 U.S. Dist. LEXIS 16654 (E.D. Tex. Mar. 8, 2007) (loan not offered to general public not held to be a security); *Robyn Meredith Inc. v. Levy*, 440 F. Supp. 2d 378 (D.N.J. 2006) (note offered to single party in connection with a commercial transaction not held to be a security). *See also McNabb v. SEC*, 298 F.3d 1126 (9th Cir. 2002) (affirming SEC determination that notes were securities despite not being sold to the broad public because, among other things, they were sold to persons other than sophisticated financial institutions).
325. *See, e.g., Complaint, SEC v. Capital Fin. Partners, LLC*, No. 15-cv-14477 (D. Mass. Apr. 1, 2015) (alleging that Ponzi scheme seeking investors to fund high interest rate loans to professional athletes constituted securities fraud, even though the loans were offered to a small, targeted audience of individual investors, marketed exclusively as loans, and documented under loan agreements).
326. The question is also relevant to whether an associated person of a broker-dealer would need to comply with FINRA requirements concerning “private securities transactions” under NASD Rule 3040 in arranging for the sale of notes that are securities, but not otherwise.

the status of an instrument as a security is relevant to banking entities subject to the Volcker Rule.³²⁷ The final implementing regulations define “proprietary trading” broadly to mean “engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.”³²⁸ A “financial instrument” is defined in the final implementing regulations as any security, derivative or futures contract, or option on any such investment, but excludes a “loan.”³²⁹ “Loan” is defined as “any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.”³³⁰ “Security” is defined as having the meaning specified in section 3(a)(10) of the Exchange Act.³³¹ As a result, whether or not a CD, loan, or other instrument is considered a “security” may determine whether or not it is within the definition of “financial instrument” and (absent an exception) subject to the Volcker Rule prohibition on proprietary trading.

§ 2:4.4 OTC Derivatives

[A] Generally

The regulation of the OTC derivatives market has changed dramatically with the signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010, and as rules implementing the Dodd-Frank Act have been promulgated. Understanding the Dodd-Frank regime requires an introduction to the historical development of the regulation of OTC derivatives.

[B] 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),³³² both the SEC and the CFTC³³³ (which has

327. See also *infra* section 2:4.4[D][2] (regarding the Volcker Rule).

328. See, e.g., 12 C.F.R. § 248.3(a).

329. See, e.g., 12 C.F.R. § 248.3(c)(1).

330. See, e.g., 12 C.F.R. § 248.2(s).

331. See, e.g., 12 C.F.R. § 248.2(y).

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

333. 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

exclusive jurisdiction over most commodity futures and options on such futures) sought to assert 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.³³⁴ Partly to address the uncertainties, Congress passed the CFMA in December 2000.

[C] CFMA—Section 3A, 15(i)

In 2000, the CFMA inserted section 3A into the Exchange Act (which, as discussed below, was modified upon the effectiveness of the Dodd-Frank Act) to exclude from the definition of “security” any security-based or non-security-based swap agreement.³³⁵ Section 3A(b) expressly prohibits the SEC from registering, or requiring, recommending, or suggesting the registration of any security-based swap agreement under the Exchange Act.³³⁶

334. created the CFTC as an independent regulatory agency with powers greater than those of its predecessor agency, the Commodity Exchange Authority. The SEC asserted that a “treasury-linked swap” had sufficient optionality to be viewed as a security. *See In re BT Securities Corp.*, SEC Release No. 34-35136 (Dec. 22, 1994); *In re Vazquez*, SEC 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 Tr. Co.*, 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.

335. *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.”).

336. Exchange Act § 3A(b)(2). Although the CFMA excepted the security-based swap agreements from the definition of security, the CFMA amended the anti-fraud 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

Under sections 206A and 206C of the Gramm-Leach-Bliley Act, which was enacted as part of the CFMA, but heavily modified by the Dodd-Frank Act, “swap agreement” and “security-based swap agreement” were very broadly defined; however, certain options on securities and security indexes, and certain forward contracts were excluded.³³⁷

The CFMA also amended section 15(i) of the Exchange Act (subsequently renumbered as section 15(j) by the Dodd-Frank Act), limiting the SEC’s rulemaking and enforcement authority regarding new hybrid products³³⁸ offered by banks.

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

In the wake of the 2008 financial crisis, Congress enacted the Dodd-Frank Act in 2010, and with it, sweeping revisions to the securities and banking laws. One significant emphasis of Dodd-Frank is on the regulation of swaps and other OTC derivatives. Among many other changes, Title VII (the derivatives title) of Dodd-Frank:

- (i) created 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 allocated jurisdiction over swaps, swap dealers, SEFs, and MSPs to the CFTC and over SBS, SBS dealers, SBS SEFs, and SBS MSPs to the SEC;
- (iii) amended the definition of “security” in the Exchange Act to include SBS;
- (iv) modified exclusions from regulation of OTC derivatives in section 3A of the Exchange Act;
- (v) amended the definition of “dealer” in the Exchange Act to exclude dealing activities relating to SBS (other than with non-eligible contract participants (“non-ECPs”));

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.

337. *See* SEC v. Rorech, 720 F. Supp. 2d 367 (S.D.N.Y. 2010) (interpreting these provisions).

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

- (vi) created new mandatory clearing and exchange trading (or SEF/SBS SEF trading) requirements for swaps and SBS (subject to limited exceptions);
- (vii) incorporated SBS into the Exchange Act's beneficial ownership reporting requirements; and
- (viii) requires that a person holding collateral for cleared SBS be registered as a broker-dealer or SBS dealer.³³⁹

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

Title VII of Dodd-Frank includes a large number of regulatory rulemaking requirements, though some provisions of the statute do not require rulemaking to become operative. These rules were generally required to be adopted by July 16, 2011, the same date on which most of Title VII's requirements were to be effective.³⁴⁰ In light of the delays in rulemaking, however, the SEC and CFTC have both used exemptive authority to delay the effectiveness of many of the title's self-implementing provisions (although many of the CFTC provisions have since become effective).³⁴¹

339. See generally *OTC DERIVATIVES REGULATION UNDER DODD-FRANK: A GUIDE TO REGISTRATION, REPORTING, BUSINESS CONDUCT, AND CLEARING* (William C. Meehan & Gabriel D. Rosenberg, eds., 2016).

340. Dodd-Frank Act §§ 754 and 774. Sections 754 and 774 of Dodd-Frank provide that the derivatives provisions generally become effective on July 16, 2011, unless the statute provides otherwise or a rulemaking is required. If a rulemaking is required under a provision, that provision cannot be effective earlier than the later of (i) July 16, 2011, or (ii) at least 60 days after the rule is published.

341. See Second Amendment to July 14, 2011 Order for Swap Regulation, 77 Fed. Reg. 41,260 (July 13, 2012) (amending 17 C.F.R. ch. 1); Amendment to July 14, 2011 Order for Swap Regulation, 76 Fed. Reg. 80,223 (Dec. 23, 2011) (amending 17 C.F.R. ch. 1); Effective Date for Swap Regulation, 76 Fed. Reg. 42,508 (July 19, 2011) (amending 17 C.F.R. ch. 1); Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36,287 (June 22, 2011) (amending 17 C.F.R. pt. 240).

[D][1] New and Amended Definitions**[D][1][a] “Swap,” “SBS” and “Security”**

Title VII of Dodd-Frank, 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. Title VII introduces certain key terms with respect to the SEC’s oversight of the SBS market.³⁴² Some of these terms have been further defined by the SEC, in some cases in conjunction with the CFTC.³⁴³

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 statutory definition of “swap” is complex and is provided in its entirety in the Online Appendix to this chapter.³⁴⁴ 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:³⁴⁵

...

- (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

342. 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.

343. See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; “Mixed Swaps”; “Security-Based Swap Agreement Recordkeeping,” SEC Release No. 34-67453 (July 18, 2012); Online Appendix, *supra* note 225.

344. See also *id.*; Online Appendix, *supra* note 225.

345. Dodd-Frank also gives the Treasury Secretary the authority, under certain findings, to exclude “foreign exchange swaps” and “foreign exchange forwards” for most purposes. Dodd-Frank Act § 721. Pursuant to this authority, on November 20, 2012, the Treasury Secretary issued a determination that foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the Commodity Exchange Act for most purposes (*e.g.*, mandatory swap clearing). Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012).

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.*);
- (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].³⁴⁶

346. CEA § 1a(47). “Mixed swaps” are generally those security-based swaps that are also “based on the value of 1 or more interest or other rates, currencies,

“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.³⁴⁷

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).³⁴⁸ 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.³⁴⁹

commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.” See CEA § 1a(47)(D) and Exchange Act § 3(a)(68)(D).

347. Exchange Act § 3(a)(68)(A).

348. Exchange Act § 3(a)(68)(C).

349. The Dodd-Frank Act 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, the Dodd-Frank Act authorizes the

Dodd-Frank added “security-based swap” to the definition of “security” in section 3(a)(10) of the Exchange Act.³⁵⁰ 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 “does not include any security-based swap agreement.”

New and amended definitions of “swap agreement” and “security-based swap agreement” may be found in the Online Appendix.³⁵¹ Significantly, the definition of “security-based swap agreement” excludes any SBS. Therefore, amended section 3A only serves to exclude from the definition of “security” certain securities-related derivatives that do not constitute SBS as defined above.

[D][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 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 an 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.³⁵²

The definition of SBS dealer specifically excludes “a person that enters into security-based swaps for such person’s own account, either

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.

350. Exchange Act § 3(a)(10).

351. Online Appendix, *supra* note 225.

352. Exchange Act § 3(a)(71)(A).

individually or in a fiduciary capacity, but not as a part of regular business.”³⁵³ The statutory definition also 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.”³⁵⁴ 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.³⁵⁵

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. An 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;
- (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.³⁵⁶

353. Exchange Act § 3(a)(71)(C).

354. Exchange Act § 3(a)(71)(D).

355. Exchange Act § 3(a)(71)(B).

356. Exchange Act § 3(a)(67)(A).

As with SBS dealers, an entity may be designated an SBS MSP for one or more categories of SBS without being classified as an SBS MSP for all classes of SBS.³⁵⁷ The SEC and the CFTC have adopted joint rules on the definition of, among other terms, SBS dealer and SBS MSP.³⁵⁸

Dodd-Frank requires the SEC to adopt rules providing for the registration of SBS Dealers and SBS MSPs. These registration requirements apply regardless of whether the person is also registered with the CFTC as a Swap Dealer or MSP.³⁵⁹ 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.³⁶⁰ 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, for banks.³⁶¹ In addition, there is no concept in Dodd-Frank of a regime parallel to Rule 15a-6 whereby foreign persons can avoid registration as an SBS dealer or SBS MSP through intermediation by a registered SBS dealer or SBS MSP.³⁶²

357. Exchange Act § 3(a)(67)(C).

358. Swap Entity Definition Release, *supra* note 225 (amending 17 C.F.R. pts. 1 & 240); Online Appendix, *supra* note 225.

359. Exchange Act § 15F(c).

360. For example, an SBS between two counterparties that are not SBS dealers or MSPs may be subject to the trade reporting, clearing, and exchange trading rules, in which case, among other things, one of the two counterparties (or, if both counterparties are non-U.S. persons and the trade is executed through a registered broker-dealer or SBS SEF, the broker-dealer or SBS SEF, as appropriate) would be required to report the SBS transaction.

361. For a discussion of exclusions from the definition of "broker" and "dealer" for banks, see *infra* section 2:7.4.

362. For a discussion of Rule 15a-6, see *infra* section 2:7.2.

As noted above, Dodd-Frank introduced 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 an SBS SEF.³⁶³ 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.³⁶⁴

To be registered and maintain registration, an 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.³⁶⁵

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

Dodd-Frank also altered 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 eligible contract participants is not required to register as a broker-dealer. In particular, Dodd-Frank added the following underlined text to the first two paragraphs of the “dealer” definition:

363. Exchange Act § 3C(h).

364. Exchange Act § 3(a)(77).

365. Exchange Act § 3D(d).

- (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.³⁶⁶

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.³⁶⁷ 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. The SEC has proposed Rule 15a-12 under the Exchange Act,³⁶⁸ which would, if adopted in the form proposed, exempt registered SBS SEFs from Exchange Act requirements that are applicable to broker-dealers.³⁶⁹

The SEC has also proposed amending Rule 3a1-1 under the Exchange Act to exempt registered SBS SEFs from the definition of “exchange” if they do not provide a marketplace for transactions in securities other than SBS and comply with regulations applicable to SBS SEFs.³⁷⁰

366. Exchange Act § 3(a)(5).

367. The SEC has, however, temporarily exempted persons that act as brokers with respect to SBS, subject to certain limitations and conditions, from being subject to broker-dealer registration as a result of engaging in SBS brokerage activity. *See* Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, SEC Release No. 34-64795 (July 1, 2011); Order Extending Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, SEC Release No. 34-71485 (Feb. 5, 2014); *see also supra* note 277 and accompanying text.

368. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10,948, 11,052 (proposed Feb. 28, 2011) (amending 17 C.F.R. pts. 240, 242, and 249).

369. *See supra* section 2:1.2.

370. *See* 76 Fed. Reg. 10,948, 10,959 (proposed Feb. 28, 2011) (amending 17 C.F.R. pts. 240, 242, and 249) (discussing the requirements from which SBS SEFs are not exempt).

[D][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. In December 2013, the SEC, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and the CFTC issued final rules implementing the Volcker Rule.³⁷¹ The impact of the Volcker Rule on how affected institutions conduct their trading activities has been significant.

Additionally, section 716 of Dodd-Frank,³⁷² 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 insured depository institutions and U.S. uninsured branches or agencies of foreign banks that are swap dealers or SBS dealers (collectively, “Covered Depository Institutions”). Covered Depository Institutions are subject to the Swaps Push-out Rule only to the extent these entities engage in “structured finance swaps,” which include SBS based on “asset-backed securities” (ABS) or a group or index comprised primarily of ABS. However, these structured finance swaps need not be pushed out if undertaken for hedging or risk management purposes or if they are permitted by rules jointly adopted by the relevant prudential regulators.³⁷³

The Swaps Pushout Rule explicitly allows a Covered Depository Institution to have or establish a swaps entity affiliate. Thus, certain

371. See OCC, Federal Reserve, FDIC and SEC, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Dec. 10, 2013); CFTC, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5808 (Dec. 10, 2013).

372. Section 716 of Dodd-Frank was amended on December 16, 2014, to significantly narrow the scope of swaps and SBS subject to the Swaps Push-out Rule. See Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235 (113th Cong. 2d sess. 2014).

373. Specifically, each ABS underlying the structured finance swap must be of a credit quality and type or category with respect to which the prudential regulators have jointly adopted rules authorizing swap or SBS activity by Covered Depository Institutions.

activities previously permitted to be conducted in a bank may 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.³⁷⁴

§ 2:4.5 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.³⁷⁵ 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].”³⁷⁶ 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.³⁷⁷ A “security futures product” refers to a security future or any put, call, straddle, option, or privilege on any security future.³⁷⁸

Under the regulatory framework established by the CFMA, futures contracts on exempted securities or on broad-based security indices³⁷⁹ 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.³⁸⁰

374. For certain exceptions from the definitions of “broker” and “dealer” for banks, see *infra* section 2:7.4.

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

376. Exchange Act § 3(a)(55)(A); CEA § 1a(44). Section 1a(44) expressly excludes from the definition of “security future” any agreement, contract, or transaction excluded from the CEA 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.

377. CEA § 1a(31).

378. See Exchange Act § 3(a)(56); CEA § 1a(45).

379. 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 Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume; Application of the Definition of Narrow-Based Security Index, SEC Release No. 34-44288 n.8 (May 10, 2001).

380. See *id.*

Broker-dealers who transact security futures must register with both the SEC and the CFTC.³⁸¹

§ 2:5 Exempted Securities

§ 2:5.1 Generally

“Exempted securities” under the Exchange Act, as defined in section 3(a)(12), include, among others, government securities and municipal securities.³⁸² 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.³⁸³

§ 2:5.2 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.³⁸⁴

381. Firms already registered with either the SEC or the CFTC may 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 85; *see* CEA § 6f(a)(2); Exchange Act § 15(b)(11); Rule 15b11-1; Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the Securities Exchange Act of 1934, SEC Release No. 34-44730 (Aug. 21, 2001) (adopting Rule 15b11-1).

382. *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).

383. *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).

384. Exchange Act § 3(a)(42); *see also* Nat’l Credit Union Admin., SEC No-Action Letter (Sept. 24, 2010) (stating that securities guaranteed by the

[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 15.³⁸⁵ 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 other than certain financial institutions³⁸⁶ to register with the SEC and comply with other requirements set forth under section 15C,³⁸⁷ including maintaining membership in a national securities exchange or a national securities association, that is, FINRA.³⁸⁸

§ 2:5.3 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 15.³⁸⁹

National Credit Union Administration will be considered obligations guaranteed as to principal and interest by the United States for purposes of section 3(a)(42) of the Exchange Act).

385. Exchange Act § 15(a)(1).

386. “Financial institution” generally includes a bank, a foreign bank, and a savings association with FDIC deposit insurance. *See* Exchange Act § 3(a)(46).

387. *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). Even if not required to register with the SEC, U.S. and foreign banks engaging in government securities broker or dealer activities may be required to file a notification on Form G-FIN with the designated bank regulatory agency. *See* Exchange Act § 15C(a)(1)(B).

388. Exchange Act § 15C(e)(1).

389. Exchange Act § 3(a)(12)(B).

[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, and therefore a municipal securities broker must register as a broker-dealer.³⁹⁰ Section 15B requires that 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.³⁹¹

§ 2:5.4 Other Exempted Securities

Besides government securities and municipal securities, there are five other categories of exempted securities under section 3(a)(12).³⁹² In addition, securities issued by the International Bank for Reconstruction and Development are deemed to be exempted securities under the Exchange Act.³⁹³ 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).³⁹⁴

§ 2:6 Intrastate 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”).³⁹⁵ This is an extremely narrow exemption, and the SEC has construed the

390. 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.

391. See Exchange Act § 15B.

392. See Exchange Act § 3(a)(12)(A)(iii)–(vii).

393. 22 U.S.C. § 286k-1.

394. 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).

395. 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).

term “exclusively intrastate” strictly.³⁹⁶ 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,³⁹⁷ nor from applicable state requirements.

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.³⁹⁸ 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.³⁹⁹

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)⁴⁰⁰ of the Securities Act and Rule 147⁴⁰¹ promulgated under it provide guidance on ascertaining when the issuer is deemed to be a “resident” of, and “doing business” within, a state.⁴⁰² Under Rule 147,

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396. 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); Study on Investment Advisers and Broker-Dealers, *supra* note 29, at 89.
397. 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 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).
398. See Don Chamberlin, SEC No-Action Letter (Aug. 10, 1979); Heritage Homes and Investment of Palo Alto, SEC No-Action Letter (Aug. 10, 1979).
399. 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 re* Professional Investors, Inc., 37 S.E.C. 173 (May 25, 1956).
400. 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.”
401. See Securities Act Rule 147(c).
402. 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

all of the persons being offered and sold securities must be residents of and located within the same state.⁴⁰³ The SEC has, however, recently proposed to amend Rule 147 to eliminate the restriction on offers (but not sales) to out-of-state residents and ease the issuer residence requirement.⁴⁰⁴

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.⁴⁰⁵ 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.⁴⁰⁶

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.⁴⁰⁷ All aspects of the transaction must be exclusively within the state, and the broker-dealer cannot otherwise engage in securities activities having interstate implications.⁴⁰⁸

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 Intrastate 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).

403. *See* Arizona Property Investors, Ltd., SEC No-Action Letter (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 re* Capital Funds, Inc., Admin. Proc. File No. 8-10968 (Sept. 19, 1963).
404. *See* Exemptions to Facilitate Intrastate and Regional Securities Offerings, SEC Release No. 33-9973 (Nov. 10, 2015).
405. Arizona Property Investors, Ltd., SEC No-Action Letter (Nov. 17, 1979); American Liberty Financial Corp., SEC Denial of No-Action Letter (Dec. 21, 1975).
406. *See* American Liberty Financial Corp., SEC Denial of No-Action Letter (Dec. 21, 1975).
407. CMS Financial Group, Inc., SEC Denial of No-Action Letter (Apr. 2, 1990); *In re* Professional Investors, Inc., 37 S.E.C. 173 (May 25, 1956); Buy Blue Chip Stocks Direct, SEC Denial of No-Action Letter (Jan. 24, 1996).
408. *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.

§ 2:7 Other Exemptions from Registration

§ 2:7.1 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.⁴⁰⁹ 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. . . .”⁴¹⁰ However, the commercial paper exclusion in the Exchange Act’s definition of security has been construed as coextensive with the commercial paper exemption in section 3(a)(3) of the Securities Act.⁴¹¹

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.”⁴¹² 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.⁴¹³

409. Exchange Act § 15(a)(1).

410. Exchange Act § 3(a)(10). In *Reves v. Ernst & Young*, 494 U.S. 56, 65 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.

411. Compare Securities Act § 3(a)(3), with Exchange Act § 3(a)(10); see also *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); *Prescient Markets, Inc.*, SEC No-Action Letter (Jan. 29, 2001). The question of whether commercial paper is a “security” is also relevant for banking entities’ compliance with the Volcker Rule’s restrictions on proprietary trading. See *supra* note 327 and accompanying text.

412. See Interpretation of Section 3(a)(3), SEC Release No. 33-4412 (Sept. 20, 1961); *In re Minotaur Capital, Inc.*, SEC Release No. 34-42155 (Nov. 18, 1999); *UBS Asset Mgmt. (New York) Inc. 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).

413. See *Mercury Finance Co.*, SEC No-Action Letter (Feb. 21, 1989); *Russell Corp.*, SEC No-Action Letter (Sept. 22, 1988); *Imperial Corp. of Am.*, SEC No-Action Letter (Sept. 21, 1988); *Coles & Griffin, Ltd.*, SEC No-Action Letter (Aug. 5, 1982) (reiterating “prime quality” requirement).

§ 2:7.2 **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 any means or instrumentality of interstate commerce to effect securities transactions.⁴¹⁴ The definitions of “broker” and “dealer” include “any person” regardless of their citizenship or location.⁴¹⁵ 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.”⁴¹⁶ 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.⁴¹⁷

414. Exchange Act § 15(a)(1).

415. Exchange Act §§ 3(a)(4)(A) and 3(a)(5)(A).

416. Exchange Act § 3(a)(17). The term “interstate commerce” also includes intrastate use of (i) any facility of a national securities exchange or of a telephone or other interstate means of communication, or (ii) any other interstate instrumentality. *Id.*

417. See Rule 15a-6 Adopting Release, *supra* note 31, at n.20. The SEC has recently brought several enforcement actions against several foreign banks and financial services firms for acting as unregistered broker-dealers by virtue of their solicitation of U.S. persons. See, e.g., *In re HSBC Private Bank (Suisse) SA*, SEC Release No. 34-73681 (Nov. 25, 2014); *In re Credit Suisse Group AG*, SEC Release No. 34-71593 (Feb. 21, 2014); *In re ABN AMRO Bank N.V.*, SEC Release No. 34-70086 (July 31, 2013); *In re Ambit Capital Pvt. Ltd.*, SEC Release No. 34-68295 (Nov. 27, 2012); *In re Motilal Oswal Securities Ltd.*, SEC Release No. 34-68296 (Nov. 27, 2012); *In re JM Financial Institutional Securities Private Ltd.*, SEC Release No. 34-68297 (Nov. 27, 2012); *In re Edelweiss Financial Services, Ltd.*, SEC Release No. 34-68298 (Nov. 27, 2012) (finding Indian financial services firm violated section 15(a) by contacting U.S. investors regarding potential investments in public offerings of Indian issuers); *In re Banco Espirito Santo S.A.*, SEC Release No. 34-65608 (Oct. 24, 2011) (finding that Banco Espirito Santo S.A. acted as an unregistered broker-dealer by offering brokerage services and investment advice to U.S. residents who were primarily Portuguese immigrants without the intermediation of a Registered Broker-Dealer); and *SEC v. UBS AG*, 100:09-CV-00316, 2009 U.S. Dist. LEXIS 123034 (D.D.C. Feb. 18, 2009) (alleging that UBS AG conducted a cross-border business by soliciting U.S. persons and offshore entities with U.S. citizens as beneficial owners through client advisers primarily located in Switzerland who traveled to the United States several times a year for the purpose of soliciting and communicating with U.S. cross-border clients).

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.⁴¹⁸ 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.⁴¹⁹ In 1981, the SEC permitted a foreign broker-dealer to prepare research for distribution into the United States through a Registered Broker-Dealer that disseminated research under its own name and had the primary relationship with U.S. customers in connection with transactions in the researched securities.⁴²⁰ 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.⁴²¹ 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.⁴²² The SEC also issued several no-action letters to exempt foreign affiliates of U.S. banks or U.S. branches of foreign banks that

418. 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).

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

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

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

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

proposed to execute transactions through, or on behalf of, a U.S. broker-dealer affiliate.⁴²³

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.⁴²⁴ Accordingly, these no-action letters continue to provide guidance on the registration requirements for 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 a business in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent evasion of this title."⁴²⁵ Before the adoption of Rule 15a-6, the SEC had not recognized any exemptions under this provision.⁴²⁶ By contrast, courts held that the section 30(b) exemption is unavailable under three circumstances:⁴²⁷

- (i) if transactions occurred in a U.S. securities market;⁴²⁸
- (ii) if offers and sales were made abroad to U.S. persons or in the United States to facilitate sales of securities abroad;⁴²⁹ or
- (iii) if the United States was used as a base for securities fraud perpetrated on foreigners.⁴³⁰

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 "without the jurisdiction of the United States" in section 30(b) does not refer to territorial limits of this country, and a broker-dealer

423. 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).

424. See Rule 15a-6 Adopting Release, *supra* note 31, at 32.

425. Exchange Act § 30(b).

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

427. See Rule 15a-6 Adopting Release, *supra* note 31.

428. *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. Bank of Bermuda, Ltd.*, 385 F. Supp. 415 (S.D.N.Y. 1974).

429. *SEC v. United Fin. Grp., Inc.*, 474 F.2d 354 (9th Cir. 1973).

430. *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).

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.⁴³¹

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.⁴³²

In 2010, in *Morrison v. National Australia Bank Ltd.*,⁴³³ the U.S. Supreme Court held that the anti-fraud 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,⁴³⁴ or (ii) the purchase

431. See Rule 15a-6 Adopting Release, *supra* note 31, at 13.

432. See, e.g., Dilworth Capital Management LLC, SEC Denial of No-Action Request (Dec. 9, 2004); *but see* SEC v. Benger, 934 F. Supp. 2d 1008 (N.D. Ill. 2013) (rejecting this reading of section 15(a) and finding the broker-dealer registration requirement does not apply to a person in the United States that solicits foreign investors to invest in foreign securities).

433. *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010); *see also* Elliott Assocs. v. Porsche Auto. Holding SE, 759 F. Supp. 2d 469 (S.D.N.Y. 2010) (explaining the Exchange Act does not permit a cause of action for “transactions in foreign-traded securities—or swap agreements that reference them—where only the purchaser is located in the United States”), *aff'd on other grounds*, Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings, No. 11-397-CV(L) (2d Cir. 2014); *see also In re Société Générale Sec. Litig.*, No. 08 Civ. 2495, 2010 U.S. Dist. LEXIS 107719 (S.D.N.Y. Sept. 9, 2010) (finding section 10(b) of the Exchange Act inapplicable to trades in American Depository Shares because they are predominantly foreign securities transactions); *see also In re Royal Bank of Scot. Grp. PLC Sec. Litig.*, 765 F. Supp. 2d 327 (S.D.N.Y. 2011) (rejecting an argument that the Exchange Act applies to any securities listed on a U.S. exchange, regardless of whether the security is purchased in the United States or through a U.S. exchange); *see also* Absolute Activist Value Master Ltd. v. Ficeto, 672 F.3d 143 (2d Cir. 2012) (holding that in order for a transaction other than on a U.S. exchange to be a “domestic transaction” subject to section 10(b) under *Morrison*, either irrevocable liability was incurred or title transferred in the United States).

434. *But see* City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, 752 F.3d 173 (2d Cir. 2014) (holding that *Morrison* precludes claims brought under the Exchange Act by purchasers of shares of a foreign issuer on a foreign exchange, even if those shares are cross-listed on a U.S. exchange); *see also* Elliott Assocs. v. Porsche Automobil Holding SE, 759 F. Supp. 2d 469, 473 (S.D.N.Y. 2010) (finding section 10(b) of the Exchange Act inapplicable to a domestic security-based swap agreement that referenced a foreign security and where the allegedly fraudulent statements occurred mostly outside of the United States), *aff'd on other grounds*, Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

or sale of any other security in the United States.⁴³⁵ It is unclear at present how the holding in this case might be extended to the broker-dealer registration context, although some courts have found that *Morrison* narrows the scope of broker-dealer registration requirements to apply only to domestic transactions.⁴³⁶

Finally, it should be noted that Title VII of the Dodd-Frank Act amended 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

435. *But see id.* (holding the mere placement of a buy order in the United States, standing alone, for the purchase of foreign securities on a foreign exchange is not sufficient to allege that a purchaser incurred irrevocable liability in the United States). As part of the Dodd-Frank Act, Congress attempted to supersede *Morrison* with respect to U.S. government and SEC actions, providing the SEC and U.S. courts with jurisdiction with respect to alleged violations of the anti-fraud provisions of the securities laws. *See* Dodd-Frank Act § 929P. As amended by Dodd-Frank, in U.S. government and SEC actions, jurisdiction includes “conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors” as well as “conduct occurring outside the United States that has a foreseeable substantial effect within the United States.” Exchange Act § 27, as amended by Dodd-Frank Act § 929P. Commentators and courts have, however, questioned whether the Dodd-Frank amendments actually supersede *Morrison*—as the Dodd-Frank amendments only addressed the question of subject matter jurisdiction, while *Morrison* addressed the substantive scope of the application of the securities laws. *See, e.g.,* SEC v. A Chi. Convention Ctr., 961 F. Supp. 2d 905 (N.D. Ill. 2013) (discussing “complex interpretation issue” of “how to interpret Section 929P(b) in light of th[e] conflict between the language as drafted and Congress’s possible intent” to supersede *Morrison*). In response to this decision, the SEC adopted Rule 250.1, codifying by rule its own interpretation of the scope of its cross-border antifraud enforcement authority. *See* Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities, SEC Release No. 34-72472 (June 25, 2014).

436. *See* SEC v. Bengert, 934 F. Supp. 2d 1008 (N.D. Ill. 2013) (holding that *Morrison* precluded the SEC from bringing an action against a person for failure to register as a broker-dealer where the person conducted brokerage activity from within the United States, but the transactions were to occur outside the United States and involved non-U.S. securities); *see also* SEC v. Battoo, No. 1:12-CV-07125, 2016 U.S. Dist. LEXIS 8380 (N.D. Ill. Jan. 25, 2016) (finding broker-dealer registration requirements applied because, under *Morrison*, at least some investors incurred irrevocable liability within the United States).

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 2010.⁴³⁷

The SEC and CFTC have taken steps to clarify the scope of the extraterritorial reach of Title VII of Dodd-Frank. The CFTC adopted interpretive guidance regarding the cross-border application of the swap-related provisions of Title VII of the Dodd-Frank Act,⁴³⁸ while the SEC has proposed and adopted rules regarding the extraterritorial application of particular SBS-related requirements.⁴³⁹ The SEC has indicated that it anticipates addressing the remaining issues from the proposed cross-border rules in subsequent releases.⁴⁴⁰ These swap and SBS cross-border rules may be relevant to the SEC's future thinking on broker-dealer cross-border issues.

[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.⁴⁴¹ Rule 15a-6 provides conditional exemptions from broker-dealer registration for foreign broker-dealers⁴⁴² that have indirect contacts with U.S. persons

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

438. See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013). See also Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 43,785 (July 22, 2013).

439. See Cross-Border Security-Based Swap Activities, SEC Release No. 34-69490 (May 1, 2013); Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent, SEC Release No. 34-74834 (Apr. 29, 2015); Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, SEC Release No. 34-17194 (Feb. 19, 2016).

440. See *id.* at text accompanying n.6.

441. Rule 15a-6 Adopting Release, *supra* note 31, at 5.

442. "Foreign broker or dealer" is defined 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'".

through unsolicited transactions, distribution of research reports to large institutions, solicitation or effecting of transactions with certain U.S. institutional investors through Registered Broker-Dealers,⁴⁴³ or solicitation or effecting of securities transactions with certain defined classes of persons without intermediaries.⁴⁴⁴

[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) of the Exchange Act.⁴⁴⁵ 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.⁴⁴⁶ Thus, an individual securities transaction by a client 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.⁴⁴⁷

in sections 3(a)(4) or 3(a)(5) of the [Exchange] Act.” Rule 15a-6(b)(3). This definition also includes foreign banks to the extent that they operate from outside the United States, but not their U.S. branches or agencies. Rule 15a-6 Adopting Release, *supra* note 31, at 35.

443. FINRA staff has recently scrutinized carefully proposed activities of FINRA members and applicants under Rule 15a-6 arrangements. *See also* SEC Staff 15a-6 FAQ, *supra* note 195.

444. *See* Rule 15a-6 Adopting Release, *supra* note 31, at 29–30.

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

446. 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 31, at 21; SEC Staff 15a-6 FAQ, *supra* note 195, at Question 9. Solicitation would not, however, include providing an investor on an otherwise unsolicited transaction with a transaction confirmation, periodic account statements, or documents required to be delivered under foreign law. *See* SEC Staff 15a-6 FAQ, *supra* note 195, at Question 3.

447. The SEC staff has, however, indicated that a foreign broker-dealer that provides employee stock plan services to a foreign issuer could, under certain circumstances, rely on the unsolicited exemption to effect transactions for U.S. employees participating in the foreign employer’s stock plan. *See also* SEC Staff 15a-6 FAQ, *supra* note 195, at Questions 2–2.4.

[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 reports⁴⁴⁸ directly to major U.S. institutional investors⁴⁴⁹ 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;⁴⁵⁰
- (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;⁴⁵¹

448. 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 31, at n.106.

449. 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 455, the definition of “major U.S. institutional investor” was effectively extended in a subsequent no-action letter and SEC staff guidance 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, or any entity owned exclusively by one or more major U.S. institutional investors.

450. 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 31, at 100–01.

451. 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

- (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);⁴⁵² 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.⁴⁵³

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)⁴⁵⁴ through a Registered Broker-Dealer (an

in Rule 15a-6(a)(3). *See* Rule 15a-6 Adopting Release, *supra* note 31, 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*].

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

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

454. 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 *Nine Firms 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 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 451. The SEC staff has also interpreted “major U.S. institutional investor” to include any entity, all of the equity owners of which are major U.S. institutional investors. SEC Staff 15a-6 FAQ, *supra* note 195, at Question 18. Although an investor generally must have \$100 million in financial assets in order to be considered a “major U.S. institutional investor,” the staff has on one occasion permitted an unregistered foreign firm providing cross-border M&A advice pursuant to a chaperoning arrangement in reliance on Rule 15a-6(a)(3) to treat companies that have

“(a)(3) Arrangement”).⁴⁵⁵ 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;⁴⁵⁶
- (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;⁴⁵⁷
- (iv) take all required capital charges in compliance with 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;⁴⁵⁸

\$100 million in *total* assets (even if not financial assets) as though they were major U.S. institutional investors. Ernst & Young Corporate Finance (Canada) Inc., SEC No-Action Letter (July 12, 2012).

455. 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 31, at 57. A foreign broker-dealer may also simultaneously maintain an intermediation relationship with numerous Registered Broker-Dealers for the same potential transaction, with the intermediating broker-dealer deemed to be whichever effects the transaction. See LiquidityHub Limited, SEC No-Action Letter (Oct. 5, 2007). An unregistered foreign broker-dealer may also solicit major U.S. institutional investors for transactions to be entered into with other unregistered foreign broker-dealers—so long as the unregistered foreign broker-dealer entering into the transaction itself conducts the transaction pursuant to a 15a-6(a)(3) arrangement with a Registered Broker-Dealer. *Id.* As discussed in section 2:2.7[C][2], the SEC staff recently granted no-action relief that would allow direct communications—outside of Rule 15a-6—between a non-U.S. broker representing a non-U.S. company in a potential M&A transaction and potential targets in the United States.

456. The Registered Broker-Dealer could, however, satisfy this obligation through the delivery of confirmations and account statements by the foreign broker-dealer. See SEC Staff 15a-6 FAQ, *supra* note 195, at Questions 4-4.1.

457. See SEC Staff 15a-6 FAQ, *supra* note 195, at Question 16.

458. 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 that: (i) the transactions involve foreign securities or U.S.

- (vi) review trades executed by the foreign broker-dealer for indications of possible violations of the federal securities laws;⁴⁵⁹ and
- (vii) obtain consents to service of process from the foreign broker-dealer and its foreign associated persons⁴⁶⁰ 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.”⁴⁶¹

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.⁴⁶² In addition, the foreign broker-dealer must provide the SEC (upon request or pursuant to agreements between

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 451.

459. This requirement is not explicit in Rule 15a-6, but it is expressed in the Rule 15a-6 Adopting Release, *supra* note 31.

460. Rule 15a-6 Adopting Release, *supra* note 31, 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).

461. Rule 15a-6(a)(3)(ii).

462. 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 United States 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

the SEC and the foreign securities authority) with any information or documents within its possession, subject to exceptions.⁴⁶³

[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:

- (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;⁴⁶⁴
- (v) non-U.S. branches or agencies of U.S. persons outside the United States, provided that transactions occur outside the United States; and
- (vi) with certain exceptions, U.S. citizens resident outside the United States.⁴⁶⁵

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

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 451.

463. Rule 15a-6(a)(3)(i)(B).

464. Whether a person is "temporarily present" depends on the facts-and-circumstances; however, to be considered a "foreign person," the person generally could not be a U.S. citizen or lawful permanent resident. See SEC Staff 15a-6 FAQ, *supra* note 195, at Question 1.

465. 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 31, at 97.

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).⁴⁶⁶

The SEC, in a 1996 no-action letter, permitted U.S.-affiliated foreign broker-dealers to effect transactions in foreign securities⁴⁶⁷ with U.S. resident fiduciaries⁴⁶⁸ for “offshore clients”⁴⁶⁹ 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”;

466. 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).

467. 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 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).

468. 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 *id.*

469. “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 (A) has \$500,000 or more under the management of the U.S. resident fiduciary or (B) has, together with the person’s spouse, a net worth in excess of \$1 million, 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 *id.*

- (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.⁴⁷⁰

[C] Other Cross-Border Issues

In 2000, the SEC published guidance on the use of electronic media by issuers of all types, including operating companies, investment companies and municipal securities issuers, as well as market intermediaries to ensure full and fair disclosure.⁴⁷¹ Among other things, the SEC outlined the basic legal principles that issuers, underwriters and other offering participants should consider in conducting online offerings. The guidance 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.⁴⁷²

[D] 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-6.⁴⁷³ The proposal would have lowered the asset threshold for investors under the rule and, in certain circumstances, would have allowed foreign broker-dealers to effect transactions and custody securities and funds.

The SEC has not acted on this proposal, although its staff has indicated that there may be interest in renewing efforts to update Rule 15a-6.

§ 2:7.3 Mutual Recognition of Foreign Broker-Dealers

Foreign broker-dealers seeking access to U.S. investors currently are required to register under Exchange Act section 15(a), with limited

470. *See id.*

471. SEC Interpretation: Use of Electronic Media, SEC Release No. 34-42728 (Apr. 28, 2000).

472. *Id.*

473. Exemptions of Certain Foreign Brokers or Dealers, SEC Release No. 34-58047 (June 27, 2008).

exemptions provided by Rule 15a-6.⁴⁷⁴ As the need of U.S. investors to access foreign securities increases, the SEC has in the past considered expanding U.S. investors' access 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."⁴⁷⁵ Under this approach, foreign broker-dealers (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.⁴⁷⁶ 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.⁴⁷⁷ On August 26, 2008, the SEC and its Australian counterpart signed a mutual recognition agreement.⁴⁷⁸ Mutual recognition exemptions have not resulted from these agreements.

§ 2:7.4 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

474. See Exchange Act § 15(a); Rule 15a-6.

475. 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 United States with major U.S. institutional investors. See Recognition of Foreign Broker-Dealer Regulation, SEC Release No. 34-27018 (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 United States. See Regulation of Exchanges, SEC Release No. 34-38672 (May 23, 1997).

476. Press Release, SEC, SEC Announces Next Steps for Implementation of Mutual Recognition Concept (Mar. 24, 2008), <http://www.sec.gov/news/press/2008/2008-49.htm>.

477. Press Release, SEC, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement (May 29, 2008), <http://www.sec.gov/news/press/2008/2008-98.htm>.

478. Press Release, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 26, 2008), <http://www.sec.gov/news/press/2008/2008-182.htm>.

or dealers. Among other things, the GLBA amended sections 3(a)(4) and 3(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.⁴⁷⁹ The SEC later adopted rules implementing the “push-out” provisions.⁴⁸⁰

[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 any one or more of the following activities:

- (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;⁴⁸¹ and

479. 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.

480. See Regulation R Adopting Release, *supra* note 115.

481. 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 creditworthiness; 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

(x) transactions in municipal securities.⁴⁸²

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. 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,⁴⁸³ which among other things, provides interpretive guidance for the exemptions provided for banks listed in section 3(a)(4).⁴⁸⁴ 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.⁴⁸⁵

[B][3] Networking Arrangements

The “push-out” provisions permit banks to enter into arrangements with Registered Broker-Dealers, under which the broker-dealers

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. § 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. However, a bank engaging in certain derivatives activity may need to register as a security-based swap dealer or swap dealer. *See* Swap Entity Definition Release, *supra* note 225.

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

483. This joint rulemaking was required by the Financial Services Regulatory Relief Act of 2006. *See* Regulation R Adopting Release, *supra* note 115.

484. *Id.* 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.

485. Regulation R Rules 700, 721, 740 and 760; *see* Regulation R Adopting Release, *supra* note 115, at 10.

offer brokerage services on or off the premises of the bank (“networking arrangements”) if certain conditions are met.⁴⁸⁶ 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.⁴⁸⁷ 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 net worth customers.”⁴⁸⁸ 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.⁴⁸⁹

[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 that is regularly examined for compliance with fiduciary principles and standards).⁴⁹⁰ 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.⁴⁹¹ Regulation R provides criteria for determining “relationship compensation” and a bank’s compliance with the trust and fiduciary activities exception.⁴⁹²

In addition, when a bank’s activities would result in a transaction in publicly traded securities in the United States, section 3(a)(4)(C) conditions the exception for trust and fiduciary activities (and certain of the other GLBA exceptions) on the trade being (i) directed to a

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

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

488. Regulation R 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 Regulation R Rule 701.

489. Regulation R Rule 701(iv).

490. 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.

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

492. See Regulation R Rules 721 and 722.

Registered Broker-Dealer for execution; (ii) a cross-trade, subject to certain conditions; or (iii) conducted in some other manner permitted by SEC rules.

[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.⁴⁹³ Regulation R provides definitions for “money market fund,” “no-load,” and other terms,⁴⁹⁴ and a conditional exemption for banks effecting transactions in money market funds.⁴⁹⁵

[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.⁴⁹⁶

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.⁴⁹⁷ 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

493. Exchange Act § 3(a)(4)(B)(v).

494. Regulation R Rule 740.

495. Regulation R Rule 741.

496. 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.

497. Regulation R Rule 760.

bank complies with the trade execution and carrying broker requirements of the Exchange Act.⁴⁹⁸ The trade execution limitation in section 3(a)(4)(C) referred to above in section 2:7.4[B][4] 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;
- (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.⁴⁹⁹

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.⁵⁰⁰

[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."⁵⁰¹ 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

498. Regulation R Rule 760(d).

499. Regulation R Rules 771, 772, 775, 776 and 780.

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

501. 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 further discussion of the dealer-trader distinction, see *supra* section 2:3.2.

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.⁵⁰²

[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.⁵⁰³ However, the number of such riskless principal 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 500.⁵⁰⁴

502. Exchange Act § 3(a)(5)(C). All of these exceptions, other than the exception for engaging in securities transactions for the bank’s investment purposes and the exception for engaging in certain asset-backed transactions, are also exceptions from the “broker” definition. *See* Exchange Act §§ 3(a)(4)(B)(ii), (iii), and (ix).

503. 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 (May 11, 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 (May 11, 2001).

504. 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* Bank Exemptions Adopting Release, *supra* note 213.

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

Ordinarily, persons in the United States may not act as broker-dealers 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.⁵⁰⁵ Rule 3a5-2 provides a similar exemption for banks that effect riskless principal transactions⁵⁰⁶ with non-U.S. persons involving Regulation S Securities.⁵⁰⁷

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

- (i) purchases an eligible security⁵⁰⁸ from an issuer or a broker-dealer and sells that security in compliance with the requirements of Rule 903 of Regulation S to a purchaser⁵⁰⁹ 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;⁵¹⁰ 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.⁵¹¹

505. Regulation R Adopting Release, *supra* note 115.

506. “Riskless principal transaction” is defined in Rule 3a5-2(b)(4) and has the same meaning as that in Rule 3a5-1(b).

507. *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).

508. “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.

509. 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).

510. *See* Rule 3a5-2(a)(2).

511. *See* Rule 3a5-2(a)(3).

[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.⁵¹² Rule 3a5-3 provides an exemption from the definition of “dealer” for banks engaging in certain securities lending transactions, as conduit lenders.⁵¹³

Under Rule 3a5-3, a bank is exempt from the definition of “dealer” to the extent that, as a conduit lender,⁵¹⁴ it engages in or effects securities lending transactions, and any securities lending services⁵¹⁵ in connection with such transactions.⁵¹⁶ 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,⁵¹⁷ or (ii) any employee benefit plan that owns and invests, on a discretionary basis, not less than \$25 million in investments.⁵¹⁸

§ 2:7.5 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

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

513. 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).

514. 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).

515. “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).

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

517. 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.

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

a charitable organization,⁵¹⁹ or any person⁵²⁰ of such a charitable organization acting within the scope of such person's employment or duties with such organization,⁵²¹ that 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 charitable organization, (ii) a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment 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.⁵²² 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 fundraising 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.⁵²³

§ 2:7.6 Funding Portals

The JOBS Act created a new exemption from Securities Act registration for qualified “crowdfunding” transactions.⁵²⁴ In order for

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519. Nemzoff & Company LLC, SEC Denial of No-Action Request (Nov. 30, 2010) (consulting company providing services to a not-for-profit entity does not fall into the category of “charitable organization” under section 3(e) of the Exchange Act).
520. Such person includes any trustee, director, officer, employee, or volunteer of such a charitable organization. *See* Exchange Act § 3(e)(1).
521. “Charitable organization” is defined in section 3(c)(10)(D)(iii) of the Investment Company Act.
522. Exchange Act § 3(e)(1).
523. Exchange Act § 3(e)(2). *See also* Nemzoff & Co. LLC, SEC Denial of No-Action Request (Nov. 30, 2010) (receipt of transaction-related compensation for the sale of not-for-profit entity is “inconsistent with the compensation limitation in Section 3(e)(2)”; *but see* Social Finance Inc., SEC No-Action Letter (Nov. 13, 2014) (granting no-action relief to a not-for-profit entity intermediating the offering of “social impact bonds” notwithstanding its receipt of annual intermediation fees commencing on the closing of a social impact bond offering).
524. Under section 4(a)(6) of the Securities Act, subject to various conditions, a transaction would be exempt from registration under section 5 of the Securities Act if the total aggregate amount of securities sold by an issuer during the 12-month period preceding the date of the transaction is not more than \$1 million, and the amount sold to any investor during a 12-month period is (i) for investors with less than \$100,000 in net worth

a transaction to qualify for the exemption, among other things, it must be conducted through a registered broker or a registered “funding portal” that fulfills obligations in connection with the transaction, such as providing risk disclosures to investors and taking measures to reduce the risk of fraud.

A funding portal is defined as a person that acts as an intermediary in a crowdfunding transaction, but does not offer investment advice or recommendations; solicit offers or transactions; compensate employees, agents, or other persons for solicitation or based on the sale of securities; or hold, manage, or possess investor funds or securities.⁵²⁵ A funding portal is required to register as such with the SEC. However, the JOBS Act requires the SEC to adopt rules exempting funding portals from broker-dealer registration, provided that the funding portal:

- (i) is a member of a registered national securities association;
- (ii) remains subject to SEC examination, enforcement, and rule-making authority; and
- (iii) meets such other requirements that the SEC deems appropriate.⁵²⁶

While a funding portal must become a member of a registered national securities association, the national securities association may only examine for and enforce with regard to funding portal members those rules specifically written for registered funding portals.

In October 2015, the SEC adopted Regulation Crowdfunding, which governs the offer and sale of securities under section 4(a)(6) of the Securities Act and also provides the framework for the regulation of registered funding portals, among other things.⁵²⁷ Additionally, in January 2016, FINRA also adopted its own separate rulebook for funding portal members.⁵²⁸ FINRA’s proposed funding portal member

or annual income, the greater of \$2,000 or 5% of their annual income or net worth, and (ii) for investors with greater than \$100,000 in annual income or net worth, up to 10% of the investor’s annual income or net worth, not to exceed \$100,000.

525. The SEC has authority to adopt other restrictions by rule. Exchange Act § 3(a)(80)(E). In adopting crowdfunding rules, the SEC did not elect to impose any additional prohibited activities in which a funding portal may not engage. *See* Crowdfunding, SEC Release No. 33-9974 (Oct. 30, 2015).

526. Exchange Act § 3(h); *see also* Crowdfunding, SEC Release No. 33-9974 (Oct. 30, 2015).

527. *Id.*

528. *See* FINRA Regulatory Notice 16-06 (Jan. 2016). For a further discussion of the SEC’s and FINRA’s crowdfunding rules, *see* Davis Polk Client Memorandum, SEC Adopts Crowdfunding Rules (Nov. 19, 2015), http://www.davispolk.com/sites/default/files/2015-11-19_SEC_Adopts_Crowdfunding_Rules.pdf.

rules are based on its existing rules that apply to broker-dealer members, but simplified to reflect the limited nature of funding portals' business.

§ 2:7.7 Associated Persons of Registered Broker-Dealers

[A] Section 15(a)(1)

Absent an exemption, a person (including a natural 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.⁵²⁹ 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 any person associated with a broker-dealer whose functions are solely clerical or ministerial.⁵³⁰ 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.⁵³¹ Of course, the broker-dealer with whom the natural person is associated must register with the SEC, absent an exemption.

[B] Retired Brokers—SEC Guidance and FINRA Rules 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 Broker-Dealer.

However, 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 person upon retirement.⁵³² In each case, there has to be a bona fide contract between

529. 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).

530. Exchange Act § 3(a)(18).

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

532. *See, e.g.*, Packerland Brokerage Services, SEC No-Action Letter (Mar. 18, 2013); Securities Industry and Financial Markets Ass'n, SEC No-Action Letter

the securities firm and the retiring representative providing 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 predetermined percentage scale between the retiring representative and the receiving registered representative;
- (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, and may not be 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 or 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.⁵³³

(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].

533. See Retiring Representative No-Action Letters, *supra* note 532.

In addition, the securities firm must approve the receiving representative, who must meet certain eligibility criteria.⁵³⁴ 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.⁵³⁵

Effective August 2015,⁵³⁶ FINRA has adopted much of the SEC's prior guidance into its rules. FINRA Rule 2040 generally prohibits FINRA members and associated persons from paying, 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 and related activities, would be required to be so registered.⁵³⁷ The rule permits, however, members to pay continuing commissions to a retired registered representative of the member, after the representative ceases to be employed by the member, where the commissions are derived from accounts held for continuing customers of the retired 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 federal securities laws, and SEC rules and regulations.⁵³⁸

534. 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.*

535. *See id.*

536. FINRA Rule 2040 is effective on August 24, 2015. *See* FINRA Regulatory Notice 15-07 (Mar. 2015).

537. *See infra* section 2:8.4[A].

538. While FINRA Rule 2040 does not expressly list each condition set forth in the prior SEC no-action letters, FINRA has stated that the rule incorporates the SEC's prior guidance by requiring that any proposed compensation arrangement comply with applicable SEC rules and regulations. *See* Order Approving Proposed Rule Change to FINRA Rules 0190 (Effective

§ 2:7.8 **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.⁵³⁹ 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.⁵⁴⁰ The rule is intended to facilitate participation by qualified lending institutions in the SBA's guaranteed loan program.⁵⁴¹

§ 2:7.9 **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.⁵⁴² The SEC must find that any such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.⁵⁴³

Date of Revocation, Cancellation, Expulsion, Suspension or Resignation) and 2040 (Payments to Unregistered Persons) in the Consolidated FINRA Rulebook, and Amend FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar), SEC Release No. 34-73954 (Dec. 30, 2014).

539. Rule 15a-2.

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

541. *Id.*

542. Dodd-Frank Act § 772 amended § 36 of the Exchange Act to prohibit the SEC from granting exemptions to security-based swap-related provisions unless expressly authorized by the statute.

543. *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); *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).

§ 2:8 Doing Business As an Unregistered Broker-Dealer

§ 2:8.1 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 law violations.⁵⁴⁴ 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.⁵⁴⁵ The SEC can also impose civil penalties⁵⁴⁶ and require accounting and disgorgement.⁵⁴⁷

544. Exchange Act § 21(a)(1).

545. Exchange Act § 21C; *see also In re Ranieri Partners LLC*, SEC Release No. 34-69091 (Mar. 8, 2013); *In re OX Trading, LLC*, SEC Release No. 34-66831 (Apr. 19, 2012); *In re Sharespost, Inc.*, SEC Release No. 34-66594 (Mar. 14, 2012); *In re CentreInvest, Inc.*, SEC Release No. 34-60450 (Aug. 5, 2009); *In re Warrior Fund LLC*, SEC Release No. 34-61625 (Mar. 2, 2010).

546. The Dodd-Frank Act amended section 21B to provide the SEC with authority to impose civil penalties against any person, including persons not otherwise regulated by the SEC, in administrative proceedings. *See* Dodd-Frank Act § 929P(a). Previously, the SEC could only obtain civil penalties against such persons in an action brought in federal court. Some defendants not otherwise regulated by the SEC facing administrative proceedings have challenged the constitutionality of use of the forum (with its reduced discovery, administrative law judge, and no right to a jury) as a violation of equal protection, due process, or the Appointments Clause of the Constitution. For the most part, these challenges have yet to be decided on the merits. *See, e.g., Bebo v. SEC*, No. 15-cv-00003, 2015 U.S. Dist. LEXIS 25660 (E.D. Wis. Mar. 3, 2015) (describing defendant's claims as "compelling and meritorious," but dismissing for failure to exhaust administrative remedies); *Chau v. SEC*, 2014 U.S. Dist. LEXIS 171658 (2014) 72 F. Supp. 3d 417 (S.D.N.Y. 2014) (same); *but see Hill v. SEC*, No. 1:15-cv-1801-LMM, 2015 U.S. Dist. LEXIS 74822 (N.D. Ga. June 8, 2015) (granting a preliminary injunction to halt SEC administrative proceedings on the grounds that the appointment of an ALJ by a person other than the President, a court of law, or a department head likely violates the Appointments Clause of the Constitution); *Duka v. SEC*, 2015 U.S. Dist. LEXIS 49474 (2015) (declining to issue an injunction on grounds similar to those claimed in *Hill*).

547. Exchange Act § 21B; *see also* Complaint at 9, *SEC v. Banc de Binary Ltd.*, No. 2:13-cv-00993 (D. Nev. June 5, 2013); Complaint at 24, *SEC v. Olive*,

The SEC can also bring an action in court and seek permanent or temporary injunction or a restraining order against an unregistered broker-dealer.⁵⁴⁸ In addition to an injunction, the SEC may also seek civil penalties and equitable relief for such violation.⁵⁴⁹ In addition, the SEC may transmit such evidence of securities laws violations to the attorney general, who may, in his or her discretion, institute the necessary criminal proceedings under the Exchange Act.⁵⁵⁰

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 2:1.4, most states have their own

No. 2:13-cv-14047 (S.D. Fla. Feb. 4, 2013). SEC actions seeking civil penalties are generally subject to a five-year statute of limitations. *See* 28 U.S.C. § 2462. This five-year period begins when the conduct constituting the violation occurs, rather than when the cause of action is discovered or should reasonably have been discovered. *See* SEC v. Gabelli, 133 S. Ct. 1216 (2013). The Supreme Court's decision in *Gabelli* applied the five-year statute of limitations to civil penalties, but did not address its applicability to actions seeking other forms of relief. The SEC has taken the position that the limitations period under 28 U.S.C. § 2462 does not apply to claims for equitable remedies, such as cease-and-desist orders or disgorgement. With respect to disgorgement of profits after the statute of limitations, some courts and administrative law judges have agreed with the SEC. *See, e.g., In re* Grossman and Adams, SEC Initial Decision Release No. 727 (Dec. 23, 2014); SEC v. Pentagon Capital Mgmt. PLC, 725 F.3d 279, 280–81, 288 n.8 (2d Cir. 2013); SEC v. Riordan, 627 F.3d 1230, 1234–35 (D.C. Cir. 2010); SEC v. Collyard, No. 11-cv-3656 (D. Minn. Dec. 9, 2015). An appellate court, however, recently found that disgorgement is essentially a form of forfeiture and therefore squarely within the five-year statute of limitations. *See* SEC v. Graham, No. 14-13562 (11th Cir. May 26, 2016).

548. Exchange Act § 21(d)(1); *see also* SEC v. Small Bus. Capital Corp., No. 88-2533-WD, 2012 U.S. Dist. LEXIS 178392 (N.D. Cal. Dec. 17, 2012); SEC v. Siris, No. 12-CV5810 (S.D.N.Y. July 30, 2012); SEC v. Gary Collyard, No. 11-CV-03656 (D. Minn. Dec. 21, 2011); SEC v. Sky Way Glob., 2010 U.S. Dist. LEXIS 88616 (M.D. Fla. July 29, 2012); SEC v. Martino, 255 F. Supp. 2d 268 (S.D.N.Y. 2003); SEC v. Dowdell, 2002 U.S. Dist. LEXIS 4522, Fed. Sec. L. Rep. (CCH) ¶ 91,728 (W.D. Va. Mar. 14, 2002); *In re* Morris, SEC Release No. 34-60171 (June 25, 2009); SEC v. McMillin, No. 07cv2636-REB-MEH (D. Colo. Jan. 8, 2009); *In re* McMillin, SEC Release No. 34-59263 (Jan. 16, 2009); SEC v. Rabinovich & Assocs., L.P., No. 07 Civ. 10547 (S.D.N.Y. Nov. 27, 2007); *In re* Lovaglio, SEC Release No. 34-59190 (Dec. 31, 2008); SEC v. Novosselov, No. 3:05-CV-951 (D. Conn. 2007); SEC v. Century Inv. Transfer Corp., Fed. Sec. L. Rep. (CCH) ¶ 93,232 (S.D.N.Y. Oct. 5, 1971).

549. Exchange Act §§ 21(d)(3) and (5); *see also* SEC v. City Capital Corp., No. 1:12-cv-01249-WSD (N.D. Ga. filed Apr. 12, 2012); SEC v. SW Argyll Invs. LLC, No. 122CV0646L WVG (S.D. Cal. filed Mar. 15, 2012); SEC v. Stanford Int'l Bank, Ltd., No. 3-09CV0298-L, 2009 U.S. Dist. LEXIS 132999 (N.D. Tex. Feb. 16, 2009).

550. Exchange Act § 21(d)(1).

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.⁵⁵¹ 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.⁵⁵² 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.⁵⁵³ States have brought numerous enforcement actions against unregistered broker-dealers.⁵⁵⁴ In cases where fraud is involved, states have brought criminal charges against such broker-dealers.⁵⁵⁵

§ 2:8.2 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*).⁵⁵⁶ The Supreme Court has recognized a private right of rescission under this section.⁵⁵⁷ 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.⁵⁵⁸ Although a contract engaging an unregistered broker-dealer in a securities transaction may not be illegal by its terms, the

551. 1956 Act § 408; 2002 Act § 603.

552. 2002 Uniform Act § 604; *see also* California Desist and Refrain Order against Markow Tsai on May 15, 1998; Alabama Cease and Desist Order against Markow Tsai on March 3, 2000.

553. 1956 Act § 409; *see also* Kahn v. State, 493 N.E.2d 790 (Ind. Ct. App. 1986).

554. *See, e.g.*, State v. Casper, 297 S.W.3d 676 (Tenn. 2009); State v. Roger, 298 S.E.2d 110 (W. Va. 1982); State v. Milne, 690 P.2d 829 (Colo. 1984).

555. *See, e.g.*, State v. Milne, 690 P.2d 829 (Colo. 1984).

556. 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. U.S. Trust Co. of N.Y., 490 U.S. 1091 (1989) (discussing Mills v. Elec. Auto-Lite Co., 396 U.S. 375 (1970)).

557. Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (citing Mills v. Elec. Auto-Lite Co., 396 U.S. 375 (1970)); Royal Air Props., Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962).

558. Regional Props., Inc. v. Fin. & Real Estate Consulting Co., 678 F.2d 552 (5th Cir. 1982).

performance of it may involve a violation of section 15(a) of the Exchange Act.⁵⁵⁹ In such cases, some courts have found the contract to be void and have allowed rescission under section 29(b).⁵⁶⁰

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,⁵⁶¹ and that the unregistered broker-dealer is not entitled to any fees as yet unpaid.⁵⁶² 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.⁵⁶³

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.⁵⁶⁴ 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
- (iii) he or she is in the class of persons the Exchange Act was designed to protect.⁵⁶⁵

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

559. *See id.*

560. *See id.*; *Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357 (5th Cir. 1968), *cert. denied*, 393 U.S. 913 (1968); *W. 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); *Landegger v. Cohen*, No. 11-cv-01760-WJM-CBS (D. Colo. Sept. 30, 2013).

561. *Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P., II LLC*, No. 0984CV02521, 2011 Mass. Super. LEXIS 86, at *11 (Mass. May 31, 2011); *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 387–88 (1970); *Berkeley Inv. Grp., 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. Schneberger v. U.S. Tr. Co. of N.Y.*, 490 U.S. 1091 (1989); *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).

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

563. *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. Tex. 2007).

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

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

rather than collateral or tangential to the contract.⁵⁶⁶ If an agreement cannot be performed without violating the securities laws, that agreement is subject to rescission under section 29(b).⁵⁶⁷

As discussed earlier in section 2:1, 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.⁵⁶⁸

§ 2:8.3 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.⁵⁶⁹ 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 liable⁵⁷⁰ (including to the SEC in any action brought under section 21(d)(1) or (3)), 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 or recklessly 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.

566. *Berkeley Inv. Grp.*, 455 F.3d 195; *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 201 (3d Cir. 2001); *Salamon v. Teleplus Enters.*, 2008 U.S. Dist. LEXIS 43112 (D.N.J. June 2, 2008).

567. *Berkeley Inv. Grp.*, 455 F.3d 195.

568. *See, e.g.*, CAL. CORP. CODE § 25501.5 (2015); CONN. GEN. STAT. § 36b-29 (2014); FLA. STAT. § 517.211 (2014); 815 ILCS 5/13 (2014); N.J.S.A. 49:3-71(c) (2015); TEX. REV. CIV. STAT. art. 581-33 (2015); *cf.* N.Y. GEN. BUS. § 353 (2015) (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).

569. In general, neither the SEC nor FINRA regulate the parent company of a broker-dealer in its capacity as such; however, each may require that information about the parent company (or in certain cases, other material affiliates) be provided. *See* Rule 17h-2T (requiring certain broker-dealers to report information regarding material affiliates); FINRA By-Laws Article I(rr)(3) and FINRA Rule 8210 (requiring "associated persons" of a FINRA member, defined for this purpose to include direct owners listed on Schedule A of Form BD, to provide FINRA staff with requested books, records and accounts).

570. *See, e.g.*, SEC v. Gibraltar Glob. Sec., Inc., No. 13 Civ. 2575, 2016 WL 153090 (S.D.N.Y. Jan. 11, 2016) (finding founder, president, and sole owner of unregistered broker-dealer liable as control person).

Pursuant to sections 21(d)(1), (3), and (5) of the Exchange Act, the SEC can bring enforcement actions against such controlling persons and seek injunctions or restraining orders, 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 injunctions and restraining orders, disgorgement and prejudgment interest, or civil penalties.⁵⁷¹ Some state laws impose liabilities on controlling persons who materially aid in the acts or transactions constituting violations of the state securities laws.⁵⁷²

§ 2:8.4 Concerns for Registered Broker-Dealers

[A] Compensation Sharing

FINRA rules also prohibit FINRA members from engaging in certain compensation sharing arrangements. Under FINRA Rule 2040, FINRA members and associated persons are prohibited from paying, 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 and related activities, would be required to be so registered. FINRA members are expected to determine that proposed payments would be permissible and have “reasonable support” for this determination. Support may be derived by, among other things, (i) relying on existing SEC and SEC staff guidance in the form of releases, no-action letters or interpretations; (ii) seeking no-action relief from SEC staff; or (iii) obtaining a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area.⁵⁷³

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571. See, e.g., SEC v. Murgent Corp., et al., No. CV11-00636 (C.D. Cal. Apr. 21, 2011); SEC v. Allen, No. 3-11CV-882-0 (N.D. Tex. Apr. 28, 2011); SEC v. U.S. Pension Tr. Corp., No. 07-22570-CIV-MARTINEZ, 2010 U.S. Dist. LEXIS 102938 (S.D. Fla. Sept. 30, 2010); SEC v. Big Apple Consulting USA, Inc., No. 09-cv-1963 (M.D. Fla. Nov. 18, 2009); SEC v. FTC Capital Mkts., Inc., No. 09-cv-4755, 2010 U.S. Dist. LEXIS 65417 (S.D.N.Y. May 20, 2009); SEC v. Clean Care Tech., Inc., No. 08 CIV 01719 (S.D.N.Y. Feb. 21, 2008); SEC v. Am. Growth Capital Corp., No. 97-5993 (C.D. Cal. Aug. 12, 1997); SEC v. Johnston and Fiduciary Planning, Inc., 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).
572. See, e.g., CAL. CORP. CODE § 25403 (2015); CONN. GEN. STAT. § 36b-29 (2014).
573. FINRA Rule 2040.01. FINRA has also indicated that these methods of making a reasonable determination are not exclusive, and that members may, for example, rely on in-house counsel or even foreign counsel. See FINRA Regulatory Notice 15-07 (Mar. 2015).

Notwithstanding the general prohibition on payments to unregistered persons, FINRA Rule 2040 provides a few limited exceptions. For example, FINRA members are permitted to continue paying commissions to a retired representative (or the retired representative's estate) after the person ceases to be associated with a member if certain conditions are satisfied.⁵⁷⁴ In addition, FINRA Rule 2040 permits FINRA members and their associated persons to pay transaction-related compensation to non-registered foreign finders (that is, foreign persons referring foreign customers) subject to certain conditions.⁵⁷⁵

Other FINRA rules impose similar restrictions on compensation sharing. FINRA Rule 5141, for example, generally prohibits members or associated persons from offering or granting, directly or indirectly, any selling concession, discount or other allowance to a person that is not a member of a selling group in a "fixed price offering." FINRA Rule 8311 imposes restrictions on FINRA members' ability to provide compensation to persons subject to sanction or disqualification. In addition to FINRA rules, the SEC has also brought enforcement actions against Registered Broker-Dealers that shared transaction-based compensation with unregistered firms, charging them with aiding and abetting, or causing the unregistered firm's violation of the broker-dealer registration requirements.⁵⁷⁶

[B] Participating in Syndicates with Unregistered Persons

FINRA prohibits its members from participating in underwriting syndicates with unregistered persons. FINRA Rule 5110(f)(2)(K) 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 under the Exchange Act and applicable state law.⁵⁷⁷

574. FINRA Rule 2040(b). *See supra* section 2:7.7[B].

575. FINRA Rule 2040(c).

576. *See, e.g., In re Oppenheimer & Co. Inc.*, SEC Release No. 34-74141 (Jan. 27, 2015); *In re Rafferty Capital Markets, LLC*, SEC Release No. 34-72171 (May 15, 2014); *In re Visionary Trading LLC et al.*, SEC Release No. 71871 (Apr. 4, 2014).

577. FINRA Rule 5110(f)(2)(L).

[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 or recklessly 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.⁵⁷⁸ 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.⁵⁷⁹ Some state laws impose liabilities on Registered Broker-Dealers who materially aid in the acts or transactions constituting violations of the state securities laws.⁵⁸⁰

§ 2:8.5 Concerns for Issuers

[A] Liability for Aiding and Abetting or Causing

Issuers can face liability for knowingly aiding and abetting or causing an unregistered broker-dealer's violation. Section 20 of the Exchange Act imposes liabilities on persons who aid and abet another person in violation of the Exchange Act, and section 21C imposes liability on those that "cause" such a violation. The SEC has brought enforcement actions against issuers for aiding and abetting or causing an unregistered broker-dealer's violation.⁵⁸¹ Some state laws also have provisions that impose liabilities on persons who knowingly, in some cases, negligently, assist another person in violation of state securities laws.⁵⁸²

[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

578. Exchange Act § 20(e), as amended by Dodd-Frank § 929O.

579. *See, e.g., In re Oppenheimer & Co. Inc.*, SEC Release No. 34-74141 (Jan. 27, 2015); *SEC v. Chekholko*, No. 09-cv-6937 (S.D.N.Y. Aug. 6, 2009); *SEC v. FTC Capital Mkts., Inc.*, No. 09-cv-4755, 2010 U.S. Dist. LEXIS 65417 (S.D.N.Y. May 20, 2009); *SEC v. Black*, 90 Civ. 1988 (E.D.N.Y. June 13, 1990).

580. *See, e.g., CAL. CORP. CODE* § 25403 (2015); *CONN. GEN. STAT.* § 36b-29 (2014).

581. *See, e.g., In re Ranieri Partners LLC*, SEC Release No. 34-69091 (Mar. 8, 2013) (finding issuer to have been the "cause" of unregistered broker-dealer's violation); *SEC v. Jason Smith Petroleum Corp.*, No. CV 86-4419-TJH (C.D. Cal. July 8, 1986); *SEC v. Jones*, No. N81-396 (D. Conn. Sept. 9, 1981).

582. *See, e.g., CAL. CORP. CODE* § 25403 (2015); *CONN. GEN. STAT.* § 36b-29(c) (2014).

investors. Some states have provided a private right of rescission for innocent parties who buy securities through unregistered broker-dealers.⁵⁸³

[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.⁵⁸⁴

583. See, e.g., CAL. CORP. CODE § 25501.5 (2015); CONN. GEN. STAT. § 36b-29 (2014); FLA. STAT. § 517.211 (2014); 815 ILCS 5/13 (2014); TEX. REV. CIV. STAT. ANN. art. 581-33 (2014); N.J.S.A. 49:3-71(c) (2015); *Bramblewood Inv'rs, Ltd. v. C&G Assocs.*, 619 A.2d 1332 (N.J. Super. Ct. Law Div. June 26, 1992); *Carrousel N., Inc. v. Chelsea Moore Co.*, 460 N.E.2d 316 (Ohio Ct. App. 1983); *Brandenburg v. Miley Petroleum Expl. Co.*, 16 F.2d 933 (N.D. Cal. 1926).

584. See, e.g., *DeHuff v. Dig. Ally, Inc.*, 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. 1968), *cert. denied*, 393 U.S. 913 (1968). In one case, an issuer's hiring of unregistered persons in connection with its capital raising led to it entering into Chapter 11 bankruptcy to shed the potential rescission claims. See Bill Flook, *Neogenix Oncology Files Chapter 11 to Start 'Clean.'* WASH. BUS. J. (Aug. 10, 2012), <http://www.bizjournals.com/washington/print-edition/2012/08/10/neogenix-oncology-files-chapter-11-to.html>.