PUBLICATION

Unregistered Securities: Increasing Risks for Broker-Dealers

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May 10, 2012

In its 2012 Examination Priorities Letter, FINRA noted the sale of unregistered securities acquired in secondary markets as one of its areas of heightened concern. Specifically, FINRA noted that as many high profile companies have elected to remain private, secondary trading markets have emerged to trade their unregistered securities. Such trading, which is becoming increasingly prevalent, presents numerous risks of which broker-dealers must be cognizant. This Alert will highlight several of these risks.

Background

Historically, many private companies, regardless of size, turned to the public markets to raise capital and attain liquidity through Initial Public Offerings (IPOs). However, in the early 2000s, this dynamic changed as small growth companies began to perceive the public markets as hostile. Thus, many of these companies determined to remain private and forego the high costs and potential risks of public trading.

In fact, during the past three years there has been a significant shift from public to private capital raising. Between 2009 and 2010, there was both a decline in public issuances (-11 percent), and an increase in private capital raising (+31 percent). Moreover, in 2010 unregistered offerings under Regulation D (Reg D) surpassed debt offerings as the dominant offering method in terms of aggregate amount of capital raised in the U.S., totaling no less than $905 billion. Reg D remains the preferred method to meet the capital needs of small businesses. Since 2009 there have been 37,000 unique offerings with a modest median offering size of approximately $1 million.

A comparison of aggregate capital raised in 2009, 2010, and Q1 2011 by offering method (in billions of dollars) that was published by the SEC's Division of Risk, Strategy and Financial Innovation.

The growing use of private offerings has led to the accumulation of a large volume of unregistered securities that were initially offered by private companies. Increasingly, such securities are being offered for resale on secondary markets. These markets allow venture capital funds, angel investors and employees looking to dispose of their private company shares to sell to private buyers. Coupled with increased investor interest in the shares of private companies as a non-traditional investment opportunity following the market events of 2008, this has led to a dramatic increase in the trading of unregistered securities in secondary markets. However, such trading can involve significant risks.

Suitability Obligations

FINRA's present concerns, articulated in its 2012 Examination Priorities Letter, appear to relate primarily to the suitability of unregistered securities acquired in secondary markets. According to FINRA, many companies whose securities are available in such markets "are difficult to value, as the issuers may not make financial statements publicly available." FINRA also noted that "[a]cquiring interests in such securities through a pooled investment or a single security 'fund' introduces another layer of costs to the investor as well as risk associated with the fund manager."

Thus, in light of FINRA's Suitability Rule 2111, a broker-dealer must adequately consider whether investing in a particular unregistered security through a secondary market is suitable for any investor and, if so, whether it is suitable for each particular customer. The analysis must also include an adequate evaluation of the security's underlying value, and full disclosure of any variables making such valuation difficult. Moreover, as with all pooled investments, or investments into "funds," a broker-dealer must fully disclose the costs associated with such investments and the increased risks associated with a fund manager. Given FINRA's expressed concern with unregistered securities acquired in secondary markets, it is important that broker-dealers take their suitability responsibilities seriously and ensure investments in such products are proper for each specific investor.

Unregistered Resales of Restricted Securities

FINRA has also previously issued guidance reminding broker-dealers of their obligations to determine whether unregistered securities are eligible for public sale. In FINRA Regulatory Notice 09-05, FINRA reminds firms that broker-dealers play a critical role in preventing illegal, unregistered resale of restricted securities into public markets, and that therefore:

All firms must have procedures reasonably designed to avoid becoming participants in potential unregistered distribution of securities. The nature of those procedures and the required level of firm inquiry concerning the customer and the source of the security will depend on the particular circumstances. In addition, firms may not rely solely on others, such as clearing firms, transfer agents, or issuers' counsel, to fulfill these obligations.

Importantly, before selling a security in reliance on an exemption, a firm must take reasonable steps to ensure that the transaction qualifies for the exemption, regardless of whether the sale is on its own accounts or on behalf of customers. This obligation includes taking all steps necessary to ensure that the sale does not involve an issuer, a person in a control relationship with an issuer or an underwriter with a view to offer or sell the securities in connection with an unregistered distribution.

In fact, FINRA has recently brought several enforcement actions against firms that have failed to enact procedures sufficient to enable them to prevent improper distribution of unregistered securities. *See, e.g.*, *Scottsdale Capital Advisors Corp.*, FINRA Case No. 2008011593301 (January 2012); FINRA News Release April 27, 2010 (announcing that it fined five firms: Fagenson & Co., RBC Capital Markets Corp. of America, Alpine Securities Corp., Equity Station, Inc. and Olympus Securities, LLC, for the sale of unregistered securities).

In many of these enforcement actions, the broker-dealer's problems arose when the firm failed to recognize or take appropriate action when confronted with "red flags" that signaled the possibility of an illegal, unregistered distribution. Examples of such red flags include:

- A customer opens a new account and delivers physical certificates representing a large block of thinly traded or low-priced securities;
- A customer has a pattern of depositing physical share certificates, immediately selling the shares and then wiring out the proceeds of the resale;
- A customer deposits share certificates that are recently issued or represent a large percentage of the float for the security;
- Share certificates reference a company or customer name that has been changed or that does not match the name on the account;
- The lack of a restrictive legend on deposited shares seems inconsistent with the date the customer acquired the securities or the nature of the transaction in which the securities were acquired;

- There is a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security;
- The company was a shell company when it issued the shares;
- A customer with limited or no other assets under management at the firm receives an electronic transfer or journal transactions of large amounts of low-priced, unlisted securities;
- The issuer has been through several recent name changes, business combinations or recapitalizations, or the company's officers are also officers of numerous similar companies;
- The issuer's SEC filings are not current, are incomplete or are nonexistent;
- The customer (or a person publicly associated with the customer) has a questionable background or is the subject of news reports indicating possible criminal, civil or regulatory violations;
- For no apparent reason, the customer has multiple accounts under a single name or multiple names, with a large number of inter-account or third-party transfers;
- The customer's account has unexplained or sudden extensive wire activity, especially in accounts that had little or no previous activity; and,
- The customer, for no apparent reason or in conjunction with other red flags, engages in transactions involving certain types of securities, such as penny stocks, Regulation "S" (Reg S) stocks, and bearer bonds, which, although legitimate, have been used in connection with fraudulent schemes and money laundering activity. (Such transactions may warrant further due diligence to ensure the legitimacy of the customer's activity.)

Failing to detect or ignoring these or other red flags can subject a broker-dealer to exposure for the improper distribution of unregistered securities. Certainly, the amount of inquiry called for necessarily varies with the circumstances of each particular transaction; however, it is clear that the obligation to monitor for red flags extends to a broker-dealer. Moreover, broker-dealers cannot rely on clearing firms, transfer agents, issuers or issuers' counsel to fulfill this obligation. Finally, firms must also have in place sufficient supervisory procedures and controls to prevent unregistered resale of securities by its associated persons.

Company Risk

The risks related to the sale of unregistered securities in secondary markets not only affect broker-dealers, but can affect an issuing company's obligations as well. Section 12(g) of the Exchange Act, as amended by the Jumpstart Our Business Startups Act (JOBS Act - discussed below) and the rules promulgated thereunder, require private companies which have total assets greater than $10 million, and a class of equity securities held by more than 2,000 persons or 500 non-accredited investors, to comply with the Exchange Act's reporting requirements. Thus, secondary sales of a company's unregistered securities to multiple buyers can cause the number of the company's stockholders to exceed these thresholds, and therefore subject the company to increased reporting requirements—including filing audited financial information with the SEC.

This dynamic was recently experienced by Facebook which, in part due to long-time employees exercising their options and selling shares in large quantities on private markets, exceeded the then-applicable 500-person threshold and thus became subject to the Exchange Act's reporting requirements. This is generally considered to be the impetus behind the timing of Facebook's upcoming IPO. Notably, in 2004, Google suffered a similar fate and was forced to begin filing financial information with the SEC, and subsequently conducted an IPO.

Thus, private companies need to be aware of these requirements and need to monitor the sales of their unregistered securities in private markets. Additionally, companies may want to consider implementing stock option plans that prevent sales to third-party investors until an IPO or other liquidation event occurs.

Future Concerns

The foregoing discusses several of the risks both broker-dealers and companies face related to the sale of unregistered securities in secondary markets. In addition, the JOBS Act, which amends various provisions of, and adds new sections to, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002, will impact a broker-dealer's obligations in this realm as well.

The JOBS Act relaxes provisions of the federal securities laws related to the public offerings of companies considered to be "emerging growth companies" – which are generally issuers with total annual gross revenues of less than $1 billion during the most recently completed fiscal year. Specifically, these companies qualify for exemptions from various disclosure and internal control requirements. As a result, broker-dealers should similarly monitor transactions in such securities to ensure that the reduced disclosure requirements do not inhibit appropriate suitability determinations.

Moreover, the JOBS Act includes several provisions that will likely have the effect of increasing the issuance of unregistered securities. For example, the Act eliminates the prohibition on general solicitation and advertising that applies to private offerings under Rule 506 of Reg D. In addition, the JOBS Act increases the ceiling for small issue offerings, such as Reg A offerings, from $5 million to $50 million, and requires the SEC to adopt a rule, subject to various terms and conditions, generally exempting from registration a class of securities where the offering amount of all securities offered and sold within the preceding 12 months does not exceed $50 million. The increase in the ceiling for Reg A offerings may provide companies a valid alternative to IPOs. The JOBS Act also allows an issuer, subject to specific requirements, to publicly offer and sell up to $1 million of securities, without registering the securities with the SEC, through "Crowdfunding," or "Capital Raising Online while Deterring Fraud and Unethical Non-Disclosure." Crowdfunding is a method of raising capital, usually via the internet, intended to increase access to capital markets for business, entrepreneurs and developing companies.

The effect of these provisions is likely to increase the issuance of unregistered securities, and in turn, the volume of unregistered securities available in secondary markets, which will likely amplify FINRA's concerns regarding these products. As a result, broker-dealers would be well-advised to review and strengthen their policies and procedures with respect to the sales of unregistered securities acquired in secondary markets.

If you have any questions regarding these issues or any other securities-related issues, or need assistance in evaluating your company's policies and procedures, please contact your Baker Donelson attorney or any of the other attorneys in our Broker-Dealer/Registered Investment Adviser group.