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Depositing Penny Stocks with Brokers Creates Obstacles; SEC Charges E*Trade with Section 5 Violation

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Introduction

On October 9, 2014, the Securities and Exchange Commission ("SEC") filed an enforcement action against E*Trade Securities and E*Trade Capital Markets for selling billions of shares of unregistered and otherwise restricted penny stocks for their customers. The SEC found that the firms processed the sales on behalf of three customers while ignoring red flags that the offerings being conducted were in violation of the federal securities laws in that the shares were neither registered nor subject to an available exemption from registration. E*Trade Securities and E*Trade Capital Markets settled the enforcement proceeding by agreeing to pay a total of $2.5 million in disgorgement and penalties.

The SEC press release on the matter quoted Andrew J. Ceresney, Director of the SEC's Division of Enforcement, as saying, "Broker-dealers serve an important gatekeeping function that helps prevent microcap fraud by taking measures to ensure that unregistered shares don't reach the market if the registration rules aren't being followed. Many billions of unregistered shares passed through gates that E*TRADE should have closed, and we will hold firms accountable when improper trading occurs on their watch."

The securities laws generally require all offers and sales of securities to be registered with the SEC unless those offers and sales qualify for an exemption. A prima facie case for a violation of Section 5 is established upon a showing that: (1) no registration statement was filed or in effect as to the offer and sale of the securities; (2) a person, directly or indirectly, sold or offered to sell the securities; and (3) the sale or offer to sell

was made through the use of interstate facilities (including the mail). Scienter or intent is not required to establish a Section 5 violation. Once a prima facie violation of Section 5 is established, the burden shifts to the person claiming an exemption from registration to establish the availability of the claimed exemption.

Section 4(a)(4) of the Securities Act of 1933 ("Securities Act") provides an exemption for broker-dealers when executing customers' unregistered sales of securities if, after reasonable inquiry, the broker-dealer is not aware of circumstances indicating that the customer would be violating the registration requirements of Section 5 of the Securities Act. Also on October 9, the SEC issued a Risk Alert and FAQ to remind broker-dealers of their obligations related to unregistered transactions under Securities Act Section 4(a)(4) on behalf of their customers, and ensuring such transactions are being conducted in accordance with securities laws.

Section 4(a)(4) is not, in and of itself, an exemption from registration. Section 4(a)(4) allows brokers to process the sale of unregistered securities where there is a valid exemption from such registration. The SEC has stated that broker-dealers "have a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available."

Section 4(a)(4) generally works in conjunction with Section 4(a)(1), which is a registration exemption for "transactions by any person other than an issuer, underwriter, or dealer." Accordingly, a prerequisite to relying on Section 4(a)(4) is that the seller is not acting as an "underwriter." The term "underwriter" is defined in Section 2(a)(11) of the Securities Act to include "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking." For purposes of this definition, the term "issuer" includes the issuer's affiliates, including persons directly or indirectly controlling or controlled by the issuer, or under direct or indirect common control with the issuer.

Most commonly, reliance on Section 4(a)(1) includes compliance with the Rule 144 safe harbor; however, Rule 144 is only a safe harbor and compliance with Section 4(a)(1) can be separately established. A future blog will provide an in-depth discussion of Section 4(a)(1). The basic premise herein, however, is that a broker may only rely on

Section 4(a)(4) where a valid exemption from registration exists and it is the broker's responsibility to satisfy itself that such exemption exists.

Risk Alert

The Risk Alert summarizes deficiencies that were discovered by the SEC's Office of Compliance Inspections and Examinations during a targeted sweep of 22 broker-dealers that are frequently involved in the sale of microcap securities. In particular, the Staff scrutinized the broker-dealers' liquidations of large blocks of shares of microcap issuers that were also the subject of significant promotional efforts. The SEC found 80% of the firms were deficient in their compliance procedures. The SEC specifically evaluated the firms' compliance with obligations to (1) perform a "reasonable inquiry" in connection with the customers' unregistered sales of securities where the firm relied on Section 4(a)(4); and (2) file suspicious activity reports (SAR) in response to red flags.

The SEC pointed out many deficiencies in the firms' compliance procedures, including issues with firms improperly relying on the lack of restrictive legend or that the shares came into an account via DWAC or other electronic transfer. The SEC made it clear that it is not enough that the shares appear freely tradable on their face, but that a broker has its own independent responsibility to inquire and make a determination as to the shares. Brokerage firms cannot rely on transfer agents to act as a gatekeeper, but rather must be another layer of inquiry in a system of checks and balances.

Broker-dealer obligations to make reasonable inquiry under Securities Act Section 4(a)(4)

Section 5 of the Securities Act requires that ALL sales of securities must be registered unless an exemption from registration applies. Section 4(a)(4) provides a non-excusive exemption from registration for broker transactions executed on customers' orders on an exchange or on the over-the-counter market. Section 4(a)(4) does not exempt the solicitation of customer orders, but rather just the sale transaction in accordance with such customer order. In order to rely on Section 4(a)(4), the broker must not have any reason to believe that the transaction is violating Section 5 of the Securities Act.

Both the SEC and court rulings have found that a broker-dealer may rely on Section 4(a)(4) if, after reasonable inquiry, they are not aware of circumstances indicating a violation of Section 5. Circumstances that may indicate a violation of Section 5 include

evidence that the customer is acting as an underwriter in that they are making a distribution of the subject shares.

The SEC and courts both have indicated that brokers may consider Rule 144(g)(4) as part of their analysis and in particular note (ii) to such rule. Rule 144(g) addresses "broker transactions" for purposes of Rule 144 (affiliate sales under Rule 144 may only be completed in broker transactions…). Rule 144(g)(4) provides in part that a broker transaction is one in which:

(4) After reasonable inquiry [a broker] is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer.

Note (ii) provides:

(ii) The reasonable inquiry required by paragraph (g)(3) of this section should include, but not necessarily be limited to, inquiry as to the following matters:

(a) The length of time the securities have been held by the person for whose account they are to be sold. If practicable, the inquiry should include physical inspection of the securities;

(b) The nature of the transaction in which the securities were acquired by such person;

(c) The amount of securities of the same class sold during the past 3 months by all persons whose sales are required to be taken into consideration pursuant to paragraph (e) of this section;

(d) Whether such person intends to sell additional securities of the same class through any other means;

(e) Whether such person has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;

(f) Whether such person has made any payment to any other person in connection with the proposed sale of the securities; and

(g) The number of shares or other units of the class outstanding, or the relevant trading volume.

The FAQ discussed below provides further guidance on the "reasonable inquiry" requirement and a broker's assessment as to whether the sales involve an unregistered distribution or underwriting. Broker-dealers may also potentially rely on the exemption provided by Section 4(a)(3) of the Securities Act, which generally exempts "transactions by a dealer," but that exemption is unavailable for certain transactions, such as Section 4(a)(4), those involving an underwriter.

FINRA has also issued its Notice to Members 09-05 addressing these obligations and providing guidance. The Notice lists examples of red flags that brokers should consider, including:

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

Obligation to file suspicious activity reports (SAR)

The Securities Exchange Act of 1934 ("Exchange Act") requires broker-dealers to comply with the Bank Secrecy Act. The Bank Secrecy Act imposes an obligation on broker-dealers to file a SAR with the Financial Crimes Enforcement Network ("FinCEN") to report any transaction (or a pattern of transactions) involving $5,000 or more, in which it "knows, suspects, or has reason to suspect" that it "(1) involves funds derived from illegal activity or is conducted to disguise funds derived from illegal activities; (2) is designed to evade any requirements of the Bank Secrecy Act; (3) has no business or apparent lawful purpose and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts; or (4) involves use of the broker-dealer to facilitate criminal activity."

The Risk Alert points out red flags that should cause a broker to make further investigation as to whether a SAR needs to be filed, including:

- Atypical trading patterns in the issuers' securities, including trading involving sudden spikes in price and volume;
- Certain patterns of trading activity being common to several customers, including, but not limited to, the sales of large quantities of the shares of multiple issuers by the customers;
- Notifications received from the broker-dealers' clearing firms that the clearing firms had identified potentially suspicious activity in the securities of certain issuers or certain of the broker-dealers' customer accounts. Such notifications took the form of alerts, expressions of concern, or actions taken by the clearing firms to restrict trading in certain issuers' securities and/or certain customer accounts;
- The involvement of certain types of accounts, including those that provide anonymity to the beneficial owners in the liquidation of the shares of the microcap issuers (see examples below);
- Requests received from FINRA for information relating to certain issuers and the broker-dealers' customer accounts;
- Certain types of issuer information, such as nominal assets and low operating revenue, and frequent changes to the type of activity in which the business was engaged, the name of the corporate entity, directors, and/or management; and

- Sales through the broker-dealer by individuals known throughout the industry to be stock promoters.

The SEC Risk Alert gave examples of the types of accounts that should raise a red flag and therefore further inquiry. Those accounts include, but are not limited to:

- Accounts of purported stock loan companies, which may hold the restricted securities of corporate insiders who have pledged the securities as collateral for, and then defaulted on, purported loans, after which the securities are sold on an unregistered basis;
- Accounts held in the name of a corporate entity (or LLC), either for the company's own use or as a third-party custodian on behalf of other beneficial shareholders or customers, which disguise the unregistered sales of securities owned by corporate insiders of the company and allow for those insiders to withdraw proceeds individually;
- Accounts held in the names of foreign financial institutions, such as offshore banks and/or broker-dealers that sold shares of the stock on an unregistered basis on behalf of customers, who may have been stock promoters; and
- Accounts using a master/sub-structure, which allows for trading anonymity with respect to the sub-accounts' activity.

SEC Published FAQ

Also on October 9, the SEC issued a Risk Alert and FAQ to remind broker-dealers of their obligations related to unregistered transactions under Securities Act Section 4(a)(4) on behalf of their customers. The FAQ generally reiterates the information in the Risk Alert, set up in a question-and-answer format. In particular, the FAQ explains that brokers may rely on Section 4(a)(4) and lays out the brokers' obligations related to making a reasonable inquiry of the facts and circumstances surrounding the transaction, including all parties involved, as a prerequisite to reliance on the statute.

Moreover, the FAQ drills down on the brokers' independent obligation. Reiterating a long line of case law and SEC releases dating back to 1962, the SEC makes it clear that a broker may not solely rely on a third party, such as the DTC, a transfer agent, customer, or attorney for either, in making its determination.

Conclusion

Shareholders and investors that trade in small cap securities have seen a big shift in the procedures and process associated with depositing penny stocks into brokerage firms. The SEC Risk Alert explains the timing and impetus behind such shift and also provides insight into the brokerage firms' duties and procedures. To be clear, the rules did not change. Brokers were required to make independent reasonable inquiry and an independent assessment of the proper free tradability of shares, before and after the SEC knocked on their doors. However, although most had written rules and procedures, the SEC found that many of these firms, or at least their personnel, were unaware of their obligations, especially where shares appeared to be freely tradable on their face.

Now more than ever, shareholders and investors need to maintain proper records and seek legal counsel to avoid unintended actual or perceived violations of the securities laws, which violations could result in the loss of an investment or worse, regulatory enforcement proceedings.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the Producer and host of LawCast.com, The Securities Law Network.

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