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Issuer Exemption: Rule 3a4-1

Private fund managers often inquire whether an issuer that distributes its own securities through its officers and employees must register as a broker-dealer under the Securities Exchange Act of 1934 (the "Exchange Act"). Although the issuer need not register, its associated persons could only avoid registration by either complying with the safe harbor under Rule 3a4-1 of the Exchange Act or satisfying the conditions described in a series of SEC no-action letters. As described below, violations of the broker-dealer registration requirement could result in rescission of transactions, SEC and FINRA sanctions, and civil litigation. Below is a brief description of the Rule 3a4-1 as well as the requirements to become a broker-dealer.

Registration as a Broker-Dealer

Section 15(a)(1) of the Exchange Act makes it unlawful for any broker or dealer to effect a securities transaction unless such broker or dealer registers with the SEC. A broker is a person "engaged in the business of effecting transactions in securities for the account of others." A dealer is any person "engaged in the business of buying and selling securities for his own account." Consequently, an issuer is not a broker or dealer. However, this "issuer exemption" does not apply to the issuer's personnel engaged in the business of effecting securities transactions for the issuer. Rule 3a4-1 provides an exemption from registration for such persons. Additionally, the SEC, in a series of no-action letters, has provided no-action relief outside this Rule 3a4-1 safe harbor.

Rule 3a4-1

Rule 3a4-1 under the Exchange Act permits associated persons (e.g. partners, officers, directors, employees, corporate general partner) to avoid registration and licensing under the Exchange Act if such persons are not:

- Statutorily disqualified due to misconduct;
- Paid commissions based on sales; and
- Associated with a broker-dealer.

In addition, the associated person must satisfy one of the following three tests:

1. The associated person restricts participation to transactions:
    a. Distributed solely to a registered broker-dealer, registered investment company, insurance company, bank, or certain types of trusts;
    b. Involving the sale of certain exempt securities (e.g. bankruptcy exchanges, reorganizations);

c. Pursuant to a plan submitted to a vote of security holders in connection with a merger, exchange or transfer of assets; or

d. Pursuant to a bonus, pension or profit-sharing plan.

2. The associated person:

a. Primarily performs substantial duties for the issuer otherwise than in connection with transactions in securities;

b. Was not an associated person of a broker-dealer during the preceding 12 months; and

c. Does not participate in selling securities for the issuer more than once every 12 months.

3. The associated person only:

a. Prepares written communications and does not engage in oral solicitation;

b. Responds to inquiries of potential purchasers in communications initiated by the purchaser; or

c. Performs only ministerial and clerical work involved in effecting transactions.

In a situation involving the second test, the SEC has given no-action relief where an employee of an issuer was an associated person of a broker-dealer within the prior 12 months. In a no-action letter to United Income, Inc. (December 8, 1993), the issuer argued that the 12-month requirement should not apply because (a) the employees engaged in the securities offering did not participate in securities transactions for the broker-dealer and (b) the broker-dealer was sufficiently removed from the issuer in the corporate structure (including the absence of overlapping directors, officers and employees). Consequently, the issuer argued, the SEC should not have a concern about abusing the trust of clients or unduly influencing investment decisions. The SEC, in granting the no-action request, noted that United Income would dissolve the broker-dealer before the commencement of the securities offering.

Avoiding registration without complying with the safe harbor.

Associated persons that may not otherwise fall within the Rule 3a4-1 safe harbor may also avoid registration in the event that such persons comply with the factors promulgated by the SEC in a series of no-action letters. Although the SEC has indicated that the safe harbor is not the exclusive means by which persons associated with an issuer may avoid registration, the SEC has indicated that "only unusual circumstances" would support a conclusion that associated persons need not register in the event that the associated persons could not satisfy the safe harbor.

The SEC has considered the following factors relevant to a determination of whether an associated person must register:

a. Is the person an employee? An employee is less likely to have to register than an independent contractor.

b. Will the person's compensation be linked to the amount of securities sold? Receiving commissions will clearly require registration. The SEC has also indicated that additional salary for engaging in securities-related activities may also subject the associated person to registration.

c. Does the person devote a substantial portion of his/her time to activities not related to the sale of securities? A full-time permanent employee who only devotes as small portion of his/her activities to effecting transactions will more likely avoid registration than a part-time or temporary employee engaged solely to conduct securities activities.

d. Will the person remain with the issuer following conclusion of the offering?

e. Will the person continue to participate in other securities offerings? Also, the SEC will examine whether the associated person has previously (e.g. during the previous two years) affiliated with a broker-dealer or engaged in securities-related activities.

The SEC has placed differing degrees of weight on these factors, depending on the facts and circumstances of a particular no-action request.

Consequences of failing to register as a broker-dealer.

Failure to register as a broker-dealer where required could have the following consequences:

- Rescission of any purchases and sales;
- Disciplinary Action by the SEC against the firm and individuals, including, without limitation, public censure, cease and desist orders, fines and penalties, and prohibition against participation in the securities industry; and
- Civil litigation against the firm and individuals.

The likelihood of any such sanction depends on the facts and circumstances of a particular situation.

Considerations when registering as a broker-dealer.

In the event a firm registers as a broker-dealer, it must:

- Contribute sufficient capital to satisfy applicable SEC and FINRA net capital requirements, which vary depending on the nature of the broker-dealer's activities,
- Prepare and file a Form NMA with the FINRA,
- Submit fingerprint cards for each partner, director, officer and employee,
- Register with the Lost and Stolen Securities Program,
- Register as a member of the Securities Investor Protection Corporation,

- File a Designation of Account notice with the SEC,

- Become a member of FINRA by filing several documents including the Form NMA, a detailed business plan, financial statements, an organization chart, a description of the operations systems, and additional information about the firm including offices, disciplinary actions, capital, financial controls, compliance, supervisory system, and recordkeeping system.,

- Register at least two officers or directors as principals,

- Register one principal as a Financial Operations principal,

- Register applicable personnel as representatives or principals, as the case may be, including the filing of a U-4 for each person and fingerprint cards,

- Ensure that all registered principals and representatives pass the applicable FINRA examinations,

- Register all branch offices,

- Obtain blanket fidelity bonding,

- File appropriate information in the applicable states, and

- Comply with all laws and regulations applicable to broker-dealers under the Securities Exchange Act of 1934, all SEC rules, the FINRA Rules of Fair Practice, and all FINRA Notices to Members, including, without limitation, the following:

    - ✓ Antifraud Provisions: Make no misstatements or material omissions.

    - ✓ Duty of Fair Dealing: Execute orders promptly, disclose material information, charge reasonable prices, and disclose conflicts of interest.

    - ✓ Duty of Best Execution: Seek the most favourable terms for customer orders.

    - ✓ Customer Confirmation Rule: Deliver a customer confirmation at or before completion of each transaction.

    - ✓ Restrictions on Insider Trading: Enforce policies and procedures to prevent employees from misusing material non-public information including training and restrictions on proprietary trading.

    - ✓ Privacy of Consumer Financial Information: Deliver annual privacy notices to customers and adopt appropriate policies and procedures to protect customer records and information.

    - ✓ Net Capital: Maintain sufficient net capital which can equal as much as 2% of aggregate debit items for carrying/clearing firms.

- ✓ Use of Customer Balances: Establish procedures to provide information to customers maintaining free credit balances.

- ✓ Customer Protection Rule: Compute daily the amount of securities held for the account of customers and keep excess amounts in an appropriate reserve account.

- ✓ Books and Records: Maintain appropriate books and records, including E-mails, detailing securities transactions, money balances, and securities positions.

- ✓ Reporting: File periodic reports, including quarterly financial statements, with the SEC.

- ✓ Anti-Money Laundering: Implement and maintain an anti-money laundering program.

- ✓ Electronic Media: Follow guidelines with respect to using electronic media to deliver information.

- ✓ Examinations: Submit to periodic examinations by the SEC and the FINRA.