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LEGAL ISSUES FOR BROKER-DEALERS IN RELATION TO PRIVATE SECONDARY MARKET TRADING

Given the rapid growth in private securities markets, broker-dealers are increasingly being provided with opportunities to facilitate private secondary transactions. "Section 4(a)(1½)" offers flexibility to broker-dealers in effecting such transactions in a manner exempt from registration under the Securities Act of 1933. At the same time, however, since Section 4(a)(1½) is not a codified exemption from registration and is effectively an amalgamation of primary private placement and secondary market principles, it can create uncertainties for broker-dealers who wish to utilize it. In this article, we examine the legal analysis underlying Section 4(a)(1½) and the various regulatory considerations that should be taken into account by broker-dealers in relation to it.

By Naim Culhaci and Stephen P. Wink *

The rise of private markets has been one of the most significant trends in capital markets in recent years.[1] With the fast growth in the private markets, market participants have increasingly been exploring different ways in which to regularly engage in secondary transactions in private securities.

While Rule 144 and Rule 144A under the Securities Act of 1933, as amended, continue to be the exemptions from registration under the Securities Act for private resale transactions that provide the most certainty and are most commonly relied on by market participants, their various conditions, and restraints (e.g., holding periods and information requirements) can lead U.S. broker-dealers to look to different alternatives towards more flexibly facilitating trading of private securities by their customers. One such alternative is Section 4(a)(7) of the Securities Act, which was enacted by Congress in 2015, however it has not been widely adopted by market participants and has its own set of conditions that render it inflexible. Accordingly, broker-dealers looking for maximum flexibility for their customers have the option of turning to so-called "Section 4(a)(1½)." In this paper, we examine the legal analysis underlying Section 4(a)(1½) and the various regulatory considerations that should be taken into account by broker-dealers that facilitate transactions that utilize it.

I. SECURITIES ACT FRAMEWORK

Section 5 of the Securities Act generally requires that each offer and sale of a security (whether in connection

[1] Private markets assets under management totaled $13.1 trillion as of June 30, 2023, and have grown nearly 20 percent per annum since 2018. Private markets: a Slower Era, McKinsey Global Private Markets Review 2024, McKinsey & Company *available at* https://www.mckinsey.com/industries/private-capital/our-insights/global-private-markets-report-2024#/.

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with the security's initial issuance or a subsequent sale) occur pursuant to either an effective registration statement with the Securities and Exchange Commission or an available exemption from such registration.[2]

1. Section 4(a)(1) – Exemption of Ordinary Trading

The Securities Act "imposes no registration requirements when securities are the object of ordinary trading transactions between individual investors."[3] This is accomplished by "exempting from the registration procedure transactions which are not customarily a part of the distributive process, that is, transactions in which neither an issuer, an underwriter, nor a dealer (selling during the period of distribution) takes part."[4] Specifically, Section 4(a)(1) of the Securities Act provides that the Section 5 registration requirements "shall not apply to transactions by any person other than an issuer, underwriter, or dealer."[5] This exemption typically covers the vast majority of secondary market trading.

The Section 4(a)(1) exemption effectively narrows the types of transactions that may be deemed a distribution of securities — i.e., a public offering of securities.[6] In this regard, the SEC has stated that the Section 4(a)(1) exemption is:

> rooted in the fundamental distinction between distributions . . . and ordinary trading. "The term 'distribution' refers to the entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hands of the investing public." Thus, the registration requirement applies to all sales until the shares come to rest in the hands of independent investors.[7]

2. Significance of Underwriter Status

Given that Section 4(a)(1) exempts transactions by anyone other than the "issuer," "underwriter" or

[2] 7A J. William Hicks, *Exempted Transactions Under the Securities Act of 1933*, §1:39.

[3] Brief for the Securities and Exchange Commission at 12, *SEC v. Chinese Consol. Benevolent Ass'n*, 120 F.2d 738 (2d Cir. 1941), *available at* https://www.sechistorical.org/collection/papers/1940/1941_0101_SECBriefChinese.pdf ("SEC Brief"); *see also* Compl. ¶ 7, *SEC v. Procopio*, No. 3:20-cv-00182 (S.D. Cal. Jan. 29, 2020), *available at* https://www.sec.gov/litigation/complaints/2020/comp24730.pdf ("Section 5 applies to both a company (or 'issuer' of the stock) and its 'affiliates,' and it is designed to distinguish between securities offerings by the issuers (which require registration) and subsequent trading once the securities have come to rest in the hands of investors (which is generally exempt).").

[4] SEC Brief at 12.

[5] 15 U.S.C. § 77d(a)(1).

[6] Hicks, *supra* note 2, at § 9:39 (May 2022 update) ("The SEC and the courts equate the phrase 'public offering' with the word 'distribution' for purposes of the Securities Act."); § 9:18; *see,*

footnote continued from previous column…

e.g., *Ackerberg v. Johnson*, 892 F.2d 1328, 1336 (8th Cir. 1989) ("The definition of 'distribution' as used in § 2(a)(11) is generally considered to be synonymous with a public offering."); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959) (holding that "a 'distribution' requires a 'public offering'"); and *SEC v. Lybrand*, 200 F.Supp.2d 384, 393 (S.D.N.Y. 2002) ("A 'distribution' is equivalent to a public offering of securities.").

[7] SEC Post-Hearing Reply Brief at 2, *In re Bioelectronics Corp.*, No. 3-17104 (SEC Nov. 18, 2016) (quoting *Geiger v. SEC*, 363 F.3d 481, 487 (D.C. Cir. 2004)), *available at* https://www.sec.gov/litigation/apdocuments/3-17104-event-116.pdf; *see also* Compl. ¶ 16, *SEC v. Loflin*, No. 2:19-cv-02548 (D. Ariz. Apr. 19, 2019), *available at* https://www.sec.gov/litigation/complaints/2019/comp24457.pdf ("While Section 5 generally requires registration for the flow of securities from an issuer to investors, the premise of the Section 4(a)(1) exemption is that registration is no longer necessary for further sales once the shares come to rest with public investors."); Release No. 33-4552, 1962 WL 69540 (Nov. 6, 1962) (emphasizing the question "whether the securities offered have come to rest in the hands of the initial informed group or whether the purchasers are merely conduits for a wider distribution" and that persons acting in the latter capacity, "whether or not engaged in the securities business, are deemed to be 'underwriters' within the meaning of section 2(a)(11) of the Act") (citation updated).

"dealer," the statutory definition of "underwriter" is central to the distinction between a distribution and ordinary trading. Specifically, if a seller of securities is not an "issuer," and assuming that the seller is not a "dealer," the availability of the Section 4(a)(1) exemption turns on the question of whether the seller will be treated as an "underwriter." Of course, "underwriter" status is not only significant in connection with the Section 4(a)(1) availability analysis, but is also significant because of the heightened liability standard introduced under Section 11(a) of the Securities Act.[8]

Section 2(a)(11) of the Securities Act defines an "underwriter" as:

> *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, or participates or has a participation in the direct or indirect underwriting of any such undertaking.*[9]

Based on the intent to regulate distributions not only by issuers but also by controlling stockholders, the term "issuer" as used in this definition also includes affiliates of the issuer.[10]

3. Rule 144 and Rule 144A

Rule 144 and Rule 144A are two non-exclusive exemptions adopted by the SEC whereby market participants can gain certainty that a private secondary transaction is exempt from registration under the Securities Act and does not cause the seller to be deemed a Section 2(a)(11) underwriter. Rule 144, which was adopted by the SEC in 1972, can be used by both affiliate and non-affiliate sellers, however, imposes certain requirements in relation to, among other things, the holding period prior to which the seller can sell the securities, current public information regarding the issuer of the securities, and, to the extent that the resale is by an affiliate, volume limitations.[11] Rule 144A, which was adopted by the SEC in 1990 and is typically used by broker-dealers to facilitate institutional offerings of debt instruments, permits immediate resale by a purchaser to qualified institutional buyers ("QIBs") as defined under the rule,[12] subject to information requirements and certain other conditions.[13] Assuming that a resale of private securities pursuant to Section 4(a)(1) does not fit within the specific conditions of Rule 144 or Rule 144A, a broker-dealer needs to look to the "underwriter" definition itself to determine whether the person or persons effecting the secondary resale in the relevant transaction is an "underwriter."

4. Centrality of Distribution or Public Offering to Underwriter Status

The underwriter definition can be broken into three components: (1) purchased securities from the issuer or controlling stockholder with a view to the securities' distribution; (2) offers or sells for an issuer or a controlling stockholder in connection with the distribution of any security; or (3) directly or indirectly participates in the purchases, offers or sales relating to the distribution or in the underwriting of those purchases, offers or sales.[14] As shown below, none of these components apply in the absence of a distribution or public offering.

a. "Purchased from an Issuer with a View to Distribution"

Most interpretations of the underwriter definition "traditionally focus" on its first clause: those who have "purchased from an issuer [or controlling stockholder] with a view to distribution."[15] Decisions construing the first clause have focused on "the words 'with a view to' in the phrase 'purchased from an issuer with a view to . . . distribution.'"[16] As the SEC has explained, this

[8] Section 11(a)(5) of the Securities Act specifically imposes liability if any part of a registration statement, at the time it became effective, "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." A Section 11 claim can be brought by a purchaser against, among others, each underwriter participating in the offering.

[9] 15 U.S.C. § 77b(a)(11).

[10] *Id*. ("As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.")

[11] 17 C.F.R. §§ 230.144.

[12] The definition includes, in relevant part, any entity that in the aggregate owns and invests on a discretionary basis at least $100m in securities of issuers that it is not affiliated with. 17 C.F.R. §§ 230.144A(a)(1).

[13] 17 C.F.R. §§ 230.144A.

[14] *Supra* note 9. The third prong of this definition encompasses what are known as the participation clauses, which are combined together here for simplicity.

[15] Release No. 33-5223, 37 Fed. Reg. 591, 592 (Jan. 14, 1972); *see also* Rule 144 Preliminary Note, 17 C.F.R. § 230.144.

[16] 37 Fed. Reg. at 592.

clause encompasses persons who "act as links in a chain of transactions through which securities move from an issuer to the *public*," which will typically include "an investment banking firm which arranges with an issuer for the *public* sale of its securities."[17]

b. "Offers or Sells in Connection with the Distribution"

The second clause of Section 2(a)(11) encompasses any person who "offers or sells for an issuer [or controlling stockholder] in connection with the distribution." This clause is not relevant when no distribution occurs. And, where a distribution does occur, the clause "has been used sparingly in determining whether particular persons qualify as underwriters,"[18] with nearly all of those infrequent instances involving SEC enforcement actions for unregistered public offerings in violation of Section 5 of the Securities Act.[19]

c. "Participates" in the Distribution

The third and fourth clauses of Section 2(a)(11) confer underwriter status in a distribution where a person "participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking." However, in this context, "'participates' and 'participation' . . . have a technical meaning under Section 2(a)(11) and should be used with care and precision."[20] The relevant "participation" refers only to statutorily specified distribution-related activities and have no relevance where no distribution or public offering occurs.[21]

5. Distribution of Securities

As shown above, the occurrence of a distribution of securities is a required element of underwriter status. To determine the existence of a distribution under Section 2(a)(11), courts and practitioners have long turned to Section 4(a)(2) jurisprudence, which treats a distribution as equivalent to a public offering.[22]

a. Section 4(a)(2)

Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering" (i.e., private placement offerings that do not constitute "distributions"). It is Section 4(a)(2) that permits an issuer to sell securities in a "private placement" without registration under the Securities Act. Section 4(a)(2), however, is only available to the issuer, and not to persons who have acquired securities from the issuer and who wish to resell the securities.

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[17] *Id.* (emphasis added).

[18] Hicks, *supra* note 2, at § 9:39.

[19] *Id*. at § 9:39 n.19; *In re Lehman Bros. Mortgage-Backed Sec. Litig.*, 650 F.3d 167, 178 n.8 (2d Cir. 2011) (emphasis added) (citing *SEC v. Kern*, 425 F.3d 143, 147-48 (2d Cir. 2005); *SEC v. N. Am. Research Dev. Corp.*, 424 F.2d 63, 70-72, 80-82 (2d Cir. 1970); *SEC v. Culpepper*, 270 F.2d 241, 245-48 (2d Cir. 1959); and *SEC v. Chinese Consol. Benevolent Ass'n*, 120 F.2d 738, 739-41 (2d Cir. 1941)).

[20] Hicks, *supra* note 2, at § 9:54 ("The terms 'participates' and 'participation' . . . have a technical meaning under Section 2(a)(11) and should be used with care and precision. . . . An indiscriminate use of the terms 'participants,' 'participation,' and 'participates' . . . ignores not only the technical meaning that those terms have under Section 2(a)(11) but also the special meaning that they enjoy under other provisions of the federal securities laws.").

[21] The participation clauses of Section 2(a)(11) confer underwriter status only on a person who participates, directly or indirectly, in a distribution of securities by (1) purchasing securities from an issuer or controlling stockholder with a view to distribution, (2) offering or selling securities for an issuer or controlling stockholder in connection with a distribution, or (3) joining in the underwriting of such an offering. This results from the participation clauses' reference to "any such undertaking," which refers back to the activities described by the preceding two clauses of Section 2(a)(11) — i.e., purchasing under the first clause; or offering or selling under the second clause. Persons can "participate" in a distribution only by "playing roles *essential* in the *actual distribution* of securities." *Lehman Bros.*, 650 F.3d at 178 (emphasis added); *see also id.* at 182 ("[T]he text, case law, legislative history, and purpose of the statute demonstrate that Congress intended the participation clause of the underwriter definition to reach those who participate in purchasing securities with a view towards distribution, or in offering or selling securities for an issuer in connection with a distribution, *but not further*." (emphasis added)).

[22] Louis Loss, Joel Seligman & Troy A. Paredes, *Securities Regulation* 1109 n. 567 (2021) (explaining that underwriter status requires a sale to involve a contemplated distribution, "a term which the Commission regards as more or less synonymous with a 'public offering' as used in Section 4(a)(2)"); *see also* Preliminary Note 2 to Rule 144 (noting that investors "may be 'underwriters' if they act as links in a chain of transactions through which securities move from an issuer to the public").

Private placements under Section 4(a)(2) typically consist of, among other things: (1) a nonpublic offering (that is, an offering without any form of general solicitation or advertising); (2) to a limited number of offerees; (3) who are buying for investment and not with a view to distribution; and (4) who are sophisticated investors and have been provided with or have access to information about the issuer.[23] In addition, the securities issued in a private placement generally include restrictions on resales by the purchasers (such as through the use of stop-transfer orders, restrictive legends, and the like).[24]

b. "So-Called "Section 4(a)(1½)" — Using the Private Offering Exemption to Negate Underwriter Status for a Resale

The analysis of whether a holder is an underwriter for purposes of the Section 4(a)(1) exemption "necessarily entails an inquiry into whether the transaction involves a public offering."[25] A resale transaction using relevant elements of a private placement under Section 4(a)(2) will not constitute a public offering, which will mean that the resale is not part of a distribution and the seller will not be deemed an "underwriter."

To determine whether a distribution of securities is present, courts have applied the United States Supreme Court's decision in *Ralston Purina*, which focused on "the needs of the offerees for the protections afforded by registration."[26] A holder's resale to purchasers who can "fend for themselves" without registration is a relevant factor in establishing that a transaction does not involve a "public offering."[27] This type of a resale, whereby the transaction is eligible for the exemption provided by Section 4(a)(1) by way of Section 4(a)(2) (that is, applying private placement procedures to the transaction), is commonly referred to as the "Section 4(a)(1½)" resale exemption.[28] The SEC has acknowledged this type of sale as "sales in private transactions which are effected in a manner similar to private placements by issuers under Section [4(a)(2)] of the Securities Act."[29] This type of resale qualifying as exempt from registration under Section 4(a)(1) has also long been acknowledged by the courts.[30] Accordingly, as long as the transaction does not involve public offering (i.e*.,* a distribution), the seller should not be deemed an underwriter and should thus be eligible to utilize the Section 4(a)(1) exemption.[31]

c. Section 4(a)(7)

Section 4(a)(7), which was enacted in 2015, was intended by Congress to essentially be a codification of

[23] Certain courts have held that this information must be comparable to the information investors would have received in a public offering. *See,* e.g.*, Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 903 (5th Cir. 1977). However, as discussed, *infra* Section I.6.d, Reg D does not contain specific information requirements.

[24] Securities sold under Section 4(a)(2) are Restricted Securities that may not be freely resold to the public. Securities Act Rule 144(a)(3).

[25] *Ackerberg v. Johnson*, 892 F.2d 1328, 1335 (8th Cir. 1989).

[26] *SEC v. Ralston Purina Co.*, 346 U.S. 119, 127 (1953); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959) (applying *Ralston Purina* to resales and finding the resales were part of a "public offering" and therefore a "distribution," making Section 4(a)(1) unavailable because reseller was an "underwriter").

[27] *Ralston Purina Co.*, 346 U.S. at 125.

[28] *See,* e.g., "The Section '4(1-1/2)' Phenomenon: Private Resales of 'Restricted' Securities, 34 Bus. Law. 1961 (1979); Olander & Jacks, "The Section 4(1-1/2) Exemption — Reading Between the Lines of the Securities Act of 1933," 15 Sec. Reg. L. J. 339 (1988); "Reinterpreting the 'Section 4(1-1/2)' Exemption from Securities Registration: The Investor Protection Requirement," 16 U.S.F. L. Rev. 681 (1982); Schneider, "Section 4(1-1/2) — Private Resales of Restricted or Control Securities," 49 Ohio St. L. J. 501 (Spring 1988).

[29] Harris, Beech & Wilcox, SEC No-Action Letter (April 14, 1972), Environmental Sciences Corp., SEC No-Action Letter (June 28, 1973; Gadsby & Hannah, SEC No-Action Letter (August 9, 1972), Lancer Homes, Inc., SEC No-Action Letter (April 11, 1972).

[30] *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959); *see also Fuller v. Dilbert*, *32 F.R.D. 60* (S.D.N.Y. 1962); *Hirtenstein v. Tenney,* 252 F. Supp. 827 (S.D.N.Y. 1966); *Neuwirth Investment Fund, Ltd. v. Swanton*, 422 F.Supp. 1187, 1196, Fed. Sec. L. Rep. (CCH) ¶ 95,372 at 98,860 (S.D.N.Y. 1975).

[31] It should be noted however, that Section 4(a)(1½) does not preempt state registration requirements. In addition to the federal requirements under the Securities Act, each of the 50 U.S. states, the District of Columbia, and the major U.S. territories has its own securities statute and related regulations, commonly known as "Blue Sky" laws, which, like the Securities Act, require either registration or an exemption therefrom for any issuance of securities to such state's domiciliaries. So long as the contemplated sales are made to buyers that qualify as institutional investors under the relevant state securities laws, the sale will meet a self-executing exemption at the state level. While sales to QIBs will qualify for the institutional investor exemption in most states (either explicitly or by way of meeting threshold-based definitions), the definitions of institutional investor do vary by state, so attention to state law is recommended.

existing jurisprudence surrounding Section 4(a)(1½).[32] However, it imposes certain conditions that are more restrictive than Section 4(a)(1½) as traditionally understood by courts and legal practitioners. Among other things, Section 4(a)(7) requires that the securities being sold have been authorized and outstanding for at least 90 days and that with respect to resales of securities of an issuer that is not an SEC reporting company, the seller must comply with an information requirement similar to the information requirement under Rule 144, including, a description of the issuer's business; the issuer's most recent balance sheet and income statement for the two preceding fiscal years; and the names of the directors and officers of the issuer.[33] Additionally, Section 4(a)(7) requires that neither the seller, nor any person being remunerated or paid a commission for participating in the offer or sale is subject to the "bad actor" disqualifications under Regulation D under the Securities Act.[34] Because of these restrictions and how general market practices have evolved, market participants tend to view Section 4(a)(7) as best suited to closed trading platform environments.

6. Private Secondary Transaction Guardrails

In order to avoid being deemed an "underwriter" and thus being exposed to Section 11 liability, as well as ensuring that a transaction is properly exempt from registration under the Securities Act, practitioners and courts look to the following four factors in determining whether a transaction is sufficiently private to satisfy the Section 4(a)(2) exemption (and by extension, for purposes of the current analysis, Section 4(a)(1½)).[35]

a. No General Solicitation

The resale should be conducted without general solicitation. Whether there has been a general solicitation is a fact-specific determination, largely focusing on whether the issuer, or a person acting on its behalf, has a relationship with the prospective investor that is both pre-existing and substantive.[36] That is, the relationship generally must be one that has formed prior to the commencement of or participation in the securities offering and is substantive enough to provide sufficient information to evaluate a prospective offeree's financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investor.[37]

The purchasers of the securities should be solicited through a nonpublic process, without general advertising, seminars, or the like.[38] Accordingly, the seller and any

[32] The bill's sponsor, U.S. House Financial Services Committee Vice Chair Rep. Patrick McHenry (R-NC), introduced the RAISE Act "to include Section 4(a)(7) with the existing Rule 4(a)(1½) legal framework for transactions involving the secondary markets," explicitly stating that "a holder of securities issued in a private placement may resell the securities on a public trading market, after a holding period. . . [but] there is not a similar codified law for private resale of restricted securities." (McHenry Introduces the RAISE Act of 2015, United States House Committee on Financial Services, Press Release, Apr. 17, 2015).

[33] 15 U.S.C. § 77d(a)(7).

[34] *Id.*

[35] Financial Industry Regulatory Authority Regulatory Notice 09-05 ("FINRA Reminds Firms of Their Obligations to Determine Whether Securities are Eligible for Public Sale," January 2009). According to the notice, "Before selling securities in reliance on an exemption, a firm must take reasonable steps to ensure that the transaction qualifies for the exemption, regardless of

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whether the sale is for its own accounts or on behalf of customers. This includes taking whatever 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."

Such reasonable steps should mitigate not just the regulatory risk of non-compliance with FINRA Regulatory Notice 09-05, but also the potential business, litigation, and regulatory risk of a transaction effectively being rescinded if the associated offer or sale is found not to have been exempt from the registration requirements of the Securities Act. Under Securities Act Section 12(a)(1), e.g., any person who offers or sells a security in violation of Securities Act Section 5 is liable to the buyer for either (1) the consideration paid for the security (plus interest but less the amount of any income received on the security) or (2) damages (if the buyer no longer owns the security). This liability potentially extends to control persons a broker-dealer under Securities Act Section 15(a). Comm. on Fed. Reg. of Sec., ABA Section of Bus. Law, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors — A Report*, 66 BUS. LAW. 85, 93 (2010).

[36] *See,* e.g., Compliance and Disclosure Interpretations: Securities Act Rules at Questions 256.26 through 256.31 (updated Nov. 20, 2023), *available at* https://www.sec.gov/rules-regulations/staff-guidance/compliance-disclosure-interpretations/consolidated-cdi.

[37] *Id.*

[38] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9415, 78 Fed. Reg. 44771, 44774 (July 24, 2013) (noting that "an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering

broker-dealer acting on behalf of the seller should only engage in outreach with respect to the securities to a defined group of potential purchasers with whom they have a pre-existing relationship. While there is no legal requirement to have a specific limited number of offerees, instituting such a limit can help mitigate the risk of creating a perception of general solicitation. Moreover, any broker-dealers facilitating the solicitation process should monitor for any "red flags" indicating the prospective seller's or prospective buyer's participation in "pyramiding," whereby a limited number of holders sell to a limited number of purchasers, which in turn sell to a limited number of purchasers, and so on, creating a daisy chain that could effectively constitute a distribution of securities.

b. Eligibility of Purchasers

Purchasers should be limited to sophisticated investors that, either alone or with a qualified adviser, have such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment. In this regard, it is recommended for risk-mitigation purposes that the purchasers be either QIBs or, at a minimum, "accredited investors" (as defined in Regulation D, Rule 501).

c. Restrictions on Resales

The purchaser should not purchase the securities with a view to a "distribution."[39] While sometimes purchase documentation may include a representation that is broader than is legally required, such as the purchaser is not purchasing with the "intent to resell," the relevant representation in the purchase documentation can reasonably be limited to (1) not engaging in public distribution and/or (2) only selling the securities in compliance with an exemption from registration. To the extent that the relevant securities are certificated, a restrictive legend should be included referring to the fact that the securities have not been registered and may be offered and sold only if registered or if an exemption from registration is available.[40]

Broker-dealers facilitating secondary sales could also consider prudentially instituting a holding period as an additional risk mitigant. By way of analogy, Section 4(a)(7) of the Securities Act requires that the securities sold have been issued and outstanding for at least 90 days prior to the date of the transaction. To be clear, having such a holding period is not necessary so long as the offering whereby the securities were purchased was not itself a distribution. That is, a "freezer period" and other concepts regarding whether the securities offered in a distribution have "come to rest" should not apply. However, having such a holding period could help mitigate the perception that the securities were sold with a "view to distribution."

d. Access to Information

Each purchaser or its qualified adviser should receive or have meaningful access to such information as a reasonable person may need to make an informed investment decision. The specific information required will depend on the circumstances. In some cases, a holder may not be in a position to provide the purchaser information about the issuer, and the purchaser may be a sophisticated investor who is willing to purchase the securities without receiving information about the issuer from the holder. For example, Rule 506 under Regulation D does not contain an information requirement for sales to accredited investors, suggesting that access to information is not an absolute requirement in appropriate circumstances.

II. SECTION 10(b) AND RULE 10b-5

Private placements under Section 4(a)(2) are, as a general matter, not subject to Securities Act Section 12(a)(2)[41] liability on the basis that they do not involve a "prospectus" as that term is used under the Securities Act.[42] In the absence of this liability standard (and as long as they are not deemed "underwriters" and thus subject to Section 11 liability), broker-dealers acting as placements agents in private placements are held to the general antifraud provisions of the securities, under Exchange Act Section 10(b) and Rule 10(b) thereunder. The Supreme Court has held that scienter is a necessary element of a claim under Section 10(b), and that negligence, by itself, is not sufficient.[43] Although, unlike Sections 12(a)(2) and Section 11, neither Section

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because public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)").

[39] *Supra* Section 1.5.

[40] Securities Act Rule 502(d); *see also* Use of Legends and Stop-Transfer Instructions as Evidence of Non-Public Offering, Release No. 33-5121, 36 Fed. Reg. 1525 (Dec. 30, 1970).

[41] Section 12(a)(2) prohibits materially false or misleading statements in a prospectus or oral communication related to the sale. 15 U.S.C. § 77l.

[42] *Gustafson v. Alloyd Co.*, 513 U.S. 561, 567.

[43] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201.

10(b) nor Rule 10b-5 includes an express due diligence affirmative defense, market participants have adopted and courts have acknowledged a general practice of conducting due diligence in private placements in order to defeat the necessary scienter element in a Section 10(b) nor Rule 10b-5 claim.[44] Accordingly, broker-dealers effecting private secondary transactions will as a general matter want to conduct and document a reasonable investigation concerning the security and the information and representations regarding the security and issuer provided to the prospective buyer in order to mitigate Section 10(b) and Rule 10b-5 risk.[45]

A broker-dealer facilitating a private secondary transaction can also mitigate Section 10(b) and Rule 10b-5 risk by facilitating direct transfer of materials and information from the seller to the buyer (e.g., through the use of a data room) to reduce information asymmetry. Moreover, broker-dealers can adopt certain contractual protections, such as non-reliance or "big boy" provisions whereby the buyer/seller represents to the broker-dealer is a sophisticated investor capable of evaluating investment risks independently and is not relying on any recommendation or advice from the broker-dealer. While "big boy" representations are not effective protections against SEC enforcement,[46] they have been proven at times to be effective in contractual disputes between the parties.[47]

[44] Software Toolworks, 789 F.Supp. 1489; 626–627.

[45] With respect to Rule 144A offerings specifically, broker-dealers have adopted and market participants have come to expect due diligence standards that are generally commensurate with the registered offering context even though the securities laws do not expressly require this.

[46] Barclays Bank PLC and Steven J. Landzberg, SEC Litigation Release No. 20132 (May 30, 2007) *available at* https://www.sec.gov/enforcement-litigation/litigation-releases/lr-20132 (SEC brought and settled a civil enforcement action against Barclays on the basis that certain Barclays employees allegedly sold securities on the basis of MNPI that they received through their roles on creditor committees of distressed companies. The SEC stated in its complaint that the fact that Barclays had entered into big boy letters with some of the purchasers to which it had sold the securities and the fact that such big boy letters stated that Barclays may have MNPI with respect to the issuer did not insulate Barclays from liability under the federal securities laws).

[47] *See,* e.g.*, Harborview Master Fund LP v. Lightpath Techs. Inc*., 601 F.Supp.2d 537; *Pharos Capital Partners L.P. v. Deloitte & Touch* 535 Fed.Appx. 522.

III. FINRA RULE 2111

Regulation Best Interest and the FINRA suitability rule, Rule 2111, can also be drivers of a broker-dealer's due diligence obligation in connection with a private secondary transaction. Such duties specifically arise in connection with the "recommendation" by a broker-dealer to a customer of a transaction. While what constitutes a "recommendation" is not expressly defined by either the SEC or FINRA, the SEC stated in the adopting release for Reg BI that factors to be considered include whether the communication can "reasonably be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities."[48] The SEC has also stated that "the more individually tailored the communication is to a specific customer or targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a 'recommendation.'"[49]

Since Reg BI only applies to recommendations made to natural persons and their legal representatives for their personal, family, or household purposes, it is rarely applicable in the institutional investment banking context and, accordingly, the standard that is applicable to broker-dealers engaging in investment banking activity is typically the suitability standard. Under the FINRA Rule 2111 suitability rule, to the extent that a broker-dealer is deemed to be "recommending" a securities transaction to a counterparty (other than another broker-dealer), it will be subject to "reasonable-basis"[50] and "customer-specific" suitability obligations in relation to such recommendation. The "customer-specific" obligation can be largely discharged with respect to institutional investors through the receipt of an institutional account certificate,[51] and accordingly a

[48] Reg BI; *The Broker-Dealer Standard of Conduct*, SEC Release No. 34-86031 (June 5, 2019) at 79-80.

[49] *Id.*

[50] Under FINRA Rule 2111(a), the "reasonable-basis" suitability obligation requires a broker-dealer "to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable *for at least some investors*".

[51] Under FINRA Rule 2111(b), the "customer-specific" suitability requirement of Rule 2111(a) can be satisfied with respect to "institutional accounts," as defined in FINRA Rule 4512(c), if (1) the broker-dealer "has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities" and (2) "the institutional customer affirmatively indicates that it is exercising independent judgment in

broker-dealer's relevant due diligence obligation in an institutional context effectively boils down to having conducted "reasonable diligence, that the recommendation is suitable a for at least some investors."[52]

FINRA has provided guidance regarding the level of diligence that broker-dealers should conduct in connection with primary private placement offerings in connection with the "reasonable-basis" prong of the suitability obligation.[53] FINRA has specifically stated that such due diligence should include a reasonable investigation concerning the issuer and its management, its business prospects, its assets, the claims that it is making, and its intended use of the proceeds of the offering.[54] While FINRA's guidance has not addressed the level of diligence required for the secondary private transaction context, it has stated that in relation to the primary private placement context that what constitutes a "reasonable investigation" will depend on specific facts and circumstances surrounding the recommendation (including, among other things, the nature of the recommendation, the role of the broker and the broker's knowledge of and relationship to the issuer).[55] Extrapolating from this guidance, an argument can be made that diligence for a Section 4(a)(1½) transaction should be distinguished from that required for a Section 4(a)(2) transaction, as the transaction is not a primary issuance and the broker-dealer's initial gatekeeper function is no longer relevant. Nonetheless, given the lack of express regulatory guidance supporting such a distinction, broker-dealers may desire to remain consistent with their internal due diligence standards in relation to private placements.

Based on the foregoing, it would appear that a broker-dealer's due diligence investigation as part of its "reasonable basis" suitability obligation should at a minimum consist of a review of publicly available information regarding the issuer and the securities, information provided by the issuer/seller in relation to the transaction and the issuer/seller's representations in relation to the transaction for any "red flags" that would alert a prudent person to the need for further inquiry. From a disclosure perspective, a broker-dealer may also consider disclosing to the prospective buyer (1) that the broker-dealer may lack essential information regarding the issuer and (2) the risks resulting from such lack of information.

IV. CONCLUSION

Given the restrictions attendant to Rule 144, Rule 144A, and Section 4(a)(7), Section 4(a)(1½) may often be the only viable way for a broker-dealer to facilitate a private secondary transaction. At the same time, the fact that Section 4(a)(1½) is not subject to discrete parameters and is effectively an amalgamation of primary private placement and secondary market principles can create uncertainty for broker-dealers that wish to utilize it. As market demand continues to grow for private secondary transactions (e.g., exit transactions from private companies), it is likely that broker-dealers will facilitate such transactions more frequently and, barring any new regulations or guidance introducing greater certainty, broker-dealers will need to establish their own risk-based parameters to navigate the various legal and regulatory pressure points applicable to such transactions. ■

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evaluating the . . . recommendations." An "institutional account" is defined in FINRA Rule 4512(c) as "the account of: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million."

52 *Supra* note 50.

53 FINRA Regulatory Notice 10-22 and FINRA Regulatory Notice 23-08.

54 FINRA Regulatory Notice 10-22.

55 *Id.*