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THE St. Louis Broker-Dealer™

To the St. Louis small broker-dealer community, compliance officers, legal officers and small banks with securities-related activities: we forward to you with pleasure (and with some regret for the delay) the seventh issue of our newsletter.

In addition to working with small broker-dealers and registered representative's over the years, I have worked extensively in the entrepreneurial community. The first article of this issue discusses a problem which is becoming increasingly interruptive of this country's process of developing the new businesses which provide the products, services and employment -- and the subject matter for the trading markets – of the future. That problem is the fact of the holdings of the regulators that persons who assist entrepreneurs raise capital from wealthy angel investors are, and must register and be regulated as, broker-dealers while simultaneously refusing to provide a system for such registration and regulation which is appropriate for such persons' actual activity.

The "Business Memo" of this newsletter discusses, but does not answer, the question whether broker-dealers ("B-Ds") and their registered representative ("RRs") are "fiduciaries". As it turns out, there is no "answer". There is only available a conclusion as to what most courts and other authorities have held in concerning similar and differing B-D and RR activities.

Private Placement Broker-Dealers

by: Joe Soraghan (jsoraghan@dmfirm.com)

Both federal and state securities laws require registration of "every person engaged in the business of effecting transactions in securities . . . . " And such registration, of course, requires that principals and RRs take initial and continuing examinations, and that firms meet net capital and extensive ongoing record-keeping and reporting requirements. The examinations require an understanding of the public securities markets, evaluation of the nature of publicly-held securities vis-à-vis the suitability of various investors, the structure of mutual funds, annuities, derivatives and other types of investments, and other concerns of full-service B-Ds.

So, you might ask, do these not simply assure that B-Ds and their RR know how to carry out their business and report their financial well-being, thereby protecting the investing public? What is the problem?

But what about those persons assisting, or who desire to assist, new and entrepreneurial companies seeking to raise start-up and seed stage capital from angel investors. If they are to be paid for this assistance, they are "engaged in the business of effecting transactions in securities…", so they fit the definition of a B-D. Should they be subject to the testing and regulation required of full-service RR and brokers noted above, notwithstanding their subject matter are largely irrelevant to the actual activities of such persons.

The Problem

The ability of such entrepreneurs to raise capital to grow their businesses is crucial to the U.S. economy. Typically successful entrepreneurial companies outgrow their ability to finance their own expansion but are not yet large and mature enough to attract financing from venture capitalists or other institutions. This occurs typically when they need to raise between $250,000 and $5,000,000. In

Inside this issue…

...continued

this range, historically funding has best been provided by "angels", i.e., wealthy, investment-sophisticated individual investors. But "angels" typically do not advertise their status as such, and thus are difficult to find. Expertise is needed to find and educate angels about the value of the entrepreneur's business. Such expertise is typically provided by unregistered intermediaries whose role is similar to that of investment banking departments of large brokerage firms putting together registered public offerings – similar, but requiring very different skills and market knowledge from that of those departments.

(Similarly, there are [unregistered] persons whose business is the introduction and assistance in consummation of merger and acquisition ("M&A") transactions. That is, they help business owners seeking to sell their businesses and persons seeking to buy businesses to find and acquire them. When such a transaction involves the buyer acquiring the stock of the purchased company (as opposed to its assets), the intermediaries also fit the definition of "B-Ds").

These private offering and M&S intermediaries have recently come to be known as private placement broker-dealers (hereafter called "PPBDs").

The market segments in which PPBDs operate -- (i) of transactions between $250,000 and $5,000,000, (ii) with securities of entrepreneurial firms in the "pre-earnings" stage in (iii) the seemingly high legal risk area of "private offerings" – are seldom of interest to full service B-Ds registered under present regulations with the NASD and state securities commissions. And the skills, knowledge and contacts held by those PPBDs (1) are seldom possessed by such registered B-Ds, and (2) are not those required to pass the present NASD testing regime for RR and B-D principals.

And, other requirements for registration and status as a B-D under present law – e.g., net capital requirements – are not meaningful when applied to, and cannot be met by, private offering and M&A intermediaries.

The Position of the Regulators

The SEC has rarely, if ever, brought enforcement actions against PPBDs based solely on their being unregistered. However, in response to requests for "no-action letters" (i.e., interpretive letters) the SEC has held that most activities conducted by such intermediaries constitute B-D activities requiring registration as such. State securities commissions have taken essentially the same position. Further, in enforcement actions brought primarily in response to evidence of fraud, such enforcing regulators typically include charges and findings of unregistered B-D activity and seek enforcement sanctions (such as injunctions) against such activity, as well as against the fraudulent activity which was the cause for the regulators' enforcement action, in the first place.

Efforts to Resolve the Problem

The organized bar, through the American Bar Association, and the Alliance of Merger and Acquisition Advisors, an organization comprised primarily of M&A intermediaries, have thus far led efforts to resolve the problem.

Lawyers representing small businesses and entrepreneurs and M&A consultants over the years saw these issues, particularly as entrepreneurism flourished in the late 1990s. Recently the Business Law Committee of the American Bar Association established its Task Force on Private Place Broker-Dealers in response to "a widely held perception by many members of the Committee . . . that there exists a major disconnect between the various laws and regulations applicable to securities brokerage activities, and the methods and practices actually in daily use by which the vast majority of capital is raised to fund early stage businesses in the United States." The objectives of the Task Force were (i) to survey the issues, (ii) to propose a regime of regulation more applicable to the actual activities of legitimate intermediaries and the needs of their customers.

The ABA Task Force, in its Report and Recommendations of October 12, 2006, recommended that a simplified system of registration of PPBDs be created by the SEC, the NASD and state securities administrators. The Task Force also presented a working draft of regulations to implement that system. These suggested regulations would allow PPBDs to introduce buyers and sellers in connection with sales of businesses effected as sales of securities, to structure transactions and negotiate between buyers and sellers of securities; to introduce buyers and sellers in securities transactions exempt under the 1933 Act if the buyers are accredited or otherwise qualified, and to provide advice on the use of and introduction to fully registered B-Ds. Also, the requirements for NASD membership, record keeping, reporting, net capital, testing and continuing edu-

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cation would be modified to be appropriate to the actual activities of PPBDs.

The proposed system would also significantly limit the activities of PPBDs; under it, PPBDs could not:

- participate in SEC – registered public offerings;
- make offerings to persons other than accredited and otherwise qualified investors, and could make them only on a best efforts basis;
- handle or take possession of funds or securities;
- engage in secondary market or trading activity.

The Regulators' Unenthusiastic Response to Such Efforts

The Securities and Exchange Commission ("SEC"). In an exposure draft of its "recommendations" in response to an early report on these issues, the SEC Advisory Committee's Forum on Small Business Capital Formation on February 28, 2006 "supported the concept" of development of a more appropriate system of regulation of PPBDs. And in November, 2005, the staff of the SEC Division of Market Regulation, in discussions with the PPBD Task Force, indicated they plan to issue a new interpretative release, potentially modifying some of the SEC's restrictive positions. Perhaps more importantly, the SEC staff was also receptive to streamlining the application process and regulatory requirements for PPBDs, including a possible exemption from the net capital rule. The staff's chief counsel suggested the ABA Task Force prepare new rules and/or amendments. As noted above, it did so last October. The SEC has not yet responded to the October 12, 2006 ABA report and recommendations.

The NASD. The NASD staff, on the other hand, was blunt in its disinterest. In a meeting with the Chairperson of the ABA Task Force, the NASD staff noted (1) its concern that (1) PPBDs are smaller than most present NASD members, and their membership fees would probably be insufficient to support their own regulation, requiring subsidization by larger members; (2) creating a regime accommodating what the NASD staff members called a "special class" of B-Ds might cause other "niche businesses" to ask for similar treatment, and (3) adopting a simple notice filing requirement for PPBDs might, if a "notice filer" PPBD got into trouble, cause the press and the SEC to be critical of the NASD for not "knowing what is going on"

State Regulators. A Draft Report of the ABA Task Force was "well received" when presented in July, 2005 by its chairperson to a training seminar of the North American Securities Administrators' Association, the major organization of state securities regulators. But no action was taken then or since by NASAA, although the New Jersey Securities Commission is working on a draft of PPBD rules for that state.

Conclusion

The reaction of the NASD, indefinite as it is thus far, appears negative. The state regulators as a group have indicated no reaction. The SEC has appeared positive but has taken no discernible action to amend the present regulatory scheme, which is untenable. In the opinion of the undersigned, some action by Congress, either by legislation, or at least by hearings followed by directions to the SEC to take action, will be required if the problem is to be treated within a reasonable time.

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Business Memo: Are You A Fiduciary? Why Do You Care?

by: Joe Soraghan (jsoraghan@dmfirm.com)

A lawn care service company sells products and provides services. Registered representatives ("RRs") and broker-dealers ("B-Ds") also provide services and sell products (securities, etc.) to their customers. The question here is whether RRs and B-Ds have a significantly higher duty – a fiduciary duty -- to their customers.

Most RRs and BDs would automatically react that they provide much more sophisticated services and products than a lawn care service and therefore treat their customers with a higher level of care. However, when that customer complains about their service, and perhaps brings a claim in arbitration or litigation, well-advised B-Ds and RRs argue that their duty was not that of a fiduciary. Liability on such a claim frequently turns on whether, and is much more likely if, the arbitrators or court believes that the B-D and RR had a fiduciary duty to the customer.

What is a Fiduciary Duty? Fiduciary duties go beyond mere fairness and honesty; they oblige the RR to act to further the beneficiaries' best interest. Importantly, they require the RR not to act in his own or his B-D's best interest when that best interest conflicts with the best interest of the customer. It requires the RR to give the customer all information which the customer may reasonably believe relevant to his investment decisions, even if giving such information may conflict with the best interest of the RR and his B-D. This is a significantly higher order of duty than is imposed on most salesperson and service providers, and creates liabilities that do not exist otherwise. Doctors and lawyers, for example, owe fiduciary duties to their patients and their clients. (E.g. under Missouri law, a lawyer, upon demand of his client, must return the client's files to the client even if the client refuses to pay for the lawyer's past services.)

Are B-Ds and RRs fiduciaries? It is always held that RRs and B-Ds are fiduciaries when the account is discretionary, allowing the RR to make the investment decisions and enter transactions without the approval of the customer for each transaction. The question arises whether and when the RR and B-D have a fiduciary duty to customers in *non-discretionary* accounts, under which the RR recommends trades but must get the customers approval.

Court cases are at best confusing on this issue, and arbitrators almost never make findings, and so are of no assistance on this question. Court cases are confusing on whether a RR is a fiduciary, on what the duties of a fiduciary are, and in which particular differing situations a RR has a fiduciary duty and in which he does not. For example, some cases have held that RRs are not fiduciaries but then hold them to duties which in fact appear to be fiduciary; one stated that they "owe customers duties of a fiduciary nature." A detailed analysis of the cases indicates that the courts hold RRs to high levels of duties which appear to be fiduciary in nature, even when those courts deny that the RR is a fiduciary. The duties required are almost always much higher than in sales of products other than securities.

It is almost always held that an RR has a fiduciary (or other very high level of) duty when he or she is in virtual control of the functions he or she is to perform for the customer. As prior newsletters have discussed (e.g., February 2004) the factors in determining "control" are not only whether the account is "discretionary" but whether in a non-discretionary account the customer virtually always follows the recommendation of the RR, or clearly does not understand investment risk or the markets, even if he acts sophisticated.

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Missouri Law. State law controls this issue. The two or three applicable cases in Missouri on it do not address all the nuances of the questions. They have simply stated that RRs and B-Ds are fiduciaries to their customers. As one case stated:

Where the account is non-discretionary . . . the stockbroker's duties are . . . fiduciary duties. The broker must study a stock before recommending it and inform the customer of the risks involved in the particular transaction. Beyond that, the duties are to refrain from self dealing and misrepresentation, follow the customer's order and disclose any personal interest in the transaction.

A significant number of cases have held, it is true, that in a non-discretionary account these fiduciary duties do not apply *after* the trade has taken place. That is, the RR's duty with respect to a recommended investment ends upon completion of that investment, different from the continuing duty in a discretionary account. However, the initial recommendation is much more often the subject of claims by customers, and the fiduciary duty does usually apply to the purchase or sale itself in a non-discretionary account.

And, although I have been unable to find cases directly on this point, the fiduciary duty of an RR does undoubtedly require him or her to monitor and advise the customers after a trade in "fee-based" and "fee-for-service" accounts (in which the contract or the understanding with the customer is that the RR will do so.)

The courts have generally held that even though an RR is in reality a salesperson who typically derives compensation from the commissions or otherwise from transactions for his customers, the RR stands in a different legal relationship to his customers from that of other kinds of salespersons. Securities brokerage customers, the cases say (different from the recipient of lawn services) either lack the knowledge and experience to knowingly make their own decisions, or have entered into a relationship with the RR and B-D in which is it understood that the RR will do the analysis, and the customer will not, and that the customer thus becomes dependent on the RR and vulnerable to abuse by him.

Of course, there are well made arguments accepted in a minority of cases by some courts and arbitration panels that, at least in some situations, there is on the part of RRs and B-Ds no fiduciary duty or duty any greater than that of salespersons of any other products. And good attorneys, in defending claims, will make this argument and will sometimes prevail. But the thrust of this newsletter is to set forth guidelines to minimize the likelihood of being found liable while optimizing (not necessarily maximizing) the RRs and B-Ds earnings.

Conclusion

Probably, if an RR is in a position to take advantage of his customer, either because of his or her significantly greater experience and knowledge, or simply from a knowledge that the customer will accept his recommendation (even if the customer has the ability to analyze it himself or herself) the RR is thus in "control" even of non-discretionary accounts and will be held to a very high standard of conduct. They will be held to this standard in order to ensure that the customer's, not his or his B-D's, best interest is protected. Therefore, B-Ds and RRs should treat each customer as he or she would wish another B-D and RR to treat his or her parent or sibling in a similar situation.

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