

## Summary of the Rule 3a4-1 Safe Harbor for Sales of Securities by Officers, Employees and other Associated Persons of the Issuer

January 2012

The following discusses the exemption from registration as a broker under Section 15(a) of the Securities Exchange Act of 1934 (the “Exchange Act” or the “Act”) for persons associated with an issuer involved in the sale of the issuer’s securities.

### Background

Section 15(a)(1) of the Exchange Act requires the registration with the Securities and Exchange Commission (“SEC” or the “Commission”) of any person that acts as a “broker” or “dealer” in securities in interstate commerce. Under Section 3(a)(4)(A) of the Exchange Act, a “broker” is defined generally to mean “any person engaged in the business of effecting transactions in securities for others.”<sup>1</sup>

The “issuer exemption,” as it’s commonly known, typically applies to individual employees or agents of the issuer rather than the issuer itself. The Commission has noted that “the [Exchange] Act has customarily been interpreted not to require the issuer itself to register as either a broker or a dealer” because the issuer is not effecting transactions for the account of others, nor is it engaged in the business of both buying and selling securities for its own account.<sup>2</sup> However, persons acting on behalf of the issuer engaged in distributing its securities, including the issuer’s own directors, officers or employees, may be either “brokers” or “dealers” under Section 3(a) of the Act.<sup>3</sup>

It would be highly impractical for all officers and employees of an issuer to refrain entirely from any involvement in the offer or sale of an issuer’s securities in a public or private offering. Certain executive officers may be

---

<sup>1</sup> The critical test of whether a person is “engaged in the business” of securities transactions is whether there is a “regularity of participation.” *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411 (D. Mass. 1976). The SEC staff (the “Staff”) views this concept of “effecting transactions” broadly to cover participation “at the key points in the chain of distribution,” a very flexible test which has been interpreted to include assisting in structuring a transaction, identifying potential purchasers, soliciting transactions (including advertising) and participating in the order taking or order routing process (*MuniAuction, Inc.*, SEC No-Action Letter, 2000 WL 291007 (Mar. 13, 2000)). The fact that brokerage activities are only a small part of a person’s business does not necessarily mean that registration is not required. *Eastside Church of Christ v. National Plan, Inc.*, 391F.2d 357 (5<sup>th</sup> Cir. 1968).

Over time, the SEC and the Staff have provided lists of factors that are relevant including actively soliciting investors, advising investors as to the merits of an investment and receiving commissions or other transaction-based compensation (*In re Joseph Kemprowski and the Cambridge Consulting Co.*, Exchange Act Release No. 35058, 1994 WL 684628 (Dec. 8, 1994); see also *SEC v. Margolin* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) 97,025 at 94,517 (S.D.N.Y. Sept. 30, 1992) and *SEC v. Hansen*, 726 F. Supp. 74 (S.D.N.Y. 1989). Through its no-action process, the Staff has also provided guidance on a narrow scope of circumstances under which broker-dealer registration may not be required.

<sup>2</sup> See Exchange Act Release No. 34-13195, 1977 WL 174110, Jan. 21, 1977 (“Proposing Release”).

<sup>3</sup> See, e.g., David A. Lipton, *Broker-Dealer Regulation* §1:8 (noting that registration of employees of an issuer, as opposed to registration of the issuer itself, typically warrants a case-by-case analysis).

useful in speaking to prospective investors about the business strategy or financial condition of the company. Meanwhile, the company might find it efficient to utilize investor relations personnel or other administrative staff in the processing of sales to employees or other related persons. Nevertheless, an officer's or employee's status as a paid agent of the issuer necessarily brings into question his or her role as a broker with respect to any involvement he or she may have in sales of securities by the company.

For a long time, the application of any relief from registration for officers and employees of the issuer had been addressed through no-action letters by the SEC staff. Then, in 1985, the Commission promulgated Rule 3a4-1 as "an appropriate and efficient way to provide guidance in this area."<sup>4</sup>

### **The Rule 3a4-1 Safe Harbor**

Rule 3a4-1 is a "non-exclusive safe-harbor" under which an "associated person" of an issuer that performs limited securities sales for the issuer as prescribed by the rule would be deemed not to be a "broker" under Section 3(a)(4) of the Exchange Act, and, thus, not required to register in accordance with Section 15 of the Act.<sup>5</sup>

In order for the safe harbor to apply, each of three preliminary requirements and one of three alternative sets of conditions must be satisfied.

#### Preliminary Requirements

The three preliminary requirements are:

1. The associated person must not be subject to a statutory disqualification, as defined in Section 3(a)(39) of the Exchange Act, at the time of his or her participation in the sale of the issuer's securities.<sup>6</sup>
2. The associated person must not be compensated in connection with the sale of the issuer's securities by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities.<sup>7</sup> In determining whether payment of salary or a bonus satisfies this standard, all of the facts and circumstances of the compensation arrangement must be considered. The Adopting Release cites the following as examples of relevant factors in determining whether the payment of a bonus would be permissible under the rule:
  - > when the offering commences and concludes;
  - > when the employee's bonus is paid;
  - > when it is determined that the employee's bonus will be paid;
  - > when associated persons are informed of the issuer's intention to pay a bonus;
  - > whether the bonus paid to a particular associated person varies with their success in selling the issuer's securities.

---

<sup>4</sup> Exchange Act Release No. 34-22172, 1985 WL 634795, June 20, 1985 ("Adopting Release"), at 1.

<sup>5</sup> The term "associated person" includes any natural person who is a partner, officer, director or employee of the issuer or of a company or partnership that controls, is controlled by or under common control with the issuer. Adopting Release, at 2; see Rule 3a4-1(c)(1).

<sup>6</sup> See Rule 3(a)(4)-(1)(a)(i). A statutory disqualification includes, among other things, being expelled or suspended from a self-regulatory organization, or subject to a Commission order denying, suspending (for a period not exceeding 12 months) or revoking the person's registration as a broker or dealer, or barring such person from being associated with a broker or dealer for a period not exceeding 12 months. See Section 3(a)(39) of the Exchange Act.

<sup>7</sup> See Rule 3a4-1(a)(2).

One commentator has noted that even an increase in an employee's base salary beyond its normal amount to compensate for assuming the additional burdens of selling securities may be sufficient for the Staff to conclude that the compensation is indirectly related to transactions in securities.<sup>8</sup>

3. The associated person must not be an associated person of a broker or dealer at the time of the sale.<sup>9</sup> Among the reasons for this requirement discussed in the Adopting Release is the potential for abusive sales tactics or confusion of investors stemming from the dual association of the issuer's agent with a broker-dealer that may recommend the sale of the issuer's securities.

### Three Categories of Exceptions

As noted, in addition to satisfying each of the above preliminary requirements, one of the following three sets of conditions must be satisfied in order for the safe harbor to apply:

1. Sales Restricted to Certain Classes of Purchasers or Certain Transactions: This category applies where sales of the issuer's securities are made in any one of the following four ways:
  - a. The sales are to a registered broker or dealer; a registered investment company (or registered separate account); an insurance company; a bank; a savings and loan association; a trust company or similar institution supervised by a state or federal banking authority; or a trust for which a bank, a savings and loan association, a trust company, or a registered investment adviser either is the trustee or is authorized in writing to make investment decisions.<sup>10</sup>
  - b. The securities are exempted securities by reason of section 3(a)(7), 3(a)(9) or 3(a)(10) of the Securities. These exemptions include bankruptcy exchanges, issuer exchanges, and court- or agency-supervised exchanges.
  - c. The sales are made pursuant to a plan or agreement submitted for the vote or consent of the security holders who will receive securities of the issuer in connection with a reclassification of securities of the issuer, a merger or consolidation or a similar plan of acquisition involving an exchange of securities, or a transfer of assets of any other person to the issuer in exchange for securities of the issuer.<sup>11</sup>
  - d. The sales are made pursuant to a bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock ownership, stock appreciation, stock option, dividend reinvestment or similar plan for employees of an issuer or a subsidiary of the issuer.<sup>12</sup>
2. Sales Duties Are Limited in Frequency and Proportion: Under this exception, three conditions must be satisfied:
  - a. The associated person primarily performs or is intended primarily to perform at the end of the offering substantial duties for or on behalf of the issuer otherwise in connection with transactions in securities.<sup>13</sup>

---

<sup>8</sup> David A. Lipton, *Broker-Dealer Regulation* §1.10.

<sup>9</sup> See Rule 3a4-1(a)(3). The rule defines "associated person of a broker or dealer" as "any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial and any person who is required under the laws of any State to register as a broker or dealer in that State solely because such person is an issuer of securities or associated person of an issuer of securities shall not be included in the meaning of such term for purposes of this section." Rule 3a4-1(c)(2).

<sup>10</sup> See Rule 3a4-1(a)(4)(i)(A). The Adopting Release emphasized that this list of purchasers does *not* include all categories of accredited investors as defined in Rule 501(a) of the Securities Act of 1933 (the "Securities Act"). Adopting Release, at 5. Instead, it notes that during the rule's comment period, certain commentators advocated expansion of this exemption to all categories of accredited investors under Section 501(a). The Commission concluded that the fact that under limited circumstances investors do not need the protections afforded by registration under the Securities Act does not dictate a conclusion that a broad exemption from broker-dealer registration is appropriate and that existing Commission rules, as well as rules of self-regulatory organizations, designed to ensure "adequate supervision, among other things, seem no less important in this context than in others." *Id.*

<sup>11</sup> See Rule 3a4-1(a)(4)(i)(C).

<sup>12</sup> See Rule 3a4-1(a)(4)(i)(D).

- b. The associated person was not a broker or dealer, or an associated person thereof, within the preceding 12 months.<sup>14</sup>
  - c. The associated person does not participate in selling an offering of securities for any issuer more than once every 12 months (other than in reliance on the other two exceptions in 2(a) and (b) above).<sup>15</sup>
3. Sales Duties Are Passive: This exception applies where the associated person restricts his or her activities to any one or more of several specified types of selling activities, each of which is “passive” or restricted in nature:
- a. Preparing any written communication or delivering such communication through the mails or other means that does not involve oral solicitation by the associated person of a potential purchaser; *Provided, however*, that the content of such communication is approved by a partner, officer or director of the issuer.<sup>16</sup>
  - b. Responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser; *Provided, however*, That the content of such responses are limited to information contained in a registration statement filed under the Securities Act or other offering document.<sup>17</sup>
  - c. Performing ministerial and clerical work involved in effecting any transaction.<sup>18</sup>

An issuer that permits its unregistered directors, officers, employees or other associated persons to participate in the offer or sale of its securities outside the safe harbor afforded by Rule 3a4-1 runs the risk the offering may be subject to rescission by investors whose purchases were induced by such persons.

\* \* \*

Please contact us if you would like to discuss the issues raised herein in more detail.

---

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion.

[www.proskauer.com](http://www.proskauer.com)

© 2012 PROSKAUER ROSE LLP. All Rights Reserved. Attorney Advertising.

Beijing | Boca Raton | Boston | Chicago | Hong Kong | London |

Los Angeles | New Orleans | New York | Newark | Paris | São Paulo | Washington, DC

---

<sup>13</sup> See Rule 3a4-1(a)(ii)(A).

<sup>14</sup> See Rule 3a4-1(a)(ii)(B). See *supra* at n.9 for the definition of “associated person of a broker or dealer.”

<sup>15</sup> See Rule 3a4-1(a)(ii)(C). There is limited guidance on how the 12-month period is measured. A 1984 Commission notice seeking additional public comment in connection with the rule noted that the 12-month restrictive period “begins at the end of the last offering in which the associated person participated on behalf of any issuer...” Exchange Act Release No. 34-20943, 1984 WL 51087, May 9, 1984 at 9.

The Proposing Release notes that this subparagraph of the rule is designed to limit the safe harbor to employees “who are not repetitively involved in the distribution process and thus not ‘in the business’ of distributing securities.” Proposing Release at 2. The Proposing Release also notes that “the repetitive or continuous involvement of persons in effecting transactions for a series of ‘issuers,’ or even a single issuer, may indeed suggest that the persons engaged in that distribution process are doing so as part of a regular business and are therefore brokers within the meaning of Section 3(a)(4) [of the Exchange Act].” Proposing Release at 1.

<sup>16</sup> See Rule 3a4-1(a)(iii)(A).

<sup>17</sup> See Rule 3a4-1(a)(iii)(B).

<sup>18</sup> See Rule 3a4-1(a)(iii)(C).