

THE *St. Louis Broker-Dealer*™

To the St. Louis region small broker-dealers, compliance officers, legal officers and small banks with securities-related activities: We forward to you with pleasure the ninth issue of our newsletter.

The Securities and Exchange Commission, last February 15th, amended Rules 144 and 145, the rules which provide methods allowing the sale by brokers of restricted securities of companies not registered with the SEC (“restricted” securities), and securities held by control persons of companies which are so registered (“control” securities). Of course, failure to comply with the amendments could create liability on the part of a broker-dealer. But the Rules as amended simplify the broker-dealers’ efforts and thus probably reduce their exposure to liability, and so may provide an increased opportunity for revenue generation by brokers willing to provide Rule 144 services.

The “Business Memo” of this newsletter continues the discussion of last July’s issue of defenses which brokers may have to claims of unsuitability of investment recommendations, the most frequent claim made against brokers. Last July’s issue discussed the defenses of ratification, waiver, estoppel and laches. This issue discusses statutes and periods of limitations, after the expiration of which a customer may no longer bring a claim in arbitration or in court.

Amendments to Rules 144 and 145— A Source of Additional Revenues?

by: Joe Soraghan (jsoraghan@dmfirm.com)

Rules 144 and 145, since 1990 providing a method for sales of restricted and control securities, were amended by the Securities and Exchange Commission (“SEC”) effective February 15, 2008.

Reasons for Expanding Rule 144 Business.

As discussed below, the amendments to Rules 144 and 145, on balance, *significantly reduce* requirements for sellers and broker-dealers in processing sales of “control” and “restricted” securities in Rule 144 transactions. As amended, the Rule 144 restrictions no longer apply to the sale of **debt** securities. Prior to amendment, the primary task for the broker-dealer was preparation (for the customer) of Form 144 both in transactions for affiliates and for non-affiliates. After amendment, the requirement to file Form 144 for non-affiliates has been eliminated. Also, prior to amendment, the broker-dealer had to assure that sales, even by non-affiliates, met the limitations (discussed below) on volume of securities sold and manner of sale. As amended, however, those limitations no longer apply to non-affiliate sales. The amendments should make the process of sale of control and restricted securities easier and less fraught with danger for the small broker-dealer processing the transaction.

Just the elimination of manner of sale limitations on non-affiliates, by itself, may increase the ability of a broker-dealer to generate revenues. That is, prior to amendment, sales for non-affiliates could be made only in “brokers transactions,” i.e., agency transactions. As amended, sales for non-affiliates may be made in riskless principal transactions and in transactions directly with market makers, possibly allowing increased revenues for the broker-dealer. And since the non-affiliate customers’ holding periods have been significantly reduced, it is likely that a greater number of clients will seek to use Rule 144, thus also increasing the possibility for greater revenues from increased business. Small broker-dealers with contacts with (i) unregistered companies with a significant number of security holders, or with (ii) control persons of registered companies may want to consider offering Rule 144 services to those companies and security holders, or possibly even making a market in their securities, while of course maintaining a legal compliance program.

Inside this issue...

- ◆ Defending Against Allegations of Unsuitability—Part II Page 5

A Bit of Background

Federal and state securities laws make it illegal to sell securities in transactions which are not registered with the Securities and Exchange Commission ("SEC"), unless an exemption for the sale can be found. Any "seller", including a broker-dealer acting for the owner of the securities, is liable to any suing purchaser to repay the purchase price to the purchaser, if the seller cannot prove an exemption is applicable. Such unregistered securities are generally called "restricted." Other terms sometimes used are "legended" and "lettered."

Although technically not labeled "restricted", but similarly not freely tradeable and needing an exemption from registration are securities of publicly held companies, even though they have been registered, which are or have been owned by an "affiliate," i.e., a control person, of the issuing company, usually an officer or director. They are also sometimes called "control" securities. To qualify as a **non**-affiliate, a person may not have been an affiliate during the prior three months.

The SEC adopted Rule 144 to allow purchases and sales through broker-dealers of such securities under specified and restricted conditions. Over the years since its adoption, broker-dealers have developed processes to implement Rule 144. The February 15, 2008 amendments will require broker-dealers to change those processes, but as changed, the broker-dealers' efforts are simplified and reduced.

Rule 144 allowed holders of restricted and control securities to sell them only after holding them for certain periods of time (holding periods), only in restricted amounts (volume limitations), only in certain types of transactions (manner of sale limitations), only if certain information about the issuer was available to the public (publicly available information), and only if a Form 144 was filed with the SEC. These limitations continue after the recent amendments, but are altered and generally reduced in severity by the amendments. The amendments therefore will make it easier for clients and probably will bring about more requests for small broker-dealers to process Rule 144 transactions. In preparation therefore, small broker-dealers should be aware of the effects on them of such amendments and of changes they should consider in their operations.

For the below discussion, a "reporting company," is one which is required to file and has filed all required periodic reports (excluding Forms 8-K) during the 12 month period preceding the sale of the restricted securities.

The below discussion will cover the Rules' amendments, with at least a brief mention of the pre-amendment requirements for comparison purposes. This discussion will cover only **federal** requirements for exemptions for resales of control and restricted securities. The laws of Missouri and other states must also be complied with and should be checked.

The Amended Rule 144 Requirements.

Form 144. The amended Rule requires the filing of Form 144 in some cases, but significantly less frequently than before amendment. The Form 144 is signed and (in a legal sense) filed by the selling holder of the securities, but the assisting broker-dealer usually prepares the Form 144 and explains it and Rule 144 to the seller. That broker-dealer will now need to prepare and assist in filing the Form 144 less frequently because the threshold size of the sale, below which the Form need not be filed, has been increased. As amended, the Form 144 need be filed only for sales in excess of 5,000 shares or \$50,000.00. Prior to the amendment, these thresholds were 500 shares or \$10,000.00. Also, the requirement for filing Form 144 at all has been eliminated for sales by non-affiliates.

Volume Limitations. Rule 144 continues to set limits upon the amount of securities which may be sold by **affiliates** under Rule 144 in any three month period, but the amendment eliminates the volume limitations on **non-affiliates**. As thus applied to affiliates, both before and after amendment, volume limits never expire.

The volume limits restrict sale by affiliates within a three month period to the greatest of (i) one percent of the outstanding shares of the relevant class of the issuer, or (ii) the average weekly trading volume in such securities during the four calendar weeks preceding the filing of Form 144 or, if no such filing is required, the date of execution of the transaction, or (iii) the average weekly trading volume in such securities reported pursuant to an "effective transaction reporting plan".

The February amendment provides also, however, that if the securities sold are **debt** securities, the limitation is the greater of the above-stated limits or, together with all sales by the seller of such class of debt securities within the preceding three months, ten percent of the principal amount of such class outstanding or tranche of such securities for the issuer.

Manner of Sale Requirements. Prior to the February amendments, Rule 144 transactions could be made only in “brokers’ transactions,” i.e., transactions in which the broker could only execute the order as agent for the seller, receiving no more than the usual and customary agency commission, and could neither solicit nor arrange for the solicitation of customers’ orders. The amendments reduce this restriction significantly. First, there are now **no** such restrictions on the sale of **debt** securities. Second, the Rule now adds to permitted methods of sale of non-debt securities (i) “riskless principal transactions”, where the offsetting trades are executed at the same price (exclusive of an explicitly disclosed fee) and the transaction is permitted to be reported as riskless under the rules of a self-regulatory organization, and (ii) transactions directly with a market maker of the securities.

Current Public Information Requirement. In sales by affiliates, “current public information” must be available concern-

ing the issuer of the securities to be sold. Availability of “current public information” for a reporting issuer requires that such issuer have filed all required 1934 Act reports, except Forms 8-K, during the twelve months preceding the proposed sale. For the sale of securities of non-reporting issuers, there must be publicly available (usually meaning having been promulgated by the issuer to broker-dealers proposing to process transactions in the issuer’s securities) information describing the company, its business and management and its financial statements. Interestingly, this is the type of information generally found in private placement memoranda.

The nature of the current public information required was not changed in the February 2008 amendments. The current public information requirement, under the amended Rule applies always to sales by affiliates, and to sales by non-affiliates until the expiration of a one year holding period (amended from two years by the amendments).

	AFFILIATE	NON-AFFILIATE (and has not been an affiliate during the prior three months)
Restricted Securities of Reporting Issuers	<p>After six-month holding period (was one year) – may resell in accordance with all Rule 144 requirements, including:</p> <ul style="list-style-type: none"> ◆ Current public information, ◆ Volume limitations, ◆ Manner or sale requirements for equity securities (had included debt securities), and ◆ Filing of Form 144 if sell over 500 shares or \$50,000. 	<p>After six-month holding period (was one year), but before one year (was two years) – unlimited public resales (had been subject to volume and manner of sale limitations) under Rule 144 except that the current public information requirement still applies.</p> <p>After one-year holding period (had been two years) – unlimited public resales under Rule 144; need not comply with any other Rule 144 requirement</p> <p>Filing of Form 144 eliminated.</p>
Restricted Securities of Non-Reporting Issuers	<p>After one-year holding period (unchanged) – may resell in accordance with all Rule 144 requirements, including:</p> <ul style="list-style-type: none"> ◆ Current public information, ◆ Volume limitations ◆ Manner of sale requirements for equity securities (had included debt securities, and ◆ Filing of Form 144 if sell over 500 shares or \$50,000 	<p>After one-year holding period (unchanged) – unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements</p>
Unrestricted (i.e., Registered Securities)	<p>No holding period, may resell in accordance with all Rule 144 requirements, including:</p> <ul style="list-style-type: none"> ◆ Current public information; ◆ Volume limitations; ◆ Manner of sale requirements for equity securities ◆ Filing of Form 144 if sell over 500 shares or \$50,000 	<p>No holding period or any other restriction on sale. Unlimited public resales under Section 4(1) of the Securities Act.</p>

Rule 145 - New Restrictions on Shell Company Securities.

Rule 145 concerns sales of securities obtained in “business combinations” such as mergers, stock for stock acquisitions and stock for assets acquisitions. Prior to amendment, Rule 145 imposed a “presumed underwriter” status on affiliates of both the acquired companies and the acquiring companies in such combinations. That underwriter status prevented such affiliates from selling their securities (“control securities”), even when such securities were registered under the 1933 Act in a registered public offering. Rule 145 also, however, allowed such affiliates to resell such securities under the limitations and restrictions of Rule 144.

Rule 145 was amended simultaneously with Rule 144 to eliminate this “presumed underwriter” status as to affiliates of the acquired company who received 1933 Act-registered securities of the acquiring company in a business combination registered under the 1933 Act. Such affiliates of acquired companies are now able to resell their control securities immediately upon obtaining them instead of after the one year holding period as previously required. Affiliates of the acquiring company, however, and those who become its affiliates, remain subject to all the Rule 144 resale conditions, including the holding periods discussed above. (If a business combination and its resultant securities issuances were not registered under the 1933 Act, and thus are in effect exempt private placements, the various restrictions applicable to restricted securities continue to apply.)

However, if either entity in the combination was a shell company, the presumption of underwriter status, together with its resale restrictions on affiliates, continue to apply to affiliates of both the acquirer and the acquired companies. And, importantly, Rule 144 is unavailable for the sale of securities of a company which was a shell when it issued the securities or at the time of the proposed resale.

Considerations for Small Broker-Dealers.

Small broker-dealers who process Rule 144 sales should take actions based upon the above changes. Some small broker-dealers who do not presently process Rule 144 sales may, in light of the easing of restrictions on such sales, and in some cases the reduction in possible liability of sellers and their assisting broker-dealers, want to consider making such sales a part of their business.

Amending Documents as Necessary. Sales under Rule 144 are frequently complicated and require the seller and the assisting broker-dealer to prepare and execute numerous documents. Normally, the broker-dealer requires the selling security holder to execute a representation letter setting forth the facts concerning his ownership (period held, relationship to the issuing company, etc.). The broker-dealer typically also requires the seller or the issuer to provide an opinion of the attorney of either the seller or the issuer, stating that, in light of the facts set forth in the representation letter, and possibly other facts, sale under Rule 144 by the broker-dealer is legal. And broker-dealers customarily furnish the issuer’s attorney with a letter establishing they have made the sales in conformance with Rule 144. Virtually all of these forms will require amendment to accommodate the changes to Rules 144 and 145. Also, though not mentioned in most articles about Rule 144, the broker-dealers should also require assurances of the attorney that the requested transaction will comply with relevant state securities laws.

Also, broker-dealers’ compliance manuals should have sections instructing their personnel concerning the requirements for Rule 144 sales. It is also possible that some sections of Rule 10b5-1 plans of holders of control securities may have provisions concerning Rules 144 and 145 sales. The text of these sections should also be amended to accommodate the Rule 144 and 145 changes.

A Possible Trap. One trap for the unwary broker-dealer is the new prohibition on the use of Rule 144 for the sale of securities of shell companies. Amended Rule 144(i)(1)(i)(B)(ii) prohibits the use of Rule 144 for the sale of the securities of a company that was ever a shell company. And even if the issuing company itself was never a shell company, it is conceivable that it was the acquiring company in a transaction involving a shell company, thus restricting (but not prohibiting) the use of Rule 144 for sale of its securities. Obviously, the forms above-mentioned should be amended to require the selling customer to indicate whether the issuer was ever a shell company, or was a party to a combination involving a shell company. However, some customers may not even know their company was a shell company, or involved with a shell company, in the past. The broker-dealer should also require the issuing company and the attorney giving the opinion to state that the issuing company was never a shell company.

Business Memo: Defending Against Allegations of Unsuitability — Part II: The Period of Limitations

by: Joe Soraghan (jsoraghan@dmfirm.com)

The most frequent allegation brought against broker-dealers and RRs is that of “unsuitability” of recommendations. We discussed avoiding unsuitable recommendations in our July 2003, February 2004 and September 2004 issues. We discussed in our last issue, July 2007, the defenses of ratification, waiver, estoppel and laches. In this issue we will discuss the statute of limitations, or more precisely, the **period** of limitations.

As now implemented, the cause of action for “unsuitability” in arbitration has become a sort of “malpractice” action against broker-dealers and registered representatives, similar to negligence and recklessness malpractice actions against lawyers and doctors. That development arose out of the recent movement of disputes out of courts and into arbitration over the past, say, thirty years. The roots of the “unsuitability” action, even when resolved in arbitration, are actually in the court action of securities fraud. The action was created in state and federal statutes and rules (e.g., Rule 10b-5) and cases beginning early in the last century. And the roots of its period of limitations, not surprisingly, are in that same action of securities fraud.

Those roots are twisted indeed, with complications that only lawyers care about. But we need not analyze the complications. Suffice it to say that it is not possible to predict reliably how a panel will rule on a period of limitations argument.

Arbitrators deciding period of limitations questions must answer two primary sub-questions: (1) how long is it? and (2) when does it start?

How long is it? In practice, arbitrators appear to disagree, but it is pretty clear that it is either two or six years. A long line of federal and state statutes and cases culminated in the Sarbanes-Oxley Act in 2002, which states that, at least in **court**, an “action (for) . . . a claim of fraud, deceit, manipulation, or contrivance in contravention of . . . the securities laws . . . may be brought not later than the earlier of (1) 2 years after the discovery of the facts constituting the violation [the period of limitation], or (2) 5 years after such violation [the period of ‘repose’].” (Because the discovery of the facts could occur a long time after the violation, the period of “repose” is intended to set an “outer limit”, as it were, to assure the matter is finally closed at some reasonable time.)

Rule 12206(a) of the National Association of Securities (NASD, now the Financial Regulatory Authority, FINRA) rules concerning **arbitration** of disputes between customers and broker-dealers states that “no claim shall be eligible for submission to arbitration . . . where six years have elapsed from the occurrence or event giving rise to the claim.” However, under the heading “Effect of Rule on Time Limits for Filing Claim in Court”, Rule 12206(d) states that “the rule does not extend applicable statutes of limitations.”

At first blush, it may appear that paragraph (d) in effect adopts the much shorter court litigation period of limitation of (usually) two years. And this is frequently argued by broker-dealers in arbitrations. But in fact, the more frequently accepted argument is that, although technically the six-year “eligibility” period is not a period of “limitation”, it in fact acts as one, and prevails over the two-year litigation period. Most courts hold that the six-year period mentioned in paragraph (a) limits the time within which an arbitration may be started, and paragraph (d) only says that state and federal periods limiting when a **contractual arbitration clause** may be enforced will not be extended. They hold paragraph (d) does not apply *litigation* securities law fraud limitation periods to “securities fraud” claims (i.e., unsuitability, churning, unauthorized transactions, etc.) in FINRA *arbitrations*. And it appears most arbitration panels deciding limitation questions agree. They do not generally give opinions explaining their decisions, but there appear to be few arbitrations dismissed on grounds of the period of limitations.

When does the period begin to run? FINRA Rule 12206(d) states that the “eligibility” period in FINRA arbitrations runs “from the occurrence or event giving rise to the claim”. That means, for “unsuitability” claims, the arbitration period of “eligibility” begins to run on the date of the purchase(s) claimed to be unsuitable (assuming the recommendation(s) and the purchase(s) were essentially simultaneous.) (Notice: it begins to run, and it expires, regardless of when or if the customer “realizes” that a recommendation was unsuitable.)

When the court litigation period of limitation begins is more complicated. The Sarbanes Oxley provision states that it begins “after **discovery** of the facts constituting the violation...”

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This *language* would seem to indicate that the claimant has to actually *discover* the unsuitability for the period to begin running. But the courts have not been so kind to claimants. Rather, they hold that the period begins running at the earlier of when the claimant discovered, or, **in the exercise of due diligence, should have discovered**, the unsuitability (or other type of “fraud”, e.g., churning). This latter concept is sometimes called “constructive notice” and refers to the moment when, if the claimant had been sufficiently diligent, he or she would have noticed or should have suspected a recommendation was unsuitable. This concept is most often applied by the courts harshly against claimants, often starting the period of limitations when the claimant received a monthly or other statement from the broker indicating that the recommended security had dropped in value.

Small (and large) broker-dealers should take steps to take advantage of whichever period of limitations is applied by the arbitrators or a court. This should be done by assuring that evidence in writing exists of events which will cause the period to begin running. Of course, industry rules require records be kept of the date of purchase. If, however, the broker makes a recommendation well before a purchase is made, it is best to document the date of the recommendation so that if a claim is later made, the broker can claim and prove the earlier start date. And for purposes of later facing a claim, brokers should inform customers of negative news (not just positive news) about past investments made, and record the fact of giving the information, in order to be able to claim and prove that the customer had evidence of a recommendation’s negative aspects, and thus its “unsuitability”, if the arbitrators believe it was unsuitable.

Some notes about this issue

I apologize for the perceived lateness of this issue (although it is an *occasional* Newsletter). The primary reason for the delay is my new volunteer office of president of the Missouri Venture Forum, an organization of entrepreneurs, business persons, accountants, attorneys and others with an interest in fostering entrepreneurship in the Missouri region. It takes a considerable portion of my time. If any readers are interested in assisting in the cause (mainly by networking at our events),

please let me know. For more information, look us up at www.missouriventureforum.com.

The topics discussed in this issue are a bit more complicated than in some other issues. They therefore required more analysis than some previous issues. If you have any questions about them, please do not hesitate to contact me, and let’s discuss them, at no charge.

The Genesis of this Newsletter

I have represented large and small St. Louis region broker-dealers, their registered representatives and investment advisors for many years. I have wondered why there is no organization of, or publications dedicated to, the community of small broker-dealers and small banks with securities activities in that region. It also seems to me, based upon that experience, that questions arise of particular interest to that community, coverage of which benefits both that community and its clients. Therefore, I publish this informal letter to that community, on an occasional and not necessarily periodic basis, noting and discussing (1) questions and events of interest to the small broker-dealer community as they arise; and (2) business memos on topics of on-going interest. Also, if you know of topics or questions which you would like presented, and which are of general interest to small broker-dealers, please let me know.

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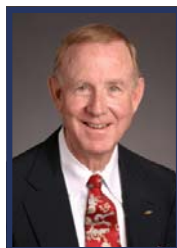
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Joe Soraghan represents broker-dealers and registered representatives in court, in arbitrations and mediations, and before the SEC and state securities commissions. He is a frequent arbitrator and mediator for the NASD. Published in several law reviews and a frequent speaker on securities, Joe also teaches Securities Law Litigation and Arbitration as an adjunct professor at Washington University School of Law.

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