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WHAT DO TRANSFER AGENT RULE PROPOSALS MEAN FOR PUBLIC COMPANIES?

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WHAT HAPPENED

The SEC recently proposed amendments to modernize rules regulating transfer agents. In addition to operational and record-keeping requirements, the proposals would:

- Replace percentage thresholds for turnaround of items with an obligation to maintain "reasonably designed" policies and procedures.
- Establish more detailed, formal requirements for removal of restrictive legends and providing a safe harbor for transfer agents based on either (1) receiving an opinion of non-affiliated outside counsel addressing prescribed matters or (2) conducting their own reasonably documented determination, in any case, without any "red flags" of potential securities law violations.

The SEC is reviewing submissions now that the comment period has expired.

TAKEAWAYS

With other proposals by the SEC ahead in the queue, the timing and content of final transfer agent rules, if any, remain uncertain. However, if adopted, the proposed rules would have potential implications for public companies:

- They may increase turnaround time for transfers of restricted securities, due to more formal diligence requirements, including opinions of outside counsel.
- The safe harbor, as proposed, would not permit opinions from in-house counsel.
- The requirement would extend to any unregistered securities, not just removal of legends.
- They may increase compliance costs for transfer agents by requiring formal policies and procedures, including risk management and diligence.

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- They would require companies to submit a list of employees authorized to instruct transfer agents on adding or removing restrictive legends.

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Restrictive Legends and Unregistered Transactions

The proposed rules would establish four requirements for transfer agents when processing unregistered securities:

- ***Maintain List of Authorized Issuer Representatives.*** Transfer agents would need to:
  - Obtain and maintain a current list of company employees authorized to instruct the transfer agent on placing or removing restrictive legends.
  - Refrain from acting on instructions from anyone not included on the list.
- ***Red Flags and Establishing Reasonable Basis Before Facilitating Certain Transactions.*** Transfer agents would be permitted to act only when they have a reasonable basis to believe that an unregistered securities transaction does not violate, or is not part of a chain of transactions that would violate, Section 5(a) of the Securities Act. The proposed rule provides three examples:
  - Processing or recording an original issuance of securities not registered pursuant to the Securities Act.
  - Processing or recording a request to remove a restrictive legend or stop order on any security.
  - The purchase, sale, or transfer of a security by an affiliate, officer, or director of the issuer of the security.

The rule would not change the burden for any seller of a security in an unregistered transaction of establishing the availability of an exemption from registration.

The SEC cites examples of “red flags” associated with unregistered securities transactions:

- trading suspensions
- concentration of ownership of the majority of freely tradeable securities
- large reverse stock splits
- companies whose assets are large but revenue is minimal

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- a shell company acquisition of a private company
- incomplete or nonexistent issuer filings with the SEC
- a sudden spike in investor demand for a thinly traded or low priced security
- suspicious documents such as inconsistent financial documents or altered certificates of incorporation
- an issuer with several recent name changes
- business combinations
- recapitalizations
- receipt of similar documents from different issuers with certain characteristics, such as involvement of the same attorney

Awareness of a red flag would require the transfer agent to take reasonable steps to inquire further regarding the red flag and proceed with processing only when it has a reasonable basis to believe that doing so will not facilitate a violation of Section 5.

Methods for Establishing Reasonable Basis. The proposed rules would create a non-exclusive safe harbor with two methods for transfer agents to establish the required reasonable basis: (1) obtaining and reviewing an opinion of counsel that meets certain specified requirements; or (2) making their own determination that the transaction may be conducted pursuant to a specific exemption from registration.

In either case, the transfer agent also must not be aware of circumstances indicating that the transaction may violate, or is part of a chain of transactions that may violate, Section 5(a) of the Securities Act.

- **Opinion of Counsel.** Key requirements of an acceptable opinion:
  - It may only be from counsel who is not an affiliate, officer, director or employee of either the company or the individual or entity seeking to resell shares of the company.
  - It must identify the documents and information the counsel reviewed and relied upon in providing the required analysis, so the transfer agent can assess the sufficiency of the factual record.
  - It must analyze the applicability and validity of a specific exemption from registration and, based on that analysis, opine that the specific transaction at issue may be conducted pursuant to the specific exemption from registration so identified.

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- ***Transfer Agent's Own Determination.*** The determination must be supported by written documentation, reviewed and approved by management of the transfer agent, that:
  - Identifies the specific exemption from registration pursuant to which the relevant transaction may be conducted.
  - Identifies the documents and information the transfer agent reviewed and relied upon in making the determination.
  - Identifies and analyzes the specific facts, including the documents and information that establish and support such facts, that support the transfer agent's determination.

Performance Standards for Turnaround and Processing

The proposed rules would require transfer agents (except when acting as an outside registrar) to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that it turns around all routine items received for transfer within the shorter of one business day or the time period specified by the Exchange Act (i.e., T+1).

Relevant factors for transfer agents could include their size, operational complexity, the nature and scope of services provided, technological capabilities, and evolving industry standards and practices, among other things.

This obligation would replace existing requirements to (1) turn around, within three business days of receipt, at least 90% of all "routine items" received during any month and (2) provide "diligent and continuous attention" to non-routine items and turn them around "as soon as possible."

In announcing the proposal, the SEC noted that currently, securities are generally either immobilized at DTC or fully uncertificated, and turnaround is a significantly more streamlined process predominantly effected electronically through book-entry accounts.

Notice Requirements

Transfer agents would be required to provide the required notifications when they fail to turn around or process more than three percent of applicable items within the proposed time frames.

Turnaround of Non-Routine Items

All routine items not turned around within the proposed time and all non-routine items not processed within the specified periods would be required to be turned around promptly.

Written Notice for Rejected Items

Transfer agents would be required to provide a written notification to the presentor for any item rejected that identifies the rejected item, the reasons for rejection, and the specific actions the

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presentor must undertake for the item to be accepted by the transfer agent for processing or turnaround to be completed.

The transfer agent must send notice within one business day of receipt of any item that it rejects.

Compliance

Proposed Rule 17ad-30 would require every registered transfer agent to establish, maintain and enforce written policies and procedures reasonably designed to:

- achieve compliance with the federal securities laws and the rules and regulations thereunder applicable to the transfer agent; and
- identify and remediate instances of non-compliance with the policies and procedures in a timely manner.

The policies and procedures would need to be reviewed and approved by the transfer agent's board of directors at least annually or following material changes to either operations or federal securities laws.

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