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REPORT

Private Placements

Vanishing Breed: The Narrowing Opportunities for Unregistered Finders

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Our society professes to value entrepreneurship. Yet starting or growing a small company requires funding, and the owners of the majority of start-ups and other small companies do not have a venture capitalist or a banker ready to provide them with the financial resources they need. Targeted government loan programs (such as those of the U.S. Small Business Administration) are seldom sufficient (and are generally not intended) in themselves to sustain a small company.

As a result, small business owners seeking investment capital frequently turn to ''finders'' for assistance—people who have not formally registered as ''broker-dealers'' with the Securities and Exchange Commission (the ''SEC'') but who offer to raise funds for them, generally taking a percentage of the proceeds as a fee.

For many years, it was believed that, if a finder only made introductions between the company and potential investors and did not otherwise participate actively in negotiating the terms of the transaction, the finder did not have to register as a broker under Section 15(a) of the Securities Exchange Act of 1934, as amended (the ''Exchange Act'').[1] This was thought to be true in part

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[1] *See, e.g.*, IMF Corp., SEC No-Action Letter, LEXIS 1246 (May 15, 1978) (''Individuals who do nothing more than act as finders by bringing together merger or acquisition-minded persons or entities and who do not participate in subsequent negotiations probably are not brokers or dealers in securities and would not be required to register with the Commission. On the other hand, persons who play an integral role in negotiating and effectuating mergers or acquisitions that involve transactions in securities generally are deemed either a broker or a dealer depending upon their particular activities, and are required to register with the Commission pursuant to Section 15(a).''). *See also*, Gary L. Pleger, Esq., SEC No-Action Letter, LEXIS 2491 (October 11, 1977), Corporate Forum, Inc., SEC No-Action Letter, LEXIS 4320 (December 10, 1972). Moana/Kauai Corporation, SEC No-Action Letter, LEXIS 412 (August

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because the simple act of making introductions did not appear to involve being ''in the business of effecting transactions in securities.''[2]

Nevertheless, the SEC has been reluctant either to modify or create an exemption from the registration requirements of Section 15. Despite pressure from the small business community (including owners, finders and lawyers) to balance the goal of investor protection with the need to promote capital growth, the SEC in this area seems determined to stress its institutional mandate to protect investors.[3]

The bias in favor of investors in the area of capital raising has also come to affect the activities of what have traditionally been known as ''business brokers'', individuals or businesses who assist in the purchase or sale of entire companies. These transactions were generally not regarded as subject to the securities laws, even if the transaction was structured as a sale of the equity in the company. In 1985, however, this view was rejected by the U.S. Supreme Court in *Landreth Timber Co. v. Landreth.*[4] Stressing that the plain language defining ''security'' in Section 2(1) of the Securities Act of 1933 specified ''stock'', the court held that when an instrument is both called ''stock'' and bears stock's usual characteristics, ''a purchaser justifiably may assume that the federal securities laws apply.''

If the sale of a business structured as a sale of equity had to be regarded as a sale of securities subject to federal securities laws, then traditional business brokers would potentially be engaged in the business of ''effecting transactions in securities for the account of others'' and thus potentially subject to the registration requirements of the Act.

In light of the publicity surrounding high profile scandals involving Bernard Madoff, Robert Allen Stanford and others, as well as other external pressures brought to bear by the financial crisis, the SEC and state securities law commissions have been significantly stepping-up enforcement of securities laws. As part of this activity, unregistered finders are being subjected to even harsher scrutiny. For example, the SEC recently issued a no-action letter, *Brumberg, Mackey & Wall, P.L.C.*,[5] in which it refused to say that a finder who merely introduces a client ''to a limited number of its contacts'' would not be required to register as a broker-dealer. In a fact scenario that could be considered very typical, the SEC refused to give assurance that it would not take action against the finder, basing its position almost exclusively on the fact that the firm was receiving transaction-based compensation.

This article will discuss the *Brumberg* letter, as well as some other recent developments affecting finders, and describe some of the risks faced by both the finder and the business owner if the finder's activity is deemed to involve ''inducing or attempting to induce'' the purchase or sale of any security.[6]

Transaction-Based Compensation

As noted in the 2005 Report of the American Bar Association's Task Force on Private Placement Broker-Dealers,[7]

> Although no single factor is dispositive of the question of whether a finder is engaged in the activities of a broker-dealer, SEC no-action letters reveal a variety of factors that are typically given some weight by the staff including: (1) whether the finder was involved in negotiations; (2) whether the finder engaged in solicitation of investors; (3) whether the finder discussed details of the nature of the securities or made recommendations to the prospective buyer or seller; (4) whether the finder was compensated on a transaction-related basis; and (5) whether the finder was previously involved in the sale of securities and/or was disciplined for prior securities activities.

Although all of these factors have played a role in the staff's interpretations of who is a broker, transaction-based compensation has frequently elicited special concern. The staff has frequently stated that such compensation gives the finder a ''salesman's stake'' in a securities transaction.[8] This seems to be based on the presumption that if a finder's compensation is tied to whether a transaction occurs (a ''success fee'') or the dollar value of a transaction (a ''percentage-based commission''), the finder will be tempted to engage in abusive sales practices to get the transaction to close. On the flip side, if the finder's compensation is *not* transaction-based, the SEC staff has appeared more willing to tolerate a broader range of activity without requiring registration.[9]

The Brumberg Letter and Other Recent Developments

According to the request for no-action in *Brumberg*, Brumberg, Mackey & Wall (''BMW'') was a Virginia law firm which did not practice securities law and was not otherwise engaged in activities involving securities. The firm proposed to assist Electronic Magnetic Power Solutions, Inc., a Tennessee corporation (''EMPS''), in

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25, 1974), Paul Anka, SEC No-Action Letter, LEXIS 925 (July 24, 1991), Caplin & Drysdale, Chartered, SEC No-Action Letter, LEXIS 2291 (Apr. 8, 1982), and John DiMeno, SEC No-Action Letter, LEXIS 2791 (April 1, 1979).

[2] Section 3(a)(4) of the Securities Exchange Act of 1934, as amended (the ''Exchange Act''), defines ''broker'' to mean ''any person engaged in the business of effecting transactions in securities for the account of others.''

[3] *See, e.g.*, the American Bar Association's Report and Recommendations of the Task Force on Private Placement Broker-Dealers (June 20, 2005), available at http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf.

[4] 471 U.S. 681 (1985).

[5] SEC No Action Letter (May 17, 2010), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf.

[6] Section 15(a)(1) of the 1934 Act: ''It shall be unlawful for any broker . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

[7] *Supra*, note 3.

[8] *See, e.g.*, Herbruck, Alder & Co., SEC No-Action Letter (June 4, 2002), available at http://www.sec.gov/divisions/marketreg/mr-noaction/herbruckadler050302.htm.

[9] *See* BSC Financial Corporation, SEC No-Action Letter, LEXIS 814 (October 3, 1996); Colonial Equities Corp., SEC No-Action Letter, LEXIS 862 (June 28, 1988). *See also* M Financial, SEC No-Action Letter, LEXIS 786 (June 14, 1988); Original Financial Information Centers of America, Inc., SEC No-Action Letter, LEXIS 2503 (August 31, 1987).

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finding financing. Their role ''would be limited to the introduction of EMPS to a limited number of its contacts who may have an interest in providing funds for financing the operations and development of EMPS.'' The letter recited that BMW would specifically not engage in negotiations with contacts, would not provide them with information about EMPS and would not be involved in advising anyone regarding any agreement to provide funding.

Nevertheless, as noted, the staff refused to grant the no-action relief requested. The staff asserted that transaction-based compensation is ''a hallmark of broker-dealer activity''.[10] However, the staff went further in explaining why merely making a limited number of introductions could still be regarded as the activities of a broker-dealer subject to registration. It took the position that these activities implied that BMW was anticipating both ''pre-screening'' potential investors for eligibility and ''pre-selling'' the securities to gauge their interest.

Therefore, although this fact situation was very different from the one in *Herbruck, Alder & Co.*[11], the staff repeated its assertion from *Herbruck* that the receipt of transaction-based compensation ''would give BMW a 'saleman's stake' in the proposed transactions and would create heightened incentive for BMW to engage in sales efforts.'' Having earlier stated that ''[a] person receiving transaction-based compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer'', the staff concluded that BMW's proposed activities would require such registration. As a result, *Brumberg* seems to mandate that a finder avoid transaction-based compensation if it wants to avoid the risks that of failing to register.

Other developments indicate heightened scrutiny of unregistered brokers by the SEC. For example, many small businesses which conduct a private offering of securities rely on an exemption from registration afforded by Regulation D[12] under the 1933 Act. However, the availability of the exemption is dependent on filing a Form D with the Commission. In 2008, the Commission revised the Form D to require disclosure of recipients of sales compensation regardless of whether the recipient is a natural person and to provide the recipient's Central Registration Depository (CRD) number if the recipient is a registered broker-dealer. Thus, issuers now must publicly disclose whether they are paying compensation to unregistered individuals or companies in connection with the placement, making it easy for federal and state[13] regulators to identify possible violators of the registration requirements. It is also noteworthy that in November 2009, the SEC approved rule changes by the Financial Industry Regulatory Association (FINRA) allowing individuals whose activities are limited to investment banking to take a new Series 79 examination instead of the broader Series 7 examination.[14]

Possible Remaining Exemptions

Despite increasingly strict requirements to register, it is still possible in fairly narrow circumstances for a finder to avoid registration, even if transaction-based compensation is paid. The most prominent example is still the staff's *Paul Anka* letter.[15] There, Mr. Anka had invested in the Ottawa Senators Hockey Club Limited Partnership and had also agreed to introduce potential ''accredited investors'' to the Senators for compensation based on the amount invested by his contacts. In the original request for no action, Mr. Anka was to approach the potential investor and give the issuer's name and the price of the securities offered. He would also disclose his interest in the company and the fact that he would receive a finder's fee. If the investor expressed interest, Mr. Anka would forward the name to the Senators, who would then conduct all further discussions with the investor.

Given the presence of transaction-based compensation, however, the staff apparently refused to confirm that even this limited activity would afford an exemption from registration. A second request had to be submitted which indicated that, instead of Mr. Anka's contacting the investors directly, he would submit to the Senators the names of potential investors ''with whom he has a preexisting personal and/or business relationship and whom he thinks may be interested'' in the investment. Someone from the Senators would then contact the investor, advising that the contact was at Mr. Anka's suggestion. Apparently on the basis of this change, the staff agreed to grant no-action relief.[16]

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[10] The staff cited *Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration*, Securities Exchange Act Release No. 61884 (April 9, 2010) (''Indeed, the receipt of transaction-based compensation often indicates that such a person is engaged in the business of effecting transactions in securities.'' (internal citation omitted)) and a letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Thomas D. Giachetti, Stark & Stark, regarding 1st Global, Inc. (May 7, 2001) (reiterating the staff's position that ''the receipt of securities commissions or other transaction related [sic] compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of 'broker' or 'dealer' . . . generally is required to register as a broker-dealer.'' (internal citations omitted)).

[11] *See* note 8 above.

[12] Rules 501 through 508 (17 C.F.R. §§ 230.501 through 508).

[13] This discussion does not address state securities laws, many of which include restrictions on unregistered finders and penalties for violations of state law. Finders (as well as registered brokers) are advised to review the laws of the states in which they may conduct business to determine what additional requirements may apply to them.

[14] FINRA Regulatory Notice 09-41, effective November 2, 2009, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119461.pdf.

[15] Paul Anka, SEC No-Action Letter, LEXIS 925 (July 24, 1991).

[16] The staff also noted that Mr. Anka ''has not previously engaged in any private or public offering of securities (other than buying and selling securities for his own account through a broker-dealer) and has not acted as a broker or finder for other private placements of securities. [Also,] he does not intend to participate in any distribution of securities after the completion of this proposed private placement.'' BMW, although stating that it was not in the securities business, did not affirmatively state that their proposed engagement with EMPS was expected to be unique.

Also, in the context of business brokers, two no-action letters are worth noting. The first is *International Business Exchange Corp.*,[17] in which a Texas business broker generally offered to sell the assets of businesses but occasionally engaged in a transaction structured as a stock sale, receiving a commission based on the sales price, calculated in the same manner as it would have been if the price had been paid for a debt-free sales of assets. The staff indicated that it would not require IBEC to register as a broker, based on the following factors:

- IBEC generally had a limited role in negotiations between the purchaser and seller.
- The businesses sold were going concerns and not shell corporations.
- Only the assets of the companies were being offered.
- If transactions involved the sale of securities, IBEC would not provide any assistance.
- IBEC did not advise the parties whether to issue securities or assess the value of any securities sold.
- IBEC's compensation did not vary depending on the form of conveyance (e.g., securities rather than assets).
- IBEC had limited involvement in assisting purchasers to obtain financing.

The staff modified this position somewhat in the *Country Business, Inc.*,[18] no-action letter. While the conditions for an exemption were generally the same, the staff in this instance noted that CBI's client ''[satisfied] the size standards for a 'small business' pursuant to the Small Business Size Regulations issued by the U.S. Small Business Administration.''[19] *Country Business* did not explicitly revoke or withdraw *International Business Exchange Corp.*, so it is unclear what the consequences would be if a finder complied with all of the specified factors except that the size of the client company exceeded the relevant SBA size standards.[20]

Risks for Brokers and Client Companies

If the SEC determines that a finder has violated Section 15 of the Exchange Act as a result of its activities, the finder will be subject to potential civil and criminal penalties. For example, in June 2009, the SEC brought enforcement proceedings against two individuals and a firm they owned for carrying on the business of finding money for investors in so-called ''PIPE'' transactions without registering as broker-dealers. The penalties included suspension from the business and fines, penalties, and interest for each in excess of $500,000.[21]

A finder also runs the risk that the client company will refuse to pay the finder's fee on the grounds that Section 29(b) of the Exchange Act permits the client company to void the finder's agreement as a violation of the securities laws.[22] This statute has indeed been used in a number of cases to permit a seller of securities to avoid its obligation to pay fees to an unregistered broker.[23]

A number of commentators have also asserted that the involvement of an unregistered broker in an otherwise bona fide exempt transaction gives rise to an ongoing right of rescission by the investor/purchaser. The reasoning is that the purchase contract between the issuer and the investor is a contract which is part of an illegal arrangement with the unregistered financial intermediary. There are certainly cases allowing investor rescission rights based on improper acts of an unregistered broker or the issuer/seller (such as general solicitations voiding the private offering exemption or breaches of Section 10(b) of the Exchange Act). However, it is difficult to identify cases where the presence of a ''voidable'' contract with an unregistered finder will, without more, support rescission by an investor/purchaser of its securities purchase contract.

In fact, what little case law there is seems to support the view that the investor/buyer's separate and distinct contract with the issuer/seller cannot be rescinded solely on the grounds that the finder's contract itself constitutes a breach of Section 29(b). In *GFL Advantage Fund, Ltd.*[24], the principal of two public companies sought loans for unrelated ventures, offering notes convertible into shares he owned of the two public companies. The conversion rates were tied to the market price of the public company's stock. The principal refused to honor his obligations to allow conversion, and refused to deliver the public company shares, on the grounds that the lender had engaged in short-selling of the public companies' stock in order to increase the number of shares it would receive upon conversion. The principal asserted that the notes were void and unenforceable under Section 29(b) because the notes were ''made in violation of'' Section 10(b) and Rule 10b-5 insofar as (1) they were part of the lender's scheme to manipulate the market prices of the public companies' stock and (2) they contained omissions of material fact about the

[17] SEC No-Action Letter, LEXIS 3065 (Dec. 12, 1986).

[18] SEC No-Action Letter, LEXIS 669 (Nov. 8, 2006).

[19] 13 C.F.R. §§ 121.101 et seq. Size standards represent the largest size that a business (including its subsidiaries and affiliates) may be to remain classified as a small business concern. These size standards apply to SBA's financial assistance and to its other programs, as well as to Federal government procurement programs when there is a benefit available to qualifying as a small business concern. Size standards have been established for types of economic activity, or industry, generally under the North American Industry Classification System (NAICS).

[20] See, however, the discussion of the scope of this exemption on pages 189-195 of the Record of Proceedings of the Twenty-Seventh Annual Sec Government-Business Forum On Small Business Capital Formation Program (November 20, 2008), available at http://www.sec.gov/info/smallbus/sbforumtrans-112008.pdf.

[21] *Ram Capital Resources, LLC*, SEC Release No. 34-60149 (June 19, 2009), available at http://www.sec.gov/litigation/admin/2009/34-60149.pdf.

[22] Section 29(b) of the Exchange Act states in relevant part that ''Every contract made in violation of any provision of [the Exchange Act] or of any rule or regulation thereunder, . . . [or] the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void.''

[23] On page 16 of ''Capital Formation — Making ''Finders'' Viable'' submitted to the SEC's Government-Business Forum On Small Business Capital Formation (September 20, 2004), and available at http://www.sec.gov/info/smallbus/hmakens.pdf, the author states that ''[Section 29] suggests that in any civil litigation an unregistered agent acting on behalf of the issuer will be compelled to return their commissions, fees and expenses; and that the issuer may justifiably refuse to pay commissions, fees and expenses at closing or recoup them at a later time.'' (Citations omitted.)

[24] 272 F.3d at 201 (3rd Cir., 2001).

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lender's short selling strategy. The court rejected the principal's argument, stating that the ''short sales are completely independent of the parties' respective obligations under the terms of the notes'' and concluding that ''the notes were neither made nor performed in violation of any federal securities laws as is required for rescission under Section 29(b).''

In reaching this conclusion, the court distinguished *Regional Properties, Inc. v. Financial and Real Estate Consulting Co.*,[25] a case which directly dealt with a violation of the registration requirements of Section 15(a). In *Regional Properties*, two real estate entrepreneurs brought suit against their broker and his firm. They alleged that the broker had violated Section 15(a)(1) of the Exchange Act by selling limited partnership interests for them without having registered with the SEC as a broker-dealer and therefore sought to rescind their agreements with the unregistered broker on the basis of Section 29(b). The *Regional Properties* court concluded that in this case rescission was proper because the unregistered broker could not perform the agreement without violating Section 15(a) of the Act.

In refusing to permit the principal in *GFL* to rescind its note obligations to the lender, the *GFL* court distinguished the *Regional Properties* case from several other cases in which the party seeking rescission was not permitted to do so despite the presence of violations of the securities laws by the other party that were not caused by the performance of the contract itself. According to the court, ''The parties could — and did — perform the contracts at issue in [the other cases] without committing any violations of the Exchange Act, but the broker in *Regional Properties* could not carry out his obligations under the agreements without violating the Exchange Act, for performance of the agreements entailed selling partnership interests, which the broker lawfully could not do due to his failure to register as a broker-dealer.''

In other words, *GFL* seems to stand for the proposition that, if an agreement between an investor/purchaser and an issuer/seller can itself be performed without violating the securities laws, then that purchase agreement should not be voidable under Section 29(b) even if the finder's agreement in the same transaction might be prohibited under the same section.[26]

Conclusion

Of course, finders can still try to avoid being treated as a broker by structuring their compensation differently. The most obvious alternative is a flat fee arrangement. In at least one letter, *Colonial Equities Corp.*[27] the staff agreed to take no action after the compensation payable by a registered broker-dealer to multiple finders was changed from a percentage of the net brokerage commissions generated from sales. Instead, the registered broker proposed to pay each finder a flat fee for each questionnaire it submitted from a prospective investor and, if the investor was found by Colonial to be suitable, an additional flat fee for arranging an introduction to the investor. In each case, the fee was payable regardless of whether the investor actually made the investment.[28]

Nevertheless, it is clear that the stakes have gotten higher in the current regulatory environment and that the SEC staff continues to view the receipt of transaction-based compensation as a strong indicator that a finder is engaged in activities requiring registration as a broker under the Exchange Act. In such circumstances, therefore, it is the staff's view that the finder should either affiliate with a registered broker or itself register as a broker.

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[25] 678 F.2d 552, 560 (5th Cir. 1982).

[26] *See also Berckeley Investment Group Ltd v. Colkitt*, 455 F. 3d 195 (3rd Cir., 2006). The Berckeley court, in describing its reasoning in *GFL*, states that ''we took a narrow view of the phrases 'made in violation of' and 'the performance of which involves the violation of' contained in Section 29(b). The test, as we applied it in *GFL Advantage Fund*, is whether the securities violations are inseparable from the underlying agreement between the parties. If an agreement cannot be performed without violating the securities laws, that agreement is subject to rescission under Section 29(b).'' (Citations omitted.)

[27] SEC No-Action Letter, LEXIS 862(June 28, 1988)

[28] Colonial's proposal indicated that the fees would be uniform for all finders but might be adjusted up or down once every twelve months on a prospective basis, depending on its ''cost-benefit analysis'' of the services provided. The staff granted no-action relief based in part on ''the fixed nature, uniform application and limitations on adjustment'' of the proposed compensation arrangements.