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ATTORNEYS AND COUNSELORS AT LAW

# THE BROKER TRAP: WHEN NETWORKING GOES BAD

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The truism "it's not what you know, it's who you know" sums up the availability of capital for most businesses. Networking is often essential to the survival of small businesses looking for money or an exit plan through a merger or acquisition. In fact, some small businesses hire attorneys, accountants and investment professionals ("Advisers") based on their seeming ability to provide this nexus to capital. For their part, Advisers often want to play this matchmaking role to help their client succeed, especially if success results in the Adviser's bill being paid. But when does networking cross the line from being a successful business strategy to being a violation of the securities laws? According to the Securities and Exchange Commission's (the "SEC") sweepingly broad definitions, it can be a slippery slope from being an accommodating advocate to an unregistered broker-dealer.

## What is a "Broker-Dealer"?

To most, the term "broker-dealer" describes a narrow subset of the financial services industry involved in the direct purchase or sale of public securities. Yet to the SEC, this term potentially encompasses a large segment of business Advisers. As a result, many Advisers may unknowingly be unregistered broker-dealers and subject to substantial civil and criminal penalties.

Slightly a misnomer, the term "broker-dealer" combines two distinct concepts: the "broker" and the "dealer." Under Section 3(a)(5)(A) of the Securities Exchange Act of 1934 (the "Exchange Act"), a "dealer" is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." Dealers are typically identified as those holding themselves out to the public as being willing to continuously purchase and sell securities.

Whereas, pursuant to Section 3(a)(4)(A) of the Exchange Act, a broker is "any person engaged in the business of effecting transactions in securities for the account of others." Often overlooked, this definition encompasses the concepts of the "finder" and the "business broker," which are typically defined as individuals who receive compensation based, directly or indirectly, on their ability to locate investors for clients.[1] These individuals often participate in the solicitation, negotiation and execution of a transaction and may also handle the securities or funds of an investor in connection with such a transaction. Although some can cross the line as a dealer, it is more common for Advisers to unwittingly act as a broker.

In No-Action Letters, the SEC has provided a non-exclusive list of potential prohibited activities by unregistered broker-dealers, including locating issuers, soliciting investors, and structuring and negotiating transactions.[2] In addition, No-Action Letters have provided guidance that has stressed the following for Advisers: (i) avoid acting as a party's agent during the solicitation of potential investors; and (ii) avoid receiving transaction-based compensation.[3] Although the SEC has granted No-Action relief for Advisers, the relief is limited and highly fact specific, making it difficult to rely on any such releases from the SEC.

**Exemptions from the Broker-Dealer Definition**

*Issuer's Exemption*

Pursuant to Section 15(a)(1) of the Exchange Act, broker-dealers are required to be registered, unless otherwise exempt from registration. Issuers (*i.e.* the companies who stock is being sold) have a generous exemption from registration. Generally, as long as the issuer is not in the business of purchasing and selling securities, the issuer will be exemption from broker-dealer registration on sales of the its own securities. In addition, this exemption also encompasses most directors, officers and employees, who:

(i) are not subject to a statutory disqualification under the Exchange Act;

(ii) are not compensated based directly or indirectly on the securities transaction;

(iii) primarily perform or intend to primarily perform non-offering related duties for the Company;

(iv) are not otherwise an associated person of a broker or dealer;

(v) are not employed by a broker-dealer during the preceding twelve (12) months; and

(iv) limit sales activities.[4]

Advisers, however, are unlikely to be included in the issuer exemption. This leaves Advisers in the uncomfortable position of either taking the risk of performing activities that may be considered prohibited or turning down engagements to avoid potential liability.

*Finder's Exemption*

Advisers often try to claim the fictitious "Finder" exemption as a haven from the definition of a "broker-dealer." Finders are typically defined by: (i) their activities, which may include making introductions between issuers and investors (or buyers and sellers in mergers and acquisitions transactions), providing due diligence services, negotiating terms and conditions or providing information regarding the transaction to other parties; and (ii) receipt of transaction-based compensation.[5] In the past, the SEC drew a distinction between finders and brokers.[6] Generally, the SEC stated that it was willing to allow finder relationships in private transactions so long as the fees paid to the finder were not based on successful sales of individual securities.[7]

Today, however, the SEC views finder relationships with suspicion.[8] Typically, the SEC will deem any person who receives transaction-based compensation a broker-dealer.[9] Consequently, entering into a finder relationship will likely require registration with the SEC.[10] Take, for example, Brumbert, Mackey & Wall, P.L.C. ("BMW"), a law firm which was engaged by a client to make introductions for the sale of securities.[11] BMW did not have a securities law practice and stated that it would not:

(i) participate in the negotiations of the offering;

(ii) provide investors with information;

(iii) make recommendations as to the terms and conditions of the offering; or

(iv) act as counsel to the company for any future offering.[12]

The SEC stated that, although BMW would only introduce its client to potential investors, the fact that the firm would accept transaction-based compensation for the successful sale of securities was enough to deem BMW's activities as requiring registration. Nevertheless, although the SEC does not recognize a Finder's exemption, the agency has been willing to respect written agreements aimed at providing introductions in securities transaction so long as the agreement does not include transaction-based compensation.

*M&A/Sale of a Business Exemption*

Prior to 1985, the SEC recognized a "Sale of Business" exemption, which allowed advisory professionals to sell a business without the federal securities laws applying to the transaction. However, in Landreth Timber v. Landreth, the Supreme Court put an end to this exemption.[13] In that case, the plaintiff was the purchaser of one hundred percent (100%) of the securities in a family business; however, the purchaser left the family in control of the day-to-day

operations of the company.[14] The Court stated that, although the sale of a business normally transfers the economic benefit and control of the company, this is not always the case.[15] Consequently, the Court ruled that a sale of a business, especially where control of the business is not transferred to the purchaser, can be deemed to be a sale of the company's securities and that the "Sale of a Business" exemption was too broad to apply to all business sale transactions.[16]

Since Landreth Timber, however, the SEC has provided limited No-Action relief for Advisers who participate in such a sale.[17] The SEC has suggested that transaction-based compensation for unregistered broker-dealers would be permissible in transactions involving the sale of a business under the following conditions:

(i) the Adviser has a limited role in negotiations between the purchaser and seller;

(ii) the sale is structured as the sale of one hundred percent (100%) of the assets or securities of a going concern, although the transaction is only advertised as the sale of assets; and

(iii) the compensation is determined prior to the decision of whether to structure the transaction as a sale of the assets or securities.[18]

**Penalties for Being Deemed an Unregistered Broker-Dealer**

There are numerous risks involved in acting as an unregistered broker-dealer. Such violations of securities laws may lead to an Adviser to be sanctioned by the SEC or a state securities regulatory body. The SEC has several different claims it can bring against an unregistered broker-dealer. Under Section 15(a)(1) of the Exchange Act, failure to register puts the broker-dealer immediately in violation of the securities laws. In addition, such a transaction may be deemed a violation of Section 10(b) of the Exchange Act, suggesting that failing to register is a manipulative or deceptive device employed in connection with the sale or purchase of a security.

Notably, under Section 29(b) of the Exchange Act, any transaction made in violation of the securities laws makes the transaction voidable. This can mean that, if the SEC deems the Adviser is an unregistered broker-dealer, the Adviser's client may terminate the contract and receive remuneration, including costs and attorney's fees. Significantly, a cease-and-desist order or enforcement action from the SEC cannot only lead to suspensions, fines and potential criminal liability (if fraud is present), it may also lead to potential lawsuits from clients and reputational damage for an Adviser.

## Are you Putting your Clients at Risk?

Clients of unregistered broker-dealers may not only have substantial liability both from the SEC and state regulatory agencies, but also from the other party to the transaction. Using an unregistered broker-dealer may result in charges of aiding and abetting a violation of the federal securities laws under Section 20(e) of the Exchange Act. This also can leave the parties with a voidable contract under Section 29(b). As a result of this rescission right, which can be exercised at any time within three years after the violation or a one year after the date of discovery, the client could not only lose the financing it has already obtained, but could also have trouble attracting future financing because of the continuing taint of the voidable contracts. Significantly, failing to inform investors of the use of an unregistered broker-dealer will likely be considered material and may destroy a Rule 506 offering under Regulation D of the Securities Act of 1933, potentially requiring a private offering to be registered.

Consequently, when Advisers act in the capacity as a broker-dealer without registering, they risk not only their own business and reputation, but that of their clients. As a result, although there is some No-Action support that allows unregistered Advisers to act as finders and sellers of business, crossing the line into prohibited activities carries significant risk and should be avoided.

## About Handler Thayer, LLP

Handler Thayer, LLP is one of the premier private client law firms in the United States. Its international practice, based out of Chicago, Illinois and Washington, D.C., utilizes interdisciplinary teams of advanced planning attorneys. In 2013, Handler Thayer was named "Best Private Client Law Firm in the United States" by *Private Asset Management Magazine*, and recognized by *Corporate International of London* as the "Best Tax Law Firm" and "Best Estate Planning Law Firm" in Illinois. In 2012, Handler Thayer was named "Best Overall Law Firm in the United States." by *Private Asset Management Magazine*, and "Best Private Client Law Firm in North America" by *Family Office Review*. The Firm has also been named to the *U.S. News & World Report* List of Best Lawyers and Best Law Firms in America. Handler Thayer, LLP is dedicated to providing distinctive, technologically-current and responsive services to affluent families, family businesses and family offices. The firm's practice is concentrated in Corporate, Real Estate & Securities Law, Sports & Entertainment Law, Federal, State & International Taxation, Trusts & Estates, and Financial & Estate Planning. Firm clientele include foundations, multinational corporations, professional athletes, prominent entrepreneurs, celebrities and family offices.

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[1] Mike Bantuveris, SEC No-Action Letter (October 23, 1975) (denying no-action relief because "the consulting firm would merely do more than act as a finder in bringing together parties"); *and* May-Pac Management Corporation, SEC No-Action Letter (December 20, 1973) (drawing a distinction between bringing companies together and participating in the negotiations and structuring the transaction).

[2] *See*, Mike Bantuveris, SEC No-Action Letter (October 23, 1975) .

[3] Dominion Resources Inc. (March 7, 2000) (overturning prior SEC No-Action correspondence) *and* Benjamin & Lang, Inc., SEC No-Action Letter (August 1, 1978); *see also* Nemzoff & Co., LLC SEC No-Action Letter (November 30, 2010); Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010); John W. Loofburrow Associates, Inc., SEC No-Action Letter (June 29, 2006).

[4] 17 C.F.R. § 240.3a4-1.

[5] Dominion Resources, Inc., SEC No-Action Letter (March 7, 2000); *see also* SEC Charges Private Equity Firm, Former Executive, and Consultant for Improperly Soliciting Investments, Press Release 2013-36 (March 11, 2013) (discussing a recent Cease-and-Desist Order pursuant to violations of Section 15 by Advisers that provided information and due diligence materials to investors, among other activities, for transaction based compensation).

[6] Dominion Resources, Inc., SEC No-Action Letter (August 22, 1985) (stating that the staff did not object to a finder providing consulting and coordinating services when fees were negotiated prior to the offering and based on financing that the client wished to obtain).

[7] *Id.*

[8] Dominion Resources, Inc., SEC No-Action Letter (March 7, 2000) (reversing the 1985 No-Action letter to Dominion Resources, Inc.).

[9] *Id.*

[10] *But see*, Paul Anka, SEC No-Action Letter (July 24, 1991) (stating that singer, Paul Anka, could provide names of potential investors in a private equity transaction, but could not contact, solicit or make recommendations to such investors or participate in the ultimate negotiations of terms).

[11] *See* Brumberg, Mackey & Wall, P.L.C., SEC No Action Letter (May 17, 2010).

[12] *Id.*

[13] 471 U.S. 681 (1985).

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] Country Business, Inc., SEC No-Action Letter (November 8, 2006).

[18] *Id.*