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Finders and Unregistered Broker-Dealers

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In the last few years, we have seen a number of important developments in the securities laws related to finders and broker-dealer registration requirements. Below we provide an overview of the broker-dealer registration requirement as it relates to finders who assist in matching issuers with investors or buyers and the latest developments in this area.

Overview

The distinction between being classified as a finder and a broker-dealer can have significant consequences. An unregistered broker-dealer may face sanctions from the Securities and Exchange Commission (SEC), and it may be unable to enforce payment for its services. In addition, transactions involving an unregistered broker-dealer may create a right of rescission in favor of the investors, allowing the investors the right to require the issuer to return the money invested. One example of the consequences of an unregistered broker-dealer occurred in the *Ranieri Partners* SEC enforcement action. In that action the SEC brought charges against a private-equity firm, its managing director, and a consultant because of the consultant's failure to register as a broker-dealer. The SEC's order found that the private equity firm paid transaction-based fees to a consultant, who was not registered as a broker-dealer, for soliciting investors for private fund investments.[1]

The federal securities laws do not specifically define the term "finder" or outline what finders can do. Instead, finders must avoid being deemed a broker or dealer under the federal securities laws unless they register as such with the SEC and the Financial Industry Regulatory Authority (FINRA). A broker is defined as "any person engaged in the business of effecting transactions in securities for the accounts of others."[2] A dealer is defined as a person that is "engaged in the business of buying and selling securities ... for such person's own account," but excludes a person that buys and sells securities for its own account, but not as part of a regular business.[3] Because the broker definition is the one that finders have the most trouble with, this discussion is focused on what activities may cause a finder to fall within the definition of a broker required to register with the SEC and FINRA.

To help determine whether certain activities bring someone within the definition of a broker, the SEC has revealed, through various no-action letters and other guidance, the various factors it considers when deciding whether a finder has violated the securities laws by failing to register as a broker-dealer. According to case law and SEC no-action letters, the following facts are typical of finders who would not need to register as a broker-dealer:

1. Introduces investors to issuers or their promoters without further involvement in discussions between the issuer and the investor(s) and without giving advice on the investment's structure or suitability;
2. Receives compensation for making introductions and the compensation is not tied to the success of the raising of capital (i.e., not a commission);
3. Assists in transactions that convey all of a business's equity securities or assets to a single purchaser or group of purchasers; and
4. Does not assist purchasers with obtaining financing, other than providing uncompensated introductions to third-party lenders or help with completing the paperwork associated with loan applications.

The following factors are typical of broker activity where the person involved may need to be a registered broker-dealer:

1. Participates in discussions and negotiations between the issuer and the potential investors;
2. Assists in structuring transactions;
3. Receives transaction-based compensation, i.e., a commission or some form of compensation that varies with the size or type of the resulting investment;
4. Engages in "pre-screening" potential investors to determine their eligibility to purchase securities;
5. Engages in "pre-selling" the issuance to gauge the level of interest;
6. Conducts or assists with the sale of securities;
7. Provides advice regarding the value of securities;
8. Locates issuers on behalf of investors;
9. Solicits new clients;
10. Disseminates quotes for securities or other pricing information;
11. Actively (rather than passively) finds investors;
12. Sends private placement memoranda, subscription documents, and

due diligence materials to potential investors;

13. Advises on portfolio allocations to accommodate an investment;

14. Provides analyses of potential investments; and

15. Provides potential investors with confidential information identifying other investors and their capital commitments.[4]

As these lists demonstrate, there is very little that a finder may do without crossing the line into activities that may trigger the requirement to register as a broker-dealer. No factor alone will determine whether a finder should register as a broker-dealer; all existing factors are considered together in making such a determination.

Nevertheless, some factors may carry more weight than others. One that appears to draw close attention from the SEC is the existence of transaction-based compensation, which often signals that the individual is more involved in the transaction than simply making introductions. The SEC has stated that "the federal securities laws require that an individual who solicits investments in return for transaction-based compensation be registered as a broker."[5] In addition, one court stated, "[transaction-based compensation] is the hallmark of a salesman."[6] Yet, the court rejected the notion that transaction-based compensation alone can trigger broker-dealer registration.[7] The reason for the SEC's concern appears to be that the existence of transaction-based compensation creates a heightened incentive to engage in sales efforts, and the securities laws aim to regulate those who engage in selling securities.

M&A Brokers

In 1985, the U.S. Supreme Court held in *Landreth Timber Co. v. Landreth* that the sale of all or a controlling interest in a business is a securities transaction.[8] Therefore, a person involved in facilitating the sale of an operating business could fall within the definition of a broker as defined in the Securities Exchange Act of 1934 (Exchange Act). There has been a great deal of ambiguity in this area ever since that decision.

In a no-action letter released on January 31, 2014, the SEC's Division of Trading and Markets (the Division) provided some helpful guidance for financial advisors involved in the sale of a private company (M&A Brokers). The Division stated that it would not recommend enforcement action to the SEC if an unregistered M&A Broker were to effect securities transactions in connection with the transfer of ownership of a privately held company, provided that the transaction complies with the terms and conditions described in the Division's no-action letter.

According to the no-action letter, an "M&A Broker" is limited to:

> effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company.

There are a number of conditions in the no-action letter that the Division expects an M&A Broker to meet. The key conditions that the Division listed are:

1. The M&A Broker will not have the ability to bind a party to an M&A transaction;

2. The M&A Broker will not provide financing for an M&A transaction;

3. The M&A Broker will not have custody, control, or possession of securities or funds in connection with the M&A transaction;

4. No party to the M&A transaction will be a shell company, other than a business combination related shell company;

5. The M&A transaction will not involve a public offering and is exempt from registration;

6. If the M&A Broker represents both buyers and sellers, it will provide clear written disclosure as to the parties it represents and obtain written consent from both parties to the joint representation;

7. The M&A Broker will not assist in the formation of a group of buyers for M&A transactions that it facilitates;

8. The buyers or group of buyers will, upon completion of the M&A transaction, control and actively operate the company or the business conducted with the assets of the business;

9. The M&A transaction will not result in the transfer of interests to a passive buyer or group of buyers;

10. The securities received by the buyer will be restricted securities; and

11. The M&A Broker and its officers, directors, and employees have not been:

    - Barred from association with a broker-dealer by the SEC, any state or any self-regulatory organization; or
    - Suspended from association with a broker-dealer.

This no-action letter does not affect state law on the matter. The North American Securities Administrators Association (NASAA) proposed a uniform state model rule that would provide an exemption for M&A Brokers from registration as brokers, dealers, and agents under state law.[9] However, nothing has been finalized as of the date of this article.

Foreign M&A Brokers have also been granted relief from broker-dealer registration. In a no-action letter in May 2013, the Division provided guidance allowing for a foreign person to interact with a U.S. target company in establishing and developing an M&A transaction without facing broker-dealer registration if:

1. The U.S. target is using internal or group-level personnel with relevant M&A experience or an external advisor, such as a broker-dealer or other relevant professional;
2. The foreign M&A Broker does not receive, acquire, or hold funds or securities in connection with the transaction;
3. The foreign M&A Broker does not represent or advise the U.S. target company in any regard with respect to the transaction; and
4. The M&A Broker complies with the antifraud provisions of the U.S. securities laws.[10]

It is important to note that the foreign M&A Broker who requested no-action relief also made the representation that it would only approach "Major U.S. Institutional Investors," as defined in Rule 15a-6(b)(4) under the Exchange Act.

FINRA Guidance

FINRA recently took action to clarify the requirements for registered broker-dealers who deal with finders and how its rules fit with the securities laws. FINRA recently issued Rule 2040, effective August 24, 2015, in an effort to align broker-dealer activity with Section 15(a) of the Exchange Act and provide guidelines relating to the payment of transaction-based compensation by member firms to unregistered persons. The rule states that registered broker-dealers may not pay "any compensation, fees, concessions, discounts, commissions or other allowances to any person that is not registered as a broker-dealer, but by reason of receipt of any such payments and the activities related thereto, is required to be so registered under applicable federal securities laws and Exchange Act rules and regulations." Broker-dealers must look to SEC rules to determine whether the activities in question require registration as a broker-dealer under Exchange Act Section 15(a). Broker-dealers can support their determination by, among other things:

1. Reasonably relying on previously published releases, no-action letters, or interpretations from the SEC staff that apply to their facts and circumstances;
2. Seeking a no-action letter from the SEC staff; or
3. Obtaining a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area.

Broker-dealers must maintain books and records that reflect the member firm's determination.

A carveout is provided in FINRA Rule 2040(c) for foreign finders, allowing a broker-dealer to pay transaction-related compensation to non-registered foreign finders, where the finders' sole involvement is the initial referral to the broker-dealer of non-U.S. customers. However, several conditions apply. See the rule for further details.[11]

Investment Platforms for Private Placements

Rule 506 of Regulation D provides a safe harbor for private offerings conducted under the exemption from registration in Section 4(a)(2) of the Securities Act of 1933. Certain websites are in the business of connecting private companies with accredited investors to effect private offerings pursuant to Rule 506.

The JOBS Act provided a limited exemption from registration as a broker-dealer for private placements done under Rule 506 of Regulation D. The exemption extends to investment platforms that would be required to register as a broker-dealer because of involvement in offerings made pursuant to Rule 506 of Regulation D under the Securities Act. This exemption is available to a person or any person associated with that person who:

1. Maintains a platform (e.g., website) that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitation or advertisements by issuers of such securities;
2. Co-invests in such securities; or
3. Provides ancillary services (as defined in the statute, e.g., due diligence services) with respect to such securities.

The person qualifies for the exemption if:

1. It does not receive compensation in connection with the purchase or sale of the security;
2. It does not take possession of customer funds or securities in connection with the purchase or sale of the security; and
3. It is not disqualified by "bad actor" provisions.[12]

Investment Platforms for Private Funds

In March of 2013, the SEC provided no-action relief from the broker-dealer registration requirements for operators of certain investment platforms that involve marketing activities for investments in private funds. Two no-action letters were issued: one to an investment platform for "angel investing" (AngelList)[13] and another to an investment platform for venture capital investing (FundersClub).[14]

FundersClub posts information on its website about investments in start-up companies. The information is available only to FundersClub members, all of whom have been pre-screened as accredited investors. Once investment interest and investor qualifications are confirmed, an investment fund is

formed, and FundersClub negotiates the final terms of the investment fund's investment. Funds are directed to a custody account at a custodian bank or trust company. FundersClub then oversees the investments and provides consulting and management assistance to the companies. FundersClub is compensated only by receiving a percentage of the profits from the investment fund (i.e., carried interest). The Division of Trading and Markets granted no-action relief to FundersClub from broker-dealer registration, based particularly on the following representations:

1. FundersClub advises and manages only venture capital funds;
2. FundersClub receives compensation (i.e., carried interest) for its services, the nature of which are traditional advisory and consulting services, and not transaction-based compensation;
3. Officers, directors, and employees of FundersClub personally do not receive transaction-based compensation for their efforts in raising investment funds;
4. Full and fair disclosure is made to investors about FundersClub's compensation and fees;
5. FundersClub does not receive the administrative fees and any remainder is distributed to investors;
6. FundersClub is unable to withdraw any deposited funds from the custody account for its own use; and
7. Neither FundersClub, nor any subsidiary, principal, employee, board member, controlling shareholder, or other associated persons are subject to "bad actor" disqualification.

The AngelList no-action request provided that AngelList form a wholly owned subsidiary, AngelList Advisors LLC (AngelList Advisors), to register as an investment adviser with the SEC or one or more states. AngelList Advisors provides an angel investing platform as part of its website that assists accredited investors in identifying companies that seek capital and in which one or more investors intend to invest. Once an angel investor (Lead Angel) and a company are matched, a separate investment vehicle (i.e., limited liability company or limited partnership) is formed and made available to investors through the platform. AngelList Advisors lines up interest from investors in the portfolio company, and the funds are then transferred directly to the bank account set up for the investment vehicle. AngelList Advisors then manages the investments and is compensated only by receiving a percentage of the profits from the investment fund (i.e., carried interest).

The Division stated it would not recommend enforcement action if AngelList Advisors operated the platform without registering as a broker-dealer. The key representations forming the basis for the Division's letter include:

1. AngelList Advisors is a registered investment adviser with the SEC or one or more states;
2. AngelList Advisors provides investment advice and administrative services to the investment vehicle;
3. AngelList Advisors operates an internet-based platform that is available exclusively to accredited investors;
4. Investments are offered and sold in compliance with Rule 506 of Regulation D;
5. AngelList Advisors and any Lead Angel receive compensation equal to a portion of the increase in value, if any, of the investment and do not receive transaction-based compensation;
6. AngelList Advisors' and the Lead Angel's services are traditional advisory and consulting in nature;
7. No officer, director, or employee of AngelList Advisors or any Lead Angel receives transaction-based compensation in connection with the investments;
8. The specific terms of any compensation paid to AngelList Advisors or any Lead Angel are described in the relevant offering document;
9. Neither AngelList Advisors nor any Lead Angel handles any customer funds or securities;
10. Neither AngelList Advisors nor any Lead Angel solicits investors other than on the website;
11. Neither AngelList Advisors nor any Lead Angel nor any principal, employee, board member, controlling shareholder, or other associated persons of AngelList, AngelList Advisors, or Lead Angels are disqualified by "bad actor" provisions.

Although these no-action letters are specific to the entities seeking no-action relief, the insight provided by the various factors indicates which activities the SEC finds acceptable for an unregistered broker-dealer.

Crowdfunding

On October 30, 2015, the SEC adopted final rules for crowdfunding pursuant to Part III of the JOBS Act (Regulation Crowdfunding). Under this exemption from registration, issuers may issue up to $1 million in a 12-month period. These offerings are conducted through a new regulated entity called a "funding portal" that is exclusive to offerings made pursuant to Regulation Crowdfunding. A funding portal is exempt from broker-dealer registration when conducting crowdfunding transactions, but it must follow certain guidelines. For further details, see our client alert, *SEC Adopts Final Rules for Securities-Based Crowdfunding*, dated November 11, 2015.[15]

12. People often refer to other types of offerings as crowdfunding offerings, e.g., private offerings conducted pursuant to Rule 506 of Regulation D through investment

platforms. However, only offerings conducted according to the requirements of Regulation Crowdfunding are eligible for the exemptions provided therein. Intermediaries conducting offerings pursuant to Rule 506 or some other exemption from registration cannot rely on the broker-dealer exemption provided for funding portals in Regulation Crowdfunding.

Potential Regulatory Action

On April 5, 2013, David W. Blass, Chief Counsel of the Division of Trading and Markets at the SEC, gave a speech in which he mentioned that the SEC, in collaboration with FINRA, has been in discussions with interested groups about how the broker-dealer registration requirements apply to placement agents, finders, and business or M&A brokers.[16]

Additionally, the SEC Advisory Committee on Small and Emerging Businesses (the Committee) has been exploring the development of a less onerous regulatory scheme for placement agents, finders, and M&A brokers. In a presentation to the Committee on June 3, 2015, Committee member Gregory C. Yadley noted that the registration process for a broker-dealer is too burdensome for finders, and an exemption or separate registration process should be provided.[17] Mr. Yadley noted in his presentation that the current broker-dealer registration system is overwhelming; a finder working for smaller businesses would find it unreasonable to maintain minimum net capital, submit audited financial statements, or maintain the compliance infrastructure required of a full-service brokerage firm.[18] The SEC, FINRA, American Bar Association, and NASAA have all been involved in discussions regarding this issue, and it is possible that we could see a less stringent registration process for finders in the future.

To that end, the Committee submitted formal recommendations to SEC Chair Mary Jo White on September 23, 2015.[19] The Committee recommended that the SEC:

1. Clarify that broker-dealer registration is not required of a person who receives transaction-based compensation solely for providing names of, or introductions to, prospective investors;

2. Provide an exemption from federal broker-dealer registration to intermediaries who are actively involved in the discussions, negotiations, and structuring, as well as the solicitation of prospective investors, for private financings on a regular basis, conditioned upon registration as a broker under state law;

3. Coordinate state regulation with NASAA and FINRA; and

4. Take immediate steps to address issues regarding regulation of intermediaries in small business capital formation transactions rather than waiting until the development of a comprehensive solution.

Conclusion

A determination of whether an intermediary is acting as a finder or an unregistered broker-dealer is a very fact-specific analysis and can often be very complex. Unfortunately for unwary entrepreneurs, company executives, and equity fund sponsors, frequently a third party assisting with capital-raising will be acting as a broker-dealer, not a finder, and therefore should not be engaged unless properly registered. It is likely that we will see further clarification or new rules from regulators in the future; regardless, it is important to always carefully consider the involvement of finders or broker-dealers in any capital-raising endeavor.

If you have any questions regarding the use of finders, or capital raising in general, please contact the Venable lawyer with whom you work, one of the authors of this article, or a member of our Corporate Finance and Securities Group.

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1. For further details, see our client alert on this action, *Finders May Pose Risk in Private Capital Raising* (Mar. 2013), available at https://www.venable.com/finders-may-pose-risk-in-private-capital-raising-03-22-2013/.
2. 15 U.S.C. § 78c(a)(4).
3. Section 3(a)(5), Exchange Act.
4. *See* Mike Bantuveris, SEC No-Action Letter (Oct. 23, 1975); Country Business, Inc, SEC No-Action Letter (Nov. 8, 2006); Putnam Investor Services, Inc., SEC No-Action Letter (Dec. 31, 2009); Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010); Nemzoff & Co., LLC, SEC No-Action Letter (Nov. 30, 2010); and SEC Guide to Broker-Dealer Registration, Division of Trading and Markets (Apr. 2008).
5. Securities Exchange Act Release No. 69091 (Mar. 8, 2013); Securities Exchange Act Release No. 69090 (Mar. 8, 2013).
6. *SEC v. Kramer*, 778 F.Supp.2d 1320, 1334 (M.D. Fla., 2011).
7. *Id.*
8. 471 U.S. 681 (1985).
9. The first request for comments was made in January 2015. *See* Notice of Request for Comment Regarding a Proposed NASAA Model Rule Exempting Certain Merger and Acquisition Brokers from Registration Pursuant to State Securities Acts (Jan. 2015), http://www.nasaa.org/34261/notice-request-public-comment-proposed-nasaa-model-rule-exempting-certain-merger-acquisition-brokers-state-registration/. A second request for comments was made in April 2015, and the comment period expired on

May 17, 2015. *See* Notice of Request for Additional Comments Regarding a Proposed NASAA Model Rule Exempting Certain Merger and Acquisition Brokers form State Registration (Apr. 2015), http://www.nasaa.org/35234/notice-of-request-for-additional-comments-regarding-a-proposed-nasaa-model-rule-exemption-certain-merger-and-acquisition-brokers-from-state-registration/.

10. *See* Roland Berger Strategy Consultants, SEC No-Action Letter (May 28, 2013).
11. *See* FINRA Regulatory Notice 15-07 (Mar. 2015), http://www.finra.org/industry/notices/15-07.
12. The Division of Trading and Markets provided additional guidance on this exemption in a set of Frequently Asked Questions posted on the SEC's website on February 5, 2013. *See* http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.
13. *See* AngelList LLC, SEC No-Action Letter (Mar. 28, 2013), http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf.
14. *See* FundersClub Inc. & FundersClub Mgm't LLC, SEC No-Action Letter (Mar. 26, 2013), http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf.
15. *See SEC Adopts Final Rules for Securities-Based Crowdfunding* (Nov. 11, 2015), https://www.venable.com/sec-adopts-final-rules-for-securities-based-crowdfunding-11-11-2015/.
16. *See* David W. Blass, *A Few Observations in the Private Fund Space* (Apr. 5, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1365171515178.
17. *See* Gregory C. Yadley, *Notable by Their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation* (June 3, 2015), http://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf.
18. *Id.*
19. *See* Letter to The Honorable Mary Jo White from the Sec. and Exch. Comm'n Advisory Comm. on Small and Emerging Companies (Sept. 23, 2015), https://www.sec.gov/info/smallbus/acsec/acsec-recommendations-regulation-of-finders.pdf.

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