Finders and Unregistered Broker-Dealers

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The issue of when a person may be considered a "broker" or "dealer" and subject to registration as such under the federal securities laws, as distinguished from so-called finders (and therefore not subject to the panoply of broker-dealer regulations and obligations), is of particular importance to deal makers, capital raisers, entities employing "finders," and their financial and legal advisors. The last decade has seen a number of important developments in the securities laws related to the regulation of the activity of persons and entities participating in capital raising and corporate transactions, who have continued to be on the enforcement radar of both federal and state regulators. Below is an overview of the current regulatory regime and implications of the distinction between "broker-dealers" on the one hand, and "finders" on the other, and the latest developments in this area.

I. Overview

The distinction between a finder and a broker-dealer, as classified by the Securities and Exchange Commission (SEC), can have significant adverse legal and business implications. For instance, acting as an unregistered broker-dealer can lead to (i) cease-and-desist orders from the SEC,[1] a state regulator, or court injunctions; (ii) civil penalties, including fines and disgorgement;[2] (iii) criminal penalties;[3] (iv) potential rescission rights of investors;[4] and (v) reputational harm.

In recent years, the SEC has brought several actions in the federal courts against finders, confirming that the activity of unregistered broker-dealers participating in capital raising remains squarely on the SEC agenda. A few notable examples of the consequences of unregistered broker-dealer activities are depicted in *SEC v. Sky Group USA, LLC, et al.*,[5] *SEC v. Richard Eden, et al.*,[6] and the SEC enforcement action in the matter of *Ranieri*.[7]

In *Sky*, the SEC brought suit against a payday loan firm (Sky) for numerous violations of the federal securities laws arising out of a Ponzi scheme, and against four of Sky's sales agents. The charges that the SEC brought against the four sales agents were for unlawful marketing of promissory notes to investors. Specifically, it was claimed that the sales agents made sales pitches to investors, and provided marketing documents and logistical help to investors to close their investment, in exchange for commissions on such sales, while not registered as broker-dealers. The four sales agents consented to entry of a final judgment, which included disgorgement of ill-gotten gains, payment of civil penalties, permanent injunction, and an officer and director bar against one of the sales agents.

In *Eden*, the SEC brought suit against an individual (Eden) for engaging in conduct that required broker-dealer registration. According to the complaint, Eden assisted with the securities offerings of multiple companies while he was not registered as a broker with the SEC. The alleged illegal actions included "identifying potential investors and attempting to secure their investments in the offerings, as well as receipt of a success fee." Eden consented to an entry of a final judgment, which included a permanent injunction restraining Eden and an entity controlled by him from soliciting the purchase or sale of any security, disgorgement of Eden's success fee, and civil penalties, totaling $1,035,864.

Another example that attracted regulatory attention because of unlawful unregistered broker-dealer activity occurred in the *Ranieri* SEC enforcement action. In *Ranieri*, the SEC brought an enforcement action against a private equity firm, its managing director, and a consultant for investor solicitation activities conducted by the

consultant, who was not registered as a broker-dealer with the SEC. The consultant's unauthorized activities included marketing interests in the private equity fund, including bringing investors to the fund, distributing information and subscription documents to the potential investors, and providing the potential investors with his analysis. In exchange for the consultant's efforts, the SEC claimed, he received a transaction-based payment for soliciting sales of a private investment fund despite not being a registered broker. The SEC and the consultant entered into a settlement agreement, pursuant to which the consultant was permanently barred from the securities industry, in addition to a disgorgement in the amount of approximately $2,830,000.[8]

Ranieri highlighted an additional concern for companies and those who control them: those who engage unregistered brokers may face liability for knowingly aiding and abetting assistance in securities transactions in violation of the broker-dealer registration requirements.[9]

Its enforcement undertakings and actions signal that the SEC remains vigilant in monitoring intermediaries engaged in capital raising and corporate transactions. It is thus critical to stay mindful of the rules of the road and stay within the permissible boundaries.

II. The Distinction Between Broker-Dealers and Unregistered Finders

The federal securities laws do not specifically define the term *finder* or outline what finders can do. Determining whether a person is a finder involves a negative analysis--finders are generally defined by the activities that they do not perform. Thus, 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, Inc. (FINRA).[10]

Broker is defined as "any person engaged in the business of effecting transactions in securities for the accounts of others."[11] *Dealer* is defined as a person who is "engaged in the business of buying and selling securities ... for such person's own account," but excludes a person who buys and sells securities for their own account, but not as part of a regular business.[12]

Because the definition of a broker is the one with which finders have the most trouble, this article is focused on activities that may cause a finder to fall within the definition of a broker as someone who may be required to register with the SEC and FINRA. Given that a finder can be viewed as someone who does not meet the definition of broker, the same factors relevant to the analysis of whether one is a broker should be considered in conducting the finder analysis. The following factors are typical of broker activity that would trigger broker-dealer registration requirements:

1. Participating in discussions between a company and potential investors or negotiating the terms of a securities transaction on behalf of buyers and/or sellers;
2. Assisting in structuring transactions;[13]
3. Receiving transaction-based compensation (i.e., a commission or some form of compensation that is tied to the size or success of a securities offering or transaction);[14]
4. Engaging in "pre-screening" potential investors to determine their eligibility to purchase securities;
5. Engaging in "pre-selling" the issuance of securities to gauge the level of interest of potential investors;
6. Conducting or assisting with the sale of securities;
7. Providing advice regarding the value of securities;
8. Locating issuers of securities on behalf of investors;
9. Handling customer funds and securities;
10. Soliciting securities transactions;
11. Disseminating quotes for securities or other pricing information;
12. Actively (rather than passively) finding investors;[15]
13. Sending private placement memoranda, subscription documents, and due diligence materials to potential investors;

14. Advising on portfolio allocations to accommodate an investment;
15. Providing analyses of potential investments; and
16. Providing potential investors with confidential information identifying other investors and their capital commitments.[16]

As this list demonstrates, 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 single factor alone will determine whether a finder should register as a broker-dealer; all existing factors are considered together in making such a determination.

Certain factors, however, may carry more weight than others. One that draws close attention from the SEC is the existence of transaction-based compensation, which often signals that the individual is more involved in a 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."[17] In addition, one court observed that "[transaction-based compensation] is the hallmark of a salesman,"[18] while noting that transaction-based compensation alone cannot trigger broker-dealer registration. 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 facilitate transactions in securities.

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 factors that it considers when deciding whether a finder has violated the securities laws by failing to register as a broker-dealer. The following facts are typical of finders who would not need to register as a broker-dealer:

1. Introducing potential investors to companies or their promoters without further involvement in discussions between the parties and without giving advice on the merits of the investment, its structure or suitability (i.e., a finder's activities tend to occur before the specifics of any actual transaction are discussed);
2. Receiving compensation for making introductions and the compensation is not tied to the success of the raising of capital (i.e., not a commission);
3. Assisting 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.

Furthermore, even where the compensation received by a finder is based on the introduction, and not the outcome of the transaction, the SEC has taken the position that a person who accepts a fee for introduction of capital more than once is probably "engaged in the business of selling securities for compensation" and required to register as a broker-dealer.[19] As a result, the ability of a finder to operate without a broker-dealer license is extremely limited.[20]

A. Relief for M&A Brokers

Intermediaries in mergers and acquisitions (M&A) transactions who have historically provided advisory services to owners of a private business, or to private equity funds and strategic buyers seeking to acquire a private business, have often been deemed to fall within the definition of brokers.

In 1985, the U.S. Supreme Court held in *Landreth Timber Co. v. Landreth* that the sale of all of or a controlling interest in a business is a securities transaction ("M&A Broker").[21] Therefore, a person involved in facilitating the sale of an operating business could fall within the definition of a broker, as defined in the Exchange Act. There has been a great deal of ambiguity in this area ever since the *Landreth* decision.

The analysis of whether an M&A Broker is subject to the broker registration requirements is similar to that for a finder. That is, an M&A Broker who solicits potential investors or participates in the negotiation of the issuance or

exchange of securities, and receives a transaction-based compensation, would generally be required to register as a broker-dealer.

1. Federal M&A Brokers Statutory Exemption

In an effort to provide relief and certainty to persons solely advising buyers and sellers of private companies, in December 2022, Congress passed a new federal statutory exemption of M&A Brokers from registration (the "Federal Exemption").[22] Effective March 29, 2023, the Federal Exemption, which largely tracks the M&A Brokers No-Action Letter (see discussion immediately below), provides an exemption from broker-dealer registration for certain M&A Brokers[23] who limit their services to private company M&A transactions.[24] To be eligible for the Federal Exemption, the M&A Broker must refrain from all of the following activities:

- Having custody of the buyer or seller's funds or securities;
- Engaging in any public offering of securities as part of the transaction;
- Providing financing for the transaction;
- Assisting in obtaining financing from an unaffiliated third party unless any compensation for such arrangement is fully disclosed to the parties and the financing arrangement otherwise complies with applicable laws;
- Facilitating a transaction involving a shell company (other than a shell company formed solely to effect a business combination or reincorporation);
- Representing both the buyer and the seller, unless they have provided written consent after receiving appropriate disclosures;
- Forming a consortium of buyers;
- Facilitating a sale to a passive buyer or group of buyers (the exemption requires that the buyer obtains and exercises control over the private company);[25] and
- Acquiring authority to bind either the seller or the buyer.

The Federal Exemption is available only for transactions involving an "Eligible Privately Held Company," which is defined as a company that has (1) no class of securities registered or required to be registered under Section 12 of the Exchange Act; (2) EBITDA less than $25 million in the last complete fiscal year; and (3) gross revenues less than $250 million in the last complete fiscal year.

In light of the enactment of the Federal Exemption, businesses and buyers seeking to use M&A Brokers should also carefully examine the Federal Exemption to ensure proper reliance.[26]

2. M&A Brokers SEC No-Action Letter

For nearly a decade prior to the Federal Exemption, M&A Brokers have relied on a now-repealed 2014 no-action letter issued by the SEC's Division of Trading and Markers (the "M&A Brokers No-Action Letter"), which enabled, in certain circumstances, M&A Brokers to effectuate private company transactions involving a change in control (and not involving any public distribution of securities), without registering as a broker-dealer.

While no-action letters are not regarded as a binding precedent on the SEC, as they are subject to revocation and modification, the M&A Brokers No-Action Letter provided useful guidance and relief to certain market participants prior to its withdrawal in connection with the Federal Exemption.[27] The SEC's Division of Trading and Markers noted 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 complied with the terms and conditions described in the M&A Brokers No-Action Letter.

According to the M&A Brokers No-Action Letter, an M&A Broker was 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."

The M&A Brokers No-Action Letter set forth a number of conditions, as listed below, that an intermediary must have followed to benefit from the "M&A Broker" status and as a result of that avoid the mandatory registration as a broker-dealer. It is worth noting that the below conditions, which are no longer applicable given the withdraw of the M&A Brokers No-Action Letter, overlap with many of the conditions now included under the Federal Exemption but may yet provide helpful guidance when considering the Federal Exemption:

1. The M&A Broker did not have the ability to bind a party to an M&A transaction;
2. The M&A Broker did not provide financing (though the M&A Broker may have arranged financing, subject to certain conditions) for an M&A transaction;
3. The M&A Broker did 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 was a shell company, other than a "business combination related shell company";[28]
5. The M&A transaction did not involve a public offering and is exempt from registration;
6. If the M&A Broker represented both buyers and sellers, the M&A Broker provided clear written disclosure as to the parties represented and obtain written consent from both parties to the joint representation;
7. The M&A Broker did not assist in the formation of a group of buyers for M&A transactions that the M&A Broker facilitated;
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 did not result in the transfer of interests to a passive buyer or group of buyers;[29]
10. The securities received by the buyer were 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.

The codification of the Federal Exemption will provide M&A Brokers, privately held companies, and other market participants additional assurance that they can engage in certain M&A activity without running afoul of the Exchange Act's broker-dealer registration requirement. In addition to ensuring compliance with the Federal Exemption requirements for broker-dealer registration, market participants should continue to consider whether certain M&A activity may trigger state registration requirements.

B. State Regulation of M&A Brokers

Both the M&A Brokers No-Action Letter and the Federal Exemption do not affect state laws and regulations on the matter. While the Federal Exemption may motivate states to adopt corresponding exemptions, Congress's decision not to preempt state law leaves unresolved the potential for conflicting requirements that would impair the usefulness of the Federal Exemption.

In response to the M&A Brokers No-Action Letter, the North American Securities Administrators Association adopted a uniform state model rule designed to provide an exemption for M&A Brokers from registration as brokers, dealers, and agents under state law. However, the model rule is not self-executing and must be adopted by a state before it becomes effective in a specific jurisdiction.

As a result, state-level broker registration remains an important consideration for M&A Brokers, even if an exemption exists at the federal level. Interestingly, New York has recently proposed, then failed to adopt, a state regulatory regime of business finders. Certain states, including California,[30] Texas,[31] and Michigan,[32] have some

form of a registration exemption for M&A Brokers. Therefore, finders should consult the applicable state broker-dealer regulations prior to engaging in activities in the particular state.

C. Foreign M&A Brokers

Generally, an intermediary soliciting a person in the United States, even from outside of the United States, to engage in a securities transaction may be required to register as a broker-dealer. Thus, a foreign M&A Broker representing a foreign client that is interested in engaging in a securities-related transaction with a U.S. company may be unable to contact persons in the United States concerning such a transaction, absent registration or an exemption.

In May 2013, the SEC issued a no-action letter allowing for foreign M&A Brokers to contact potential U.S.-based buyers or sellers ("U.S. Target"), without registering as a broker-dealer, in connection with conducting certain activities to facilitate a potential M&A transaction[33] (for which the foreign M&A Broker would be allowed to receive transaction-based compensation) under the following conditions:

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 professional with relevant experience;
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 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.[34]

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

D. FINRA Guidance

Intending to promote the underlying policy of the broker-dealer registration requirement and the investor protection regulatory scheme, FINRA, as a self-regulatory organization that supervises the activities by registered broker-dealers, has taken actions to clarify the requirements for registered broker-dealers who deal with finders and how its rules fit with the securities laws. FINRA rules generally prohibit FINRA members and associated persons from engaging in certain compensation sharing arrangements. Under FINRA Rule 2040 , FINRA members and associated persons are prohibited from paying, directly or indirectly, any compensation, fees, concessions, discounts, commissions, or other allowances to any person who is not registered with the SEC as a broker-dealer but, by reason of receipt of any such payments and related activities, would be required to be so registered.

An exception of FINRA Rule 2040 is set forth in FINRA Rule 2040(c), which allows, subject to several conditions,[35] 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.

1. FINRA Capital Acquisition Broker Rules

While a broker-dealer who is a FINRA member must comply with all applicable FINRA rules, FINRA has established a limited membership category that would be available to broker-dealers engaged solely in certain corporate financing advisory and capital-raising activities, referred to as "capital acquisition brokers" or CABs. A firm that engages only in these limited activities may elect to be regulated as a CAB, subject to a reduced and streamlined set of FINRA rules.[36] FINRA established this simplified regulatory regime in an effort to accommodate FINRA member firms that limit their corporate financing activities to such services as advising companies and private equity funds on capital raising and corporate restructuring, and acting as placement agents for the sale of unregistered securities to institutional investors.

The CAB rules that took effect in April 2017 provide a streamlined set of compliance and conduct rules for firms that meet the definition of a "capital acquisition broker."[37] For example, CABs are not subject to FINRA duty and conflict rules regarding fair prices and commissions, net transactions with customers, FINRA supervisory rules regarding annual compliance meetings, review and investigation of transactions, and internal inspections. CABs remain subject, however, to a number of existing FINRA rules, such as suitability and antifraud, anti-money laundering, and pay-to-play rules.[38]

CAB designation is limited to FINRA member firms that engage solely in any one or more of the following activities:

1. advising a company, including a private fund, concerning its securities offerings or other capital-raising activities;
2. advising a company regarding its purchase or sale of a business or assets or regarding its corporate restructuring, including a going-private transaction, divestiture, or merger;
3. advising a company regarding its selection of an investment banker;
4. assisting in the preparation of offering materials on behalf of an issuer;
5. providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;
6. qualifying, identifying, soliciting, or acting as a placement agent or finder (i) on behalf of an issuer in connection with a sale of newly issued, unregistered securities to institutional investors, or (ii) on behalf of an issuer or a control person in connection with a change of control of a privately held company; and
7. 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, in accordance with the terms and conditions of an SEC rule, release, interpretation, or "no-action" letter that permits a person to engage in such activities without having to register as a broker or dealer pursuant to Section 15(b) of the Exchange Act.

Notably, a CAB's permitted activities include specific reference to the M&A Broker activity as described in the now-withdrawn M&A Broker No-Action Letter. A CAB, however, is not permitted, among other things, to engage in the following activities:

1. carrying or acting as an introducing broker with respect to customer accounts;
2. holding or handling customers' funds or securities;
3. accepting orders from customers to purchase or sell securities either as principal or as agent for the customer, except as permitted under specific circumstances;[39]
4. having investment discretion on behalf of any customer;
5. engaging in proprietary trading of securities or market-making activities;
6. participating in or maintaining an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding or Regulation A under the Securities Act of 1933 (the "Securities Act"); or
7. effecting securities transactions that would require the broker or dealer to report the transaction under certain FINRA rules.[40]

The CAB rules were tailored to limited activities listed above in order to encourage market participants who engage in capital acquisition activities to register as CABs, thus removing "any possible ambiguity about their status as non-broker-dealers while coming under a regulatory regime that is tailored to the limited nature of their business." The inherent benefits of a CAB registration may encourage even those players eligible to rely on the Federal Exemption to consider registering as CABs, which would allow them to expand their permitted primary private placement activities without incurring the regulatory burdens associated with the full broker-dealer registration.

E. 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. The proliferation of technology has accelerated the development of different types of systems designed to facilitate securities transactions and specifically connecting private companies with accredited investors to effect private securities offerings pursuant to Rule 506. While they generally serve the same purpose of effecting securities transactions, investment platforms are designed to link broker-dealers to potential customers and to each other. Thus, such websites arguably fall under the definition of broker and would be required to register as such.

The JOBS Act, enacted in 2012, created a limited exemption from registration as a broker-dealer for private placement placements done under Rule 506 of Regulation D, where certain conditions are met. The exemption extends to investment platforms that would otherwise be required to register as a broker-dealer because of involvement in securities offerings made pursuant to Rule 506 of Regulation D. This exemption provides that an intermediary that meets the below requirements is exempted from registration as a broker or dealer solely because that person:

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.[41]

In order to qualify for the exemption, the business intermediary must:

1. not receive compensation in connection with the purchase or sale of the security;[42]
2. not take possession of customer funds or securities in connection with the purchase or sale of the security; and
3. not be subject to disqualification under "bad actor" provisions.[43]

While this exemption could be read to allow an intermediary to conduct a range of private placement activities without broker-dealer registration, the SEC has interpreted it very narrowly. Generally, the more active the system and its operator are, the more likely the intermediary would be considered a broker.[44]

As discussed below, the SEC has issued two no-action letters to allow a couple of web-based platforms operated by investment advisors to match accredited investors with companies seeking capital, without broker-dealer registration, given that certain conditions were met.[45] These no-action letters were conditioned on, among other things, the advisors and their employees not receiving any transaction-based compensation for these activities, although the advisors were permitted to receive compensation in the form of traditional advisory fees.

1. Investment Platforms for Private Funds

In 2013, the SEC provided no-action relief from the broker-dealer registration requirements for operators of a couple of investment platforms that involved marketing activities for investments in private funds: one to an investment platform for "angel investing" (AngelList), and another to an investment platform for venture capital investing (FundersClub).

a. FundersClub No-Action Letter

In March 2013, the SEC granted no action relief to the FundersClub, allowing it to post information on its website about investments in start-up companies. The information was available only to FundersClub members, all of whom are pre-screened as accredited investors.

The investment process was structured as follows: FundersClub had a wholly owned subsidiary (“FC

Management"), which in turn, sponsored a number of investment funds ("Funds"). Each of the Funds held shares in one or more startup companies. FundersClub would enter into a non-binding agreement with a startup company, setting a target amount of capital that FC Management would invest. The startup then would provide FundersClub with information to be made available online, which FundersClub members could access. If the FundersClub members decided to invest in the startup, they submitted non-binding indications of interest. When a Fund reached a certain level of interest, FundersClub negotiated the final terms of the investment with the startup company. Investors had the option to withdraw their indications of interest without penalty up until the Fund closed. When an agreement was reached between the Fund and the startup, FundersClub's members provided funds to the Fund, and the Fund, in turn, purchased shares from the startup.

In reaching its conclusion of no-action, the SEC focused on the following key points that weighed in favor of determining that FundersClub did not need to register as a broker-dealer:

1. FundersClub advised and managed only venture capital funds;
2. FundersClub received compensation (i.e., carried interest) for its services, the nature of which was traditional advisory and consulting services, and not transaction-based compensation;
3. officers, directors, and employees of FundersClub did not receive transaction-based compensation for their efforts in raising investment funds;
4. full and fair disclosure was made to investors about FundersClub's compensation and fees;
5. FundersClub did not receive the administrative fees, and any remainder was distributed to investors;
6. FundersClub was 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 were subject to "bad actor" disqualification.

b. AngelList No-Action Letter

The AngelList No-Action Letter was substantially similar to the FundersClub No-Action Letter. Like FC Management, AngelList Advisors ("AngelList Advisors"), a wholly owned subsidiary of AngelList, created two different types of funds. The first consisted of wholly owned subsidiaries in which angel investors would invest. In the second, a "Lead Angel" would take an active role in the startup companies, offering managerial or financial guidance and often worked in tandem with AngelList Advisors who, like FC Management, provided investment advice and administrative services to the companies.

Based on similar reasoning of the FundersClub No-Action Letter, the SEC granted no-action relief to AngelList as a non-registered broker:

1. AngelList Advisors was a registered investment advisor with the SEC or in one or more states;
2. AngelList Advisors provided investment advice and administrative services to the investment vehicle;
3. AngelList Advisors operated an internet-based platform that was available exclusively to accredited investors;
4. investments were offered and sold in compliance with Rule 506 of Regulation D;
5. AngelList Advisors and any Lead Angel received compensation equal to a portion of the increase in value, if any, of the investment and did not receive transaction-based compensation;
6. AngelList Advisors' and the Lead Angel's services were traditional advisory and consulting in nature;
7. no officer, director, or employee of AngelList Advisors or any Lead Angel received transaction-based compensation in connection with the investments;
8. the specific terms of any compensation paid to AngelList Advisors or any Lead Angel were described in the relevant offering document;
9. neither AngelList Advisors nor any Lead Angel handled any customer funds or securities;
10. neither AngelList Advisors nor any Lead Angel solicited investors anywhere other than on the website; and
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 were disqualified by

"bad actor" provisions.

In addition, the SEC required that AngelList Advisors register as an investment advisor, disclose potential conflicts of interest that arose between AngelList Advisors and any Lead Angel in an angel advised deal, and that neither AngelList Advisors nor any Lead Angel would handle any customer funds or securities.

It is worth noting that in the case of each of the Funders Club and AngelList No-Action Letters, it is the online platform or a related entity that invested in the startup and the "crowd" invested in an entity formed for the purpose of investing in startups and managed by the platform or its affiliate. The relief that is granted in these two no-action Letters is highly specific and does not apply to all online platforms.

2. The Narrow Exemption from Broker Registration for Crowdfunding Portals

In October 2015, the SEC adopted rules for crowdfunding designed to implement the JOBS Act requirement that the SEC exempt intermediaries that operate funding portals from broker-dealer registration ("Regulation Crowdfunding"). Under Regulation Crowdfunding, issuers are currently permitted to issue securities worth up to $5,000,000, in each 12-month period, to accredited and non-accredited investors alike. These offerings are conducted through an on-line platform operated by either a registered broker-dealer or a "funding portal" entity (that is exclusive to offerings made pursuant to Regulation Crowdfunding).[46] A funding portal is exempt from broker-dealer registration when conducting crowdfunding transactions if it follows certain guidelines.[47]

The general public often confuses different types of offerings as crowdfunding offerings (e.g., private offerings conducted pursuant to Rule 506 of Regulation D through investment platforms). Therefore, it is important to note that only offerings conducted according to the requirements of Regulation Crowdfunding are eligible for the exemptions provided therein.

III. Conclusion

A determination of whether an intermediary is acting as a finder or an unregistered broker-dealer is a fact-specific analysis and can often be 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 as a finder, and therefore should not be engaged unless it is properly registered as such. 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.

Please contact the authors or your regular Venable contact if you would like to consult or discuss of the subject matter.

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References

1 Exchange Act § 21(d)(1); *see also SEC v. Collyard*, 154 F. Supp. 3d 781 (D. Minn. 2015); *SEC v. Siris*, No. 12-CV5810 (S.D.N.Y. July 30, 2012), review denied; *Siris v. SEC*, 773 F.3d 89 (2014); *WDSEC v. Small Bus. Capital Corp.*, 2012 U.S. Dist. LEXIS 178392 (N.D. Cal. Dec. 17, 2012).

2 Exchange Act §§ 21(d)(3) and (5); *see also In re Thomas C. Muldoon*, SEC Release No. 34-86848 (Sept. 3, 2019); *SEC v. Core Performance Mgmt., LLC et al.*, No. 18-cv-81081 (S.D. Fla. 2018); *In re NW Capital Markets Inc.*, SEC Release No. 34-83840 (Aug. 14, 2018); *SEC v. City Capital Corp.*, No. 1:12-cv-01249-WSD (N.D. Ga. filed Apr. 12, 2012); *SEC v. SW Argyll Invs. LLC*, No. 122CV0646L WVG (S.D. Cal. filed Mar. 15, 2012).

3 See *State v. Casper*, 297 S.W.3d 676 (Tenn. 2009).

4 See *Landegger v. Cohen*, 2013 U.S. Dist. LEXIS 140634 (D. Colo. Sept. 30, 2013). In addition, if found to be an unregistered broker-dealer, an unregistered finder may have its agreements voided and may be required to return all finders fees received. 15 U.S.C. § 78cc(b). *See, e.g., In Torsiello Capital Partners, LLC v. Sunshine States Holding Corp.*, 2008 N.Y. slip op. 30979.

5 *SEC v. Sky Group USA, LLC, et al.*, SEC Docket No. 21-cv-23443 (Sept. 27, 2021).

6 *SEC v. Richard Eden, et al.*, SEC Docket No. 22-cv-04833 (July 14, 2022).

7 *In re Ranieri Partners LLC*, SEC Release No. 34-69091 (Mar. 8, 2013).

8 For further details, see our client alert on this action, *Finders May Pose Risk in Private Capital Raising* (Mar. 2013).

9 Besides liabilities from aiding and abetting, a company that engages unregistered broker-dealers can face private actions for rescission from investors. Some states have provided a private right of rescission for innocent parties who buy securities through unregistered broker-dealers. *See, e.g.*, Cal. Corp. Code § 25501.5 (2020); Conn. Gen. Stat. § 36b-29 (2019); Fla. Stat. § 517.211 (2019); 815 ILCS 5/13 (2016); Tex. Rev. Civ. Stat. Ann. art. 581-33 (2019); N.J.S.A. 49:3-71(c) (2019).

10 Section 15(a)(1) of the Exchange Act of 1934, as amended (the "Exchange Act"), compels registration of most brokers and dealers. In addition, pursuant to Section 15(b)(8) of the Exchange Act, except for certain statutory exceptions, brokers and dealers are required to be a member of either a national securities exchange or registered securities association. (FINRA is currently the only registered national securities association in the United States). Emphasizing that it considers the regulatory regime applicable to broker-dealers to be significant in providing safeguards to investors and market participants, in early June 2023, the SEC has charged two major crypto assets trading platforms for, among other things, operating as an unregistered broker. *See SEC v Coinbase Inc. et al.*, U.S. District Court, Southern District of New York, No. 23-04738; *see also SEC v. Binance Holdings Ltd et al.*, U.S. District Court for the District of Columbia, No. 1:23-cv-01599.

11 15 U.S.C. § 78c(a)(4).

12 Section 3(a)(5) of the Exchange Act.

13 Such activities include analyzing the financial needs of a company, recommending or designing financing methods, and discussing details of securities transactions. *See, e.g., In the Matter of BlackStreet Capital Management, LLC and Murry N. Gunty, Admin. Proc.* No. 3-17267, SEC Release No. 34-77959 (June 1, 2016); *JCS.DeHuff v. Dig. Ally, Inc.*, 2009 U.S. Dist. LEXIS 116328, at *13 (S.D. Miss. Dec. 11, 2009).

14 It is important to note, however, that a person who engages in broker-related activities but who does not receive transaction-based compensation can nevertheless be deemed a broker if the person engages in securities activities with sufficient recurrence to justify the inference that the activities are part of the person's business. In such circumstances, the person who participates in several securities transactions for a flat fee each time could be considered a broker.

15 Identifying potential purchasers of securities could include, for example, compiling a list of prospective purchasers for a company to target, as well as helping a company find an underwriter or other persons to sell the company's securities to. *See, e.g., Hallmark Capital Corp.*, SEC No-Action Letter (June 11, 2007) (entity assisting owners of small businesses in raising capital, facilitating mergers and acquisitions, and providing strategic business consulting services, which, among other things, identified broker-dealer firms that might be interested in working with the company and arranged meetings between them leading to an engagement, was denied SEC no-action relief).

16 *Nemzoff & Co., LLC*, SEC No-Action Letter (Nov. 30, 2010); *Brumberg, Mackey & Wall, P.L.C.*, SEC No-Action Letter (May 17, 2010); *Putnam Investor Services, Inc.*, SEC No-Action Letter (Dec. 31, 2009); SEC Guide to Broker-Dealer Registration, Division of Trading and Markets (Apr. 2008).

17 Securities Exchange Act Release No. 69091 (Mar. 8, 2013); Securities Exchange Act Release No. 69090 (Mar. 8, 2013).

18 *SEC v. Kramer*, 778 F.Supp.2d 1320, 1334 (M.D. Fla., 2011).

19 *See* Gregory C. Yadley, *Notable by Their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation* (June 3, 2015).

20 In October 2020, the SEC proposed a conditional exemption to permit natural persons to engage in limited securities activities as 'finders' on behalf of private companies without registering as brokers. The SEC, however, has not adopted such an exemption.

21 471 U.S. 681 (1985).

22 U.S. Congress' Title V of the Consolidated Appropriations Act of 2023. The Federal Exemption is now implemented in Section 15(b)(13) of the Exchange Act.

23 The Federal Exemption's definition of "M&A Broker" does not address whether the exemption is available only for entities and their "associated persons," or, instead, if natural persons may directly rely on the exemption without acting through a corporation, LLC, or some other entity. Individuals should be able to rely on the Federal Exemption, although past action by the SEC has suggested that the SEC may consider this distinction to be important.

24 While the Federal Exemption does not address whether the receipt of transaction-based compensation, commissions, or other variable or success-based compensation by the M&A Broker is permissible, there is a strong basis to assume that such compensation would be permissible.

25 Control is deemed to pass if the buyer acquires at least 25% of the voting power of the target company, or, in the case of a partnership or limited liability company, has the right to receive upon dissolution, or has contributed, 25% or more of the capital.

26 Exempt M&A Brokers may want to consider, prior to the procession of a contemplated M&A transaction, the prospective terms of that particular transaction that they anticipate intermediating in order to ensure that they fit within the parameters of the Federal Exemption. Further, parties contracting with exempt M&A Brokers relying on the Federal Exemption may want to seek representations and warranties related to compliance with the applicable provisions of the Federal Exemption.

27 Citing Congress's creation of the new Federal Exemption, the SEC staff withdrew its M&A Brokers No-Action Letter on March 29, 2023, effective immediately. In doing so, the SEC staff noted that the new exemption allows M&A Brokers "to engage in conduct that is largely similar to that discussed in the M&A Broker Letter, subject to certain additional conditions and limitations," and therefore it was appropriate to withdraw the M&A Brokers No-Action Letter. *See* Letter from Emily Westerberg Russell, Chief Counsel and Associate Director, Division of Trading and Markets, SEC to Faith Colish, Esq., et al. re: M&A Brokers (Mar. 29, 2023) (No-Action Withdrawal).

28 A "business combination related shell company" is defined in the M&A Brokers No-Action Letter as a shell company (as defined in Rule 405 of the Securities Act) that is (1) formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity (which

may not itself be a shell company) solely within the United States, or (2) formed by an entity defined in Securities Act Rule 165(f) among one or more entities other than the shell company, none of which is a shell company.

29 This prong should be carefully considered in the context of private equity, venture capital, and other private funds acquiring and selling operating companies.

30 *See* CA Corp Code § 25206.1. In essence, the California Department of Business Oversight enacted rules to implement an exemption from broker-dealer registration licensing requirements in the state of California for individuals acting as finders in securities transactions. The exemption sets the scope of permissible activities and allows for transaction-based compensation for finders in California, subject to satisfaction of several conditions and procedural requirements. Specifically, under Section 25206.1 of the California Corporations Code, companies are allowed to pay transaction-based compensation to finders in connection with intra-state transactions involving California-based companies and purchasers of securities. The exemption is available only to natural persons, and only in connection with the introduction or referral of accredited investors to a company in relation to a transaction or a series of related transactions with an aggregate securities purchase price of $15 million or less.

31 *See* Rule 115.1(c)(2)(B)(v) of the Texas State Securities Board. In Texas, finders are allowed to receive compensation if they register as a finder, a process less onerous than broker-dealer registration. Like California, even if registered, a finder's activities are limited and subject to numerous conditions. Texas finders are strictly limited to dealing with accredited investors.

32 *See* Michigan Uniform Securities Act (2002), Act 511 of 2008, Section 451.2102 and Rule 451.1.2 'Broker-Dealer' definition exclusion.

33 Such activities may include, among other things, creating and managing a data room, conducting negotiations on behalf of the non-U.S. client and advising the non-U.S. client on the terms of the transaction.

34 *See Roland Berger Strategy Consultants*, SEC No-Action Letter (May 28, 2013).

35 *See* FINRA Rule 2040(c) for further details. FINRA Regulatory Notice 15-07 (Mar. 2015).

36 *See* Order Approving Rule Change as modified by Amendment Nos. 1 and 2 to Adopt FINRA Capital Acquisition Broker Rules, SEC Release No. 34-78617 (Aug. 18, 2016).

37 *See* FINRA Regulatory Notice 16-37 (Oct. 2016).

38 *See* FINRA Regulatory Notice 17-37 (Nov. 2017).

39 *See* (c)(1)(F) and (G) of CAB Rule 016.

40 *See* FINRA Rules 6300 Series, 6400 Series, 6500 Series, 6600 Series, 6700 Series, 7300 Series, or 7400 Series; *see also* FINRA Regulatory Notice 16-37 (Oct. 2016).

41 15 U.S.C. § 77d(b)(1) (2012).

42 The SEC staff has indicated that it read the prohibition on receipt of "compensation in connection with a purchase or sale" broadly, to prohibit a person from relying on the exemption if there is "any direct or indirect economic benefit to the person or any of its associated persons", not merely transaction-based compensation. *See* SEC Division of Trading and Markets, Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act (Feb. 5, 2013), at Question 5.

43 The SEC provided additional guidance on this exemption in a set of Frequently Asked Questions posted on the SEC's website on February 5, 2013. *See* Frequently Asked Questions about the Exemption from Broker-Dealer Registration in Title II of the JOBS Act, SEC. & EXCH. COMM'N (Feb. 5, 2013).

44 The factors to be considered with respect to whether an operator of an investment platform should register as a broker include (i) whether investors contact other investors and/or counterparties through the site; (ii) the participation of the website operator in facilitating securities transactions; (iii) affirmative acts by the operators to solicit purchases of a particular company's securities, and (iv) the method of payment.

45 *See* AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter (Mar. 28, 2013); Funders Club Inc. and Funders Club Management LLC, SEC No-Action Letter (Mar. 26, 2013).

46 A crowdfunding portal cannot (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its platform; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform; or (4) hold, manage, possess or otherwise handle investor funds or securities. *See* 17 C.F.R. § 227.300(c)(2). A crowdfunding portal can, however, do the following, among other things: (1) provide communication channels by which potential investors can communicate with one another and with representatives of a company-issuer through the platform about offerings through the platform, so long as the funding portal does not participate in the communications, permits public access to view the discussions made in the channels, restricts postings to persons having opened an account on the platform, and require persons posting such comments to disclose whether they are a founder or employee of a company engaging in promotional activities on behalf of the company-issuer or is otherwise compensated (in the past or prospectively) to promote an company's offering; (2) advise companies on the structure or content of offerings, including assisting the company in preparing offering documentation; (3) compensate others for referring persons to the funding portal so long as the third party does not provide the funding portal with personally identifying information of any potential investor, and the compensation, other than that paid to a registered broker-dealer, is not based, directly or indirectly, on the purchase or sale of a security offered on or through the funding portal's platform; (4) accept investment commitments on the company's behalf; (5) direct investors where to transmit funds or remit payment for securities purchased via the funding portal; and (6) direct a qualified third party (as defined in and required by Rule 303(e) of Regulation Crowdfunding) to release proceeds to a company upon completion of a crowdfunding offering or to return proceeds to investors in the event an investment commitment or an offering is cancelled.

47 For further details, see our client alert, SEC Adopts Final Rules for Securities-Based Crowdfunding, dated November 11, 2015. Subsequently, the SEC has issued updated guidance regarding Regulation Crowdfunding. *See, e.g.*, Regulation Crowdfunding Compliance and Disclosure Interpretations (September 25, 2018). Also see Regulation Crowdfunding Compliance and Disclosure Interpretations (April 5, 2017).

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