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Bylined Article

Fog May Be Lifting Around Finders

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This article assesses the murky regulatory world of when and whether a US person can raise capital and receive transaction-based compensation, i.e., compensation tied to the amount of capital raised, without registering as a broker-dealer in the United States.[1]

It observes that the staff of the US Securities and Exchange Commission's aggressive stance on when finders have to register as broker-dealers has recently encountered judicial disavowal by US district courts (and certain states' high courts).

In light of these decisions (discussed below), it seems that a person interested in raising capital for an enterprise may be able to (1) obtain transaction-based compensation if acting as a "passive finder" (acting solely as an introducer), (2) obtain transaction-based compensation as an "active finder" for a small number of issuers in a few instances in the aggregate, or (3) obtain transaction-based compensation when raising capital for non-US issuers only from non-US persons outside of the United States.

It cannot be determined if the staff (or other US district courts) will defer to the analyses taken recently by the US district courts or will continue to view the presence of transaction-based compensation as the primary demarcation between a finder and a broker.[2]

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[1] Other nontransaction based compensation arrangements and their impact on the analysis of whether a finder needs to register as a broker, and whether fixed-fee services that do not entail raising capital (but may include assistance with business plans, pre-IPO cleanups and the like) are of less interest to most finders; clearly the honey pot for finders is obtaining a fee based on the finder's investors' aggregate capital contributions. Accordingly, this article does not address when fixed-fee arrangements may nonetheless require a finder to register as a broker.

[2] The staff on Jan. 31, 2014, issued a no-action letter that conditionally allows finders and brokers in private M&A transactions that meet a variety of conditions to receive transaction-based compensation and be actively involved in the acquisition process, M&A Brokers, SEC No-Action Letter (pub. avail. Jan. 31, 2014). The letter expands the narrower staff position taken in the Country Business Inc. letter, which in part required the finder to have a limited role in negotiations and that the transaction represent 100 percent of the private company's outstanding stock or

Because of this intractable unknown, the engagement agreement between the issuer and the finder should thoroughly specify the nature of the services being provided, the compensation to be paid for each set of services, and include a "severability clause" to prevent the agreement from being found to be void, should some of the services be deemed to be services that can only be conducted by or through a registered broker-dealer.[3]

A person who is "engaged in the business of effecting transactions in securities for the account of others" is a "broker."[4] A broker effecting transactions in securities (or inducing the purchase or sale of securities) must register as a broker.[5]

The fulcrum phrase for finders is "engaged in the business." The SEC staff has aggressively taken the view, most recently in 2010, that simply receiving transaction-based compensation creates a "salesman's stake" in the capital raise and constitutes being "engaged in the business."[6] Beginning with SEC v. Kramer, in 2011, and continuing through 2013, however, US district courts have required more than the presence of a "salesman's stake" for a finder to have to register as a broker.[7]

During 2013, district courts referred back to the multipronged "Hansen test" articulated in the 1980s when rejecting the staff's essentially single-pronged approach in Brumberg:

(i) whether [the] person is an employee of the [securities'] issuer; (ii) receive[s] commissions as opposed to a salary; (iii) is selling or previously sold the securities of other issuers; (iv) is involved in negotiations between the issuer and the investor; (v) makes valuations as to the merits of the investment or gives advice; and (vi) is an active rather than passive finder of investors.[8]

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assets, SEC No-Action Letter (pub. avail. Nov. 8, 2006). Historically, M&A stock transactions have been determined by the staff to require registration as a broker where a finder was actively involved and received transaction-based compensation, see, e.g., Hallmark Capital Corp., SEC No-Action Letter (pub. avail. Jun 11, 2007); John R. Wirthin [sic], SEC No-Action Letter (pub. avail. Jan 19, 1999); and Davenport Management Inc., SEC No-Action Letter (pub. avail. Apr 13, 1993). Given higher levels of staff flexibility, it is not at all clear that M&A Brokers signals a wider tolerance by the staff for finders operating in the capital-raising arena.

[3] See Torsiello Capital Partners LLC v. Sunshine State Holding Corp., 600397/06, 2008 WL 8971330, 10 - 21 (N.Y. Sup. Ct. April 1, 2008) (holding that because the finder was not a registered broker, but its proposed service fell under the SEC's definition of brokerage services, the agreement was void and rescindable and further, ordering the finder to repay the retainer fee it had previously received from the issuer)

[4] The Securities Exchange Act of 1934, as amended (the "Exchange Act") §3(a)(4), 15 U.S.C.A. §78a (West 2014).

[5] The Exchange Act, §15(a)(1) and §15(b).

[6] Brumberg Mackey & Wall PLC, SEC No-Action Letter (pub. avail. May 17, 2010); see also John W. Loofbourrow Associates Inc., SEC No-Action Letter (pub. avail. June 29, 2006); Wolff Juall Investments LLC, SEC No-Action Letter (pub. avail. May 17, 2005).

[7] SEC v. Kramer, 778 F. Supp. 2d 1320, 1337 (M.D. Fla. 2011).

[8] SEC v. Hansen, 83 CIV. 3692, 1984 WL 2413 (S.D.N.Y. Apr. 6, 1984).

Although (i) and (ii) above are less pertinent to a third-party finder and more pertinent, for example, to an analysis of a fund selling its own shares under Rule 3a4-1 of the Securities Exchange Act of 1934 (the Exchange Act), the balance of these factors are instructive in the contexts of third-party finders, and manifestly entail a more complicated factual analysis than simply determining the presence of a "salesman's stake."

The Colorado District Court in a September 2013 case declares that two of these factors should be assigned "heightened weight" — transaction-based compensation and "regularity of participation."[9] Yet the court cautions that "these two factors must not be weighted so heavily so as to subsume the others in the analysis."[10] It then rebukes the commission for being "unwilling to create the necessary guidance in order to provide clarity."[11] Amen.

Regularity of participation is asserted to be the "primary indicia of being engaged in the business [of buying and selling securities]."[12] Counting the number of transactions in which a finder engages, however, becomes a slippery part of the analysis.

Participation in "dozens" of transactions has been declared to be sufficient regularity; as has "26 transactions over [a] two-year period."[13] However, a finder was able to persuade the court that seven "completed investments" over a two-year period did not reach regularity of participation.[14] Is one no longer enough?

Nor can that question be posed independently of the other factors in the Hansen test. If a finder has participated in negotiations and provides valuation advice, and receives transaction-based compensation, she is likely no longer a finder, but a broker.[15] The same result may occur if she

[9] Landegger v. Cohen, No. 11-CV-01760-WJM-CBS, 2013 WL 5444052, 6-8 (D. Colo. Sept. 30, 2013).
[10] Id at 6.
[11] Id. In 1999, the American Bar Association formed its Task Force on Private Placement Broker-Dealers to address smaller companies raising capital in private placements; a theme later and partially (and arguably, after Sen. Merkel's amendments, ineffectually) revisited by the crowdfunding provisions of the Jumpstart Our Small Businesses Act. The task force's report and recommendations were reissued in April 2010 and identify in part a "vast and pervasive 'grey market' of brokerage activity" and "a major disconnect between the various laws and regulations applicable to securities brokerage activities, and the methods and practices actually in daily use by which the vast majority of capital is raised to fund early-stage businesses in the United States. Mary M. Sjoquist et al., Report and Recommendations of the Task Force on Private Placement Broker-Dealers (ABA Task Force), A.B.A., 36 (April 28, 2010).
[12] Landegger v. Cohen, at 5, citing SEC v. Kenton Capital Ltd., 69 F Supp. 2d 1, 12 (D.D.C. 1998).
[13] SEC v. Margolin, 92 CIV. 6307 (PKL), 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992); Landegger v. Cohen, at 8.
[14] Landegger v. Cohen, at 8.
[15] See In the Matter of Ranieri Partners LLC and Donald W. Phillips, Respondents, Release No. 3563 and 69091, 2013 WL 873219 (March 8, 2013). This decision illustrates exactly what not to do, as the unregistered broker solicited investors on behalf of private funds managed by Ranieri Partners, and his solicitation efforts included: (1) sending private placement memorandum, subscription documents and due diligence materials to potential investors, (2) urging at least one investor to consider adjusting its portfolio allocations to accommodate an

foregoes transaction-based compensation, and may occur even if she also refrains from valuation advice.

The only light on the hill here is that if a finder (1) acts as a passive finder (in the sense of simply introducing potential investors from among persons with whom she had previous business relationships), and (2) has not previously been compensated as a finder (or perhaps has only a limited and infrequent history of acting as a finder) nor (3) is otherwise involved at any "key point[s] in the chain of distribution," no registration should be required.[16]

"The line between finder and broker is not always difficult to draw."[17] The recent district court cases can be read to conclude that such a finder can receive transaction-based income and not have to register as (or associate with) a broker-dealer, even if the staff (or other district courts) do not agree.

"If a finder has participated in negotiations and provides valuation advice, and receives transaction-based compensation, she is likely no longer a finder, but a broker."

"Merely bringing together the parties to transactions, even those involving the purchase and sale of securities" is not enough to compel broker registration, even if the finder receives a fee "in proportion to the amount of the sale." The District Court for the Middle District of Florida, after acknowledging and then dismissing the staff's position in Brumberg concludes:

In this instance, [finder's] conduct consisted of nothing more than bringing together the parties to a transaction. The commission presented no evidence that [the finder] either participated in the negotiation, discussed the detail of the transaction, analyzed the financial status of [the issuer], or promoted an investment in [the issuer] to [the investors].[18]

While the finder's activities extended for several years, the SEC did not present evidence that the finder had been previously active in other capital raises.

Finders that aggressively engage in activities at key points in the distribution process and receive transaction-based compensation, but do so only in connection with offers and sales of ex-US

investment with Raneiri Partners, (3) providing potential investor with his analysis of Ranieri Partners' funds strategy and performance track record, and (4) providing potential investors with confidential information relating to the identity of other investors and their capital commitments. Furthermore, the actions implicated the firm and its managing partner, and the SEC went so far as to institute cease-and-desist proceedings against both for "failing to oversee" an unregistered broker-dealer engaging in numerous securities transactions and for willfully aiding and abetting the unregistered broker's actions.

[16] SEC v. Hansen, at 10.

[17] Landegger v. Cohen, at fn 4.

[18] SEC v. Kramer, at 1337.

securities to persons outside of the United States who are not "US persons" (as such terms are defined in Regulation S under the Securities Act of 1933), may also avoid registering as broker-dealers.

The commission in SEC v. Benger tried to argue that since the finder was acting as a broker in the United States, registration was mandated, yet the district court determined that Congressional intent regarding the reach of the Exchange Act was clearly limited to protecting "American exchange facilities."[19]

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If a finder's US activities (viewed collectively or singly) may result in a determination that she is acting as a broker, the finder will need to either (1) register as a broker or (2) associate with a broker-dealer that is registered. Registration is time-consuming and expensive, and the Financial Industry Regulatory Authority routinely requires in new member applications disclosure of past activities. A recitation of a history of capital-raising activities is likely to result in heightened review of the Form BD by FINRA.

Associating with a member firm of FINRA will typically result in 10 to 15 percent of commissions or fees earned by the finder being transferred to the broker-dealer, and will require obtaining the Series 7 and 63 licenses, if not also Series 79. Additional issues as to establishing and allocating costs of a branch office/office of supervised jurisdiction also often result.

Finally, sponsoring broker-dealers are increasingly requiring finders to use the broker-dealer domain name for even nonregulated business activity, which then means that all of a finder's business is subject to the investigatory powers of FINRA and the commission.

If a finder anticipates engaging in activities that (when considered in light of previous activities) may well give rise to an issue of the need to register or associate with a broker-dealer but who elects not to do so, she should at a minimum include in her engagement letter with the issuer a "severability clause" so as to avoid the agreement being declared void.[20]

Such a result would become a bar to payment of compensation and could provide a put right to investors in the transaction with which the finder participated (and hence injurious to the issuer

[19] SEC v. Benger, 934 F. Supp. 2d 1008, 1014 (N.D. Ill. 2013).

[20] The Exchange Act, § 29(b) provides that a contract that calls for a party to perform an act violative of any securities law is void.

as well).[21] District courts have recently held that a contract with a finder that included capital-raising activities determined to require registration as a broker by the finder is to a capital-raising service but upholding other aspects of the contract (including developing a financial model and writing a business plan).[22]

[21] See Torsiello Capital Partners LLC v. Sunshine State Holding Corp., at 10-21.
[22] Sun River Energy Inc. v. Nelson, No. 11-CV-00198-MSK-MEH, 2013 WL 1222391 (D. Colo. Mar. 25, 2013).

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