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Finders- The Facts Related To Broker-Dealer Registration Requirements

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Introduction

As a recurring topic, I discuss exemptions to the broker-dealer registration requirements for entities and individuals that assist companies in fundraising and related services. I have previously discussed the no-action-letter-based exemption for M&A brokers, the exemptions for websites restricted to accredited investors and for crowdfunding portals as part of the JOBS Act and the statutory exemption from the broker-dealer registration requirements found in Securities Exchange Act Rule 3a4-1, including for officers, directors and key employees of an issuer. I have also previously published a blog on the American Bar Association's recommendations for the codification of an exemption from the broker-dealer registration requirements for private placement finders. I've included links to each of these prior articles in the conclusion to this blog.

A related topic with a parallel analysis is the use of finders for investors and investor groups, an activity which has become prevalent in today's marketplace. In that case the investor group utilizes the services of a finder to solicit issuers to sell securities (generally convertible notes) to the investment group. These finders may also solicit current shareholders or convertible note holders to sell such holdings to a new investor or investor group.

Most if not all small and emerging companies are in need of capital but are often too small or premature in their business development to attract the assistance of a banker or broker-dealer. In addition to regulatory and liability concerns, the amount of a capital raise by small and emerging companies is often small (less than $5 million) and accordingly, the potential commission for a broker-dealer is limited. Most small and middle market bankers have base-level criteria for acting as a placement agent in a deal, which includes the minimum amount of commission they would need to collect to become engaged.

Effective on July 1, 2013, FINRA updated the private placement form that firms must file with FINRA when acting as a placement agent for the private placement of securities. The updated form drills down on due diligence conducted by the firm in an effort to ensure heightened compliance procedures related to acting as a placement agent for private offerings. This information requirement adds a level of complexity and possible deterrent to broker-dealers when considering acting as a placement agent for a small private offering.

Effective August 24, 2015, FINRA has updated Rule 2040 “Payments to Unregistered Persons” governing the payment of transaction-based compensation by member firms to unregistered persons. FINRA Rule 2040 expressly correlates with Section 15(a) of the Securities Exchange Act of 1934 (“Exchange Act”) as described below and prohibits the payment of transaction-related compensation unless a person is licensed or properly exempt from such licensing.

In addition, the Dodd-Frank Act has potentially increased liability for secondary participants through two provisions. These two provisions, which added Sections 9(a)(4) and 9(f) of the Securities Exchange Act of 1934, dramatically change the liability exposure of intermediaries in the sale of securities, such as broker-dealers. In particular, Section 9(a)(4) of the 1934 Act makes it unlawful for any broker, dealer or other person selling or offering to sell (or purchasing or offering to purchase) any security other than a government security, “to make. . . for the purpose of inducing the purchase or sale of such security, . . . any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which that person knew or had reasonable ground to believe was so false or misleading.” Previously, Section 9 of the 1934 Act applied only to securities traded on an exchange. Now it applies to any securities, excluding government securities—another change that was part of the Dodd-Frank Act. In other words, a broker-dealer can be liable for untrue statements or omissions in offering documents, including private placements and offering advertisements. Dodd-Frank also added Section 9(f) to the 1934 Act, which says that anyone who “willingly participates” in an act or transaction in violation of Section 9(a) above is liable to the person who bought the security.

FINRA scrutiny, together with the potential liability, have acted as a disincentive to broker-dealers to assist small companies in capital-raising efforts. Although the ability to advertise under 506(c) and the rise of 506(c) funding web portals has helped improve the private placement market somewhat, on a practical level, the assistance of finders often marks the difference between a successful or failed offering by a small or emerging company.

The SEC and state regulators recognize this reality and continue to explore the topic. FINRA had proposed rules for a Limited Corporate Financing Broker which would offer a license for private placement finders that do not engage in full broker-dealer services such as managing retail accounts. The proposed rule as written met with opposition as being too similar to full registration and too arduous with ongoing requirements. The comment period on the proposed rule expired April 28, 2014 without further action.

At their June 3, 2015 meeting, the SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") explored the topic of "finders," including listening to a presentation by a firm on the subject.

Current Rules on Finder's Fees

The Securities and Exchange Commission (SEC) generally prohibits the payments of commissions or other transaction-based compensation to individuals or entities that assist in effecting transactions in securities, including a capital raise, unless that entity is a licensed broker-dealer. The SEC considers the registration of broker-dealers as vital to protecting prospective purchasers of securities and the marketplace as a whole and actively pursues and prosecutes unlicensed activity. The registration process is arduous, including, for example, background checks, fingerprinting of personnel, minimum financial requirements, membership to SRO's and ongoing regulatory and compliance requirements.

Over the years, a "finder's" exemption has been fleshed out, mainly through SEC no-action letters and some court opinions. Bottom line, an individual or entity can collect compensation for acting as a finder as long as the finder's role is limited to making an introduction. The mere providing of names or an introduction without more has consistently been upheld as falling outside of the registration requirements. The less contact with the potential investor, the more likely the finder is not required to be licensed.

The finder may not participate in negotiations, structuring or document preparation or execution. Moreover, if such finder is "engaged in the business of effecting transactions in securities," they must be licensed. In most instances, a person that acts as a finder on multiple occasions will be deemed to be engaged in the business of effecting securities transactions, and needs to be licensed.

The SEC will also consider the compensation arrangement with transaction or success-based compensation weighing in favor of requiring registration. The compensation arrangement is often argued as the gating or deciding factor, with many commentators expressing that any success-based compensation requires registration. The reasoning is that transaction-based compensation encourages high-pressure sales tactics and other problematic behavior. However, the SEC itself has issued no-action letters supporting a finder where the fee was based on a percentage of the amount invested by the referred people (see Moana/Kauai Corp., SEC No-Action Letter, 1974).

More recently, the U.S. District court for the Middle District of Florida in SEC vs. Kramer found that compensation is just one of the many factual considerations and should not be given any "particular heavy emphasis" nor in itself result in a "significant indication of a person being engaged in the business of a broker."

Where a person acts as a "consultant" providing such services as advising on offering structure, market and financial analysis, holding meetings with broker-dealers, preparing or supervising the preparation of business plans or offering documents, the SEC has consistently taken the position that registration is required if such consultant's compensation is commission-, success- or transaction-based.

As pertains to finders that act on behalf of investors and investor groups, there is a lack of meaningful guidance. On a few occasions, the SEC has either denied no-action relief or concluded registration was required. However, the same basic principles apply, and it is my belief that as long as the finders limit their activity to providing names and/or introductions, without more, they are exempt from registration.

The federal laws related to broker-dealer registration do not pre-empt state law. Accordingly, a broker-dealer must be licensed by both the SEC and each state in which they conduct business. Likewise, an unlicensed individual relying on an exemption from broker-dealer registration, such as a finder, must assure themselves of the availability of both a federal and state exemption for their activities.

The Exchange Act – Broker-Dealer Registration Requirement

Section 15(a)(1) of the Exchange Act requires any "broker" that makes use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security) to register with the Commission.

The text of Section 15(a)(1) – Registration of all persons utilizing exchange facilities to effect transactions is as follows:

(a)(1) It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

From a legal perspective, determining whether a person must be registered requires an analysis of what it means to "effect any transactions in" and to "induce or attempt to induce the purchase or sale of any security." It is precisely these two phrases that courts and commentators have attempted to flush out, with inconsistent and uncertain results. As a securities attorney, I always advise to err on the conservative side where the activity is at all questionable.

FINRA Rule 2040

Effective August 24, 2015, FINRA has updated Rule 2040 "Payments to Unregistered Persons" governing the payment of transaction-based compensation by member firms to unregistered persons. FINRA Rule 2040 expressly correlates with Section 15(a) of the Securities Exchange Act of 1934 ("Exchange Act") as described below and prohibits the payment of transaction-related compensation unless a person is licensed or properly exempt from such licensing.

Rule 2040 prohibits member firms from directly or indirectly paying any compensation, fees, concessions, discounts or commissions to:

(1) any person that is not registered as a broker-dealer under SEA Section 15(a) 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 SEA rules and regulations; or

(2) any appropriately registered associated person, unless such payment complies with all applicable federal securities laws, FINRA rules and SEA rules and regulations.

FINRA guidance on the Rule states that a member firm can (i) rely on published releases, no-action letters or interpretations from the SEC staff; (ii) seek SEC no-action relief; or (iii) obtain a legal opinion from an independent, reputable U.S. licensed attorney knowledgeable in the area. This list is not exclusive and FINRA specifically indicates that member firms can take any other reasonable inquiry or action in determining whether a transaction fee can be paid to an unlicensed person.

FINRA Rule 2040 specifically allows the payments of finder's fees to unregistered foreign finders where the finder's sole involvement is the initial referral to the member firm of non-U.S. customers and certain conditions are met, including but not limited to that (i) the person is not otherwise required to be registered as a broker-dealer in the U.S.; (ii) the compensation does not violate foreign law; (iii) the finder is a foreign national domiciled abroad; (iv) the customers are foreign nationals domiciled abroad; (v) the payment of the finder's fee is disclosed to the customer; (vi) the customers provide written acknowledgment of receipt of the notice related to the payment of the fee; (vii) proper records regarding the payments are maintained; and (viii) each transaction confirm indicates that the finder's fee is being paid.

SEC Guide to Broker-Dealer Registration

Periodically, and most recently in April 2008, the SEC updates its Guide to Broker-Dealer Registration explaining in detail the rules and regulations regarding the requirement that individuals and entities that engage in raising money for companies must be licensed by the SEC as broker-dealers. On a daily basis, hundreds if not thousands of individuals and entities offer to raise money for companies as "finders" in return for a "finder's fee." Other than as narrowly set forth above, such agreements and transactions are prohibited and carry regulatory penalties for both the company utilizing the finder's services, and the finders.

Each of the following individuals and businesses is required to be registered as a broker if they are receiving transaction-based compensation (i.e., a commission):

- "finders," "business brokers," and other individuals or entities that engage in the following activities: Finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers, investment companies (or mutual funds, including hedge funds) or other securities intermediaries;
- Finding investment banking clients for registered broker-dealers;
- Finding investors for "issuers" (entities issuing securities), even in a "consultant" capacity;
- Engaging in, or finding investors for, venture capital or "angel" financings, including private placements;
- Finding buyers and sellers of businesses (i.e., activities relating to mergers and acquisitions where securities are involved);
- investment advisers and financial consultants;
- persons that market real estate investment interests, such as tenancy-in-common interests, that are securities;
- persons that act as "placement agents" for private placements of securities;
- persons that effect securities transactions for the account of others for a fee, even when those other people are friends or family members;
- persons that provide support services to registered broker-dealers; and
- persons that act as "independent contractors," but are not "associated persons" of a broker-dealer (for information on "associated persons," see below).

SEC Advisory Committee on Small and Emerging Companies is Exploring the Topic

At the June 3, 2015, meeting of the SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee"), the Advisory Committee explored the topic of "finders" including listening to a presentation by Shumaker, Loop & Kendrick ("SLK") on the topic. I am hopeful that they will continue to investigate this important area affecting small and emerging growth companies and fashion a recommendation to the SEC.

The presentation to the Advisory Committee began with basic background on the importance of small and emerging companies to the U.S. economy and the facts related to reliance on private and exempt offerings of securities to fund these enterprises. SLK, citing a 2012 report by Vlad Ivanov and Scott Bauguess, notes that in 2011 the estimated amount of private capital raises in Regulation D exempt offerings was more than $1 trillion, about equal to the amount raised in public offerings in the same year. Citing a presentation by Rachita Gullapalli to the Advisory Committee on December 17, 2014, SLK states that in the 12-month period from September 23, 2013 (the day 506(c) was enacted into law) through September 22, 2014, there were nearly 15,000 new Regulation D offerings, 99% of which were completed under Rule 506. Citing a white paper available on the SEC website, SLK notes that only 13% of Regulation D offerings between 2009 and 2012 reported using a financial intermediary such as a broker-dealer or finder.

The presentation continued with a recitation of the current state of the law and historical efforts for change, including the American Bar Association's position and efforts and M&A transaction carve-out, both of which I had previously written about.

SLK concluded with a recommendation for statutory exemption for private placement finders. SLK recommends, and I agree, that the exemption should be self-executing and include appropriate restrictions, including bad actor prohibitions.

State Law; The Florida Trap

The federal laws related to broker-dealer registration do not pre-empt state law. Accordingly, a broker-dealer must be licensed by both the SEC and each state in which they conduct business. Likewise, an unlicensed individual relying on an exemption from broker-dealer registration, such as a finder, must assure themselves of the availability of both a federal and state exemption for their activities. State securities laws vary widely, including the laws related to broker-dealer registration, and a state-by-state review is well beyond the scope of this blog.

Florida, however, gives us a reminder of the necessity to be extremely careful and mindful of state law ramifications. Florida Statute §475.41 specifically states that a contract by an unlicensed broker to sell or to negotiate the purchase or sale of a business for compensation is invalid and in particular:

No contract for a commission or compensation for any act or service enumerated in §475.01(3) is valid unless the broker or sales associate has complied with this chapter in regards to issuance and renewal of the license at the time the act or service was performed.

Fla. Stat.§475.01(3) defines “operating” as a broker as meaning “the commission of one or more acts described in this chapter as operating as a broker.” “Broker” is defined broadly in Fla. Stat.§475.01(1)(a) and includes, among other things:

… a person who, for another, and for compensation or valuable consideration directly or indirectly paid or promised, expressly or impliedly, or with an intent to collect or receive compensation or valuable consideration therefore… sells… or negotiate[s] the sale, exchange, purchase, or rental of business enterprises or business opportunities… or who advertises or holds out to the public by any oral or printed solicitation or representation that she or he is engaged in the business of appraising, auctioning, buying, selling, exchanging, leasing or renting business enterprises or business opportunities… or who directs or assists in the procuring of prospects or negotiation or closing of any transaction which does, or is calculated to, result in a sale, exchange, or leasing thereof, and who receives, expects, or is promised any compensation or valuable consideration, directly or indirectly… (emphasis added)

Relying on these provisions, Florida courts and arbitration panels have found consulting and finder arrangements related to mergers and acquisitions and other corporate finance transactions that would otherwise not require federal broker-dealer registration, to be unlawful.

In addition to the conflict with federal law, the Florida statute is particularly troubling for practitioners as it is not included in the Florida Securities and Investor Protection Act found in chapter 517 of Florida Statutes. Florida Statute §517.12 is the state equivalent to Section 15(a)(1) of the Exchange Act requiring broker-dealer registration. Like the Exchange Act, §517.12 requires registration as a broker or dealer for the sale or offer of any securities.

Section 475, on the other hand, is the Florida statute governing “Real Estate Brokers, Sales Associates, Schools and Appraisers.” Section 517 gives no reference to Section 475 and vice versa. Other than through research of case law, a practitioner would have no reason to research laws governing real estate transactions in association with business mergers and acquisitions and the payment of related finders’ fees.

The Florida provisions remind us of the complexities associated with providing advice and guidance to clients related to the payment of finders’ fees, and the necessity to seek competent legal counsel before agreeing to pay, or accept, such a fee.

Consequences for Violation

Other than the discussion above related to Florida law, I am not addressing the varied state law consequences in this blog.

The SEC is authorized to seek civil penalties and injunctions for violations of the broker-dealer registration requirements. Egregious violations can be referred to the attorney general or Department of Justice for criminal prosecution.

In addition to potential regulatory problems, using an unregistered person who does not qualify for either the statutory or another exemption to assist with the sale of securities may create a right of rescission in favor of the purchasers of those securities. That is a fancy way of saying they may ask for and receive their money back.

Section 29(b) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), provides in pertinent part:

Every contract made in violation of any provision of this title or of any rule or regulation thereunder… the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract…

In addition to providing a defense by the issuing company to paying the unlicensed person, the language can be interpreted as voiding the contract for the sale of the securities to investors introduced by the finder. The SEC interprets its rules and regulations very broadly, and accordingly so do the courts and state regulators. Under federal law the rescission right can be exercised until the later of three years from the date of issuance of the securities or one year from the date of discovery of the violation. Accordingly, for a period of at least three years, an issuer that has utilized an unlicensed finder has a contingent liability on their books and as a disclosure item. The existence of this liability can deter potential investors and underwriters and create issues in any going public transaction.

In addition, SEC laws specifically require the disclosure of compensation and fees paid in connection with a capital raise. A failure to make such disclosure and to make it clearly and concisely is considered fraud under Section 10b-5 of the Securities Act of 1933 (see, for example, SEC vs. W.P. Carey & Co., SEC Litigation Release No. 20501). Fraud claims are generally brought against the issuing company and its participating officers and directors.

Moreover, most underwriters and serious investors require legal opinion letters at closing, in which the attorney for the company opines that all previously issued securities were issued legally and in accordance with state and federal securities laws and regulations. Obviously an attorney will not be able to issue such an opinion following the use of an unlicensed or non-exempted person. In addition to the legal ramifications themselves and even with full disclosure and the time for liability having passed, broker-dealers and underwriters may shy away from engaging in business transactions with an issuer with a history of overlooking or circumventing securities laws.

Historically, it was the person who had acted in an unlicensed capacity who faced the greatest regulatory liability; however, in the past ten years that has changed. The SEC now prosecutes issuers under Section 20(e) for aiding and abetting violations. The SEC has found it more effective and a better deterrent to prosecute the issuing company than an unlicensed person who is here today and gone tomorrow.

The violations often go beyond the unlicensed broker-dealer issue. Persons who do not comply with the statutory and regulatory requirements for assisting in fundraising generally engage in inappropriate solicitation of investors, generous representations and the like in efforts to raise money and earn a commission and therefore face claims for securities fraud.

Conclusion

The payment of finder's fees is a complex topic requiring careful legal analysis on a case-by-case and state-by-state basis. No agreements for the payment or receipt of such fees should be entered into or performed without seeking the advice of competent legal counsel.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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