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BROKER-DEALERS

Proposed SEC Exemption Offers Much-Needed Clarity on Use of Finders to Raise Investment Capital

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The use of "finders" to raise capital has always been a cloudy area of securities regulation and often a pitfall for the unwary. Many folks, unaware of the regulatory framework governing broker-dealer and investment advisory activity, have walked into the crosshairs of the enforcement arm of the SEC for referring investors to issuers, including private investment funds, in exchange for compensation without being associated with an SEC-registered broker-dealer. The investment funds those investors are solicited for – as well as the investment advisers that manage those funds – also potentially face enforcement actions for paying those individuals.

The SEC recently proposed an exemptive order (Exemptive Order) that would permit unregistered finders to engage in certain limited fundraising activities without the need to associate with a broker-dealer. This article provides background on the regulatory status of finders, explains the proposed Exemptive Order and discusses its possible implications for private fund managers.

History of the Regulatory Status of Finders

Raising money from prospective investors to invest in an enterprise, whether it is a company that produces widgets or a fund that invests in securities, is considered a form of broker-dealer activity under Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act). Individuals engaged in that fundraising activity must be associated with a firm that is registered as a broker-dealer with the SEC and a member of FINRA.

Rule 3a4-1 under the Exchange Act – the so-called "issuer exemption" – is a longstanding rule that permits persons associated with an issuer or its affiliates to solicit investors without being registered with a broker-dealer, provided the conditions of the rule are satisfied. Those conditions are stringent, however, and the rule does not apply to third-party solicitors unaffiliated with the issuer. The Exemptive Order is, to some extent, modeled on the issuer exemption, although it would permit a broader range of solicitation activities.

Apart from the issuer exemption, a body of caselaw and certain SEC no-action letters have allowed persons to act as finders without being associated with broker-dealers. That interpretive authority, however, has created a good deal of ambiguity regarding when a person crosses the line into violating the broker-dealer registration requirements for soliciting investors; therefore, it has presaged the need for a clarifying rule.

See "Do In-House Marketing Activities and Investment Banking Services Performed by Private Fund Managers Require Broker Registration?" (Apr. 18, 2013).

Paul Anka No-Action Letter

In the Paul Anka no-action letter issued in 1991, the SEC stated that, if a person's activities are limited to introducing a prospective investor to an issuer or investment fund, and the person does not negotiate the terms of the investment or make any recommendation concerning the investment, that person is not required to be associated with a broker-dealer – even if the person is compensated based on the investments made.

In subsequent no-action letters and other interpretive guidance, however, the SEC appeared to pull back from that interpretation. Many commentators currently believe that if a person refers prospective investors in exchange for a fee that is contingent on the investors making the investment, and the person is not associated with a broker-dealer, the SEC enforcement staff likely will take the position that the activity violates the broker-dealer registration requirement. In such a situation, the SEC also is likely to claim that the issuer, as well as any persons acting on its behalf, are liable for aiding and abetting the violation.

For more on that no-action letter, see "Is the In-House Marketing Department of a Hedge Fund Manager Required to Register as a Broker?" (Mar. 18, 2011).

M&A Brokers No-Action Letter

The SEC has provided definitive guidance in connection with one specific kind of activity relating to fundraising that does not trigger the broker-dealer registration requirement. This is the so-called "M&A Broker" exception contained in an SEC no-action letter issued on January 31, 2014 (M&A Brokers No-Action Letter).

As a general matter, when a person or firm arranges for the sale or purchase of a business through the issuance of securities, that activity – which falls under the rubric of investment banking – requires the person or firm to be registered as a broker-dealer. Under the M&A Brokers No-Action Letter, however, a person who engages in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately held company through the purchase, sale or other transaction involving the company's securities, when the buyer will actively operate the company, will not need to be registered as a broker-dealer or associated with a registered firm.

The M&A Brokers No-Action Letter contains very specific requirements that must be satisfied for the exception to apply. Apart from that exception, the SEC has generally not been receptive to permitting persons to engage in fundraising activity without being registered as or associated with a registered broker-dealer.

See "SEC No-Action Letter Suggests That There May Be Circumstances in Which Recipients of Transaction-Based Compensation Do Not Have to Register As Brokers" (Feb. 21, 2014).

Court Decisions

Some courts have not agreed with the SEC's interpretation of the broker-dealer registration requirement and have held that a person who acts as a finder by introducing investors in exchange for a fee – even if that fee is contingent on the investment being made – does not violate the broker-dealer registration requirement.

For example, in *SEC v. Kramer*, the district court ruled against the SEC in an action seeking a permanent injunction based on its claim that the defendant, Kenneth Kramer, violated Section 15(a)(1) of the Exchange Act by acting as a broker-dealer when promoting the sale of securities without being registered as a broker-dealer with the SEC. Kramer invested in the issuer's securities himself but also received payments from the issuer for encouraging his friends to visit the company's website and review certain documents relating to the issuer, including its press releases. Many of Kramer's friends purchased the securities and also referred their own friends to invest. Based on the evidence presented at trial, the court found that Kramer did not play an active role in the negotiations between the issuer and prospective investors and did not actively promote the company. Significantly, the court stated that the "[SEC's] proposed single-factor 'transaction-based compensation' test for broker activity . . . is an inaccurate statement of the law . . ." and that "an array of factors determine the presence of broker activity."

Other courts have ruled more in line with the SEC's restrictive position concerning finders. For example, in *SEC v. Martino*, the court sided with the SEC in an action against Carol Martino and her closely held brokerage firm CMA Noel Ltd. (collectively, Martino), neither of which were registered with the SEC during the time period at issue. The SEC's complaint alleged, among other things, that Martino acted as an unregistered broker in violation of the Exchange Act. Martino specialized in brokering deeply discounted stock of U.S. companies to foreign investors pursuant to Regulation S (Reg S), promulgated under the Securities Act of 1933 (Securities Act). To effect those transactions, Martino executed several agreements. In one such agreement, Martino agreed to act as a liaison between the buyer and seller for a commission of 10 percent of the gross proceeds.

According to one of Martino's purchasers, Martino was "intimately involved in each stock transaction"; encouraged the purchaser to acquire Reg S stock; was in frequent contact to ensure timely and proper completion of the transactions; and in general acted as the "middle person" between the purchaser and the U.S. issuers. On at least two occasions, the purchaser even remitted payment for the Reg S stock directly to Martino. Pursuant to another agreement, Martino furnished potential purchasers with company information, including SEC filings and press releases, advised potential purchasers with respect to sale terms and attempted to "pre-sell" the U.S. issuer's stock to potential investors.

The court, noting that Martino was involved in every aspect of the securities transactions at issue and had continuous contact with purchasers, concluded that Martino participated in securities transactions at "key points in the chain of distribution." It held, therefore, that Martino acted as an unregistered broker in violation of the Exchange Act.

Similarly, in *Cornhusker Energy Lexington, LLC v. Prospect Street Ventures*, defendant Prospect Street Ventures (Prospect), which was not registered as a broker-dealer, agreed to identify and introduce sources of capital for the development, construction and operation of an ethanol facility project proposed by Cornhusker Energy Lexington LLC (Cornhusker), in exchange for a percentage of the investment capital raised. The agreement between the parties expressly provided that Prospect would not act in the capacity of a broker or dealer of securities, nor would it advise Cornhusker with respect to the underlying business decision to effect a transaction. The agreement provided for a consulting fee of $50,000, $15,000 per month and a success fee. The issue before the court was whether the agreement could be rescinded, based upon Section 29(b) of the Exchange Act, which provides for rescission of contracts made in violation of the Act.

The court recognized that a narrow scope of activities, as delineated by the SEC in a series of no-action letters, may be performed without subjecting an individual or entity to the broker-dealer registration requirements, such as when one is merely acting as a finder in bringing together the parties to transactions involving the purchase and sale of securities. The court then recited a list of activities that constitute the performance of broker-dealer activities, including:

1. analyzing the financial needs of an issuer;
2. recommending or designing financing methods;
3. being involved in negotiations;
4. discussing details of securities transactions;
5. making investment recommendations; and
6. having prior involvement in the sale of securities.

Unlike the court in the *Kramer* case discussed above, the court in *Cornhusker* held that transaction-based compensation is a hallmark of being a broker-dealer. As a result, the court rejected Prospect's contention that its actions under the agreement, as a matter of law, did not constitute effecting transactions in securities and denied its motion for summary judgment. Rather, it concluded that Cornhusker's allegations, if proven, demonstrated a violation of the Exchange Act provision requiring registration as a broker-dealer.

The Proposed Exemptive Order

Given the conflicting body of caselaw concerning finders, along with the SEC's overly restrictive interpretive position, the Exemptive Order provides much-needed clarity by permitting certain fundraising activity without triggering the need to register as a broker-dealer or be associated with such a firm.

The proposal allows two kinds of activities involving the referral of investors for certain types of issuers, which would not require broker-dealer registration. With respect to either type of activity:

- only accredited investors as defined in Rule 501(a) under the Securities Act may be solicited;
- only natural persons – not entities – may rely on the exemption; and
- the finder must enter into a written agreement with the issuer.

For discussion of recent updates to the definition of "accredited investor," see "SEC Adopts Incremental Expansion of Accredited Investor Definition" (Sep. 17, 2020).

The following is a general description of the two types of exemptions under the Exemptive Order. Certain other conditions enumerated in the proposal must also be satisfied.

Under the "Tier I" exemption, a person may receive compensation for referring investors to an issuer, if the person:

- engages in only one capital-raising transaction for a single issuer in any 12-month period;
- provides only contact information about prospective investors to the issuer; and
- does not discuss the issuer or the investment with the prospective investor.

Under the "Tier II" exemption, a person may:

- receive compensation for referring an unlimited number of investors to the issuer;
- distribute offering materials to prospective investors;
- discuss the issuer with prospective investors; and
- participate in meetings between the investors and the issuer.

Under the Tier II exemption, however, the finder is not permitted to give advice on the value or advisability of the investment. The Tier II exemption also requires the referring person to make certain written disclosures to investors and to obtain the investors' acknowledgement of the receipt of those disclosures.

Other Applicable Requirements

Even if the Exemptive Order is finalized, there are certain statutes and regulations that would continue to apply to the solicitation of investors, apart from the broker-dealer registration requirement. For example, the anti-fraud provisions under the Exchange Act and the Advisers Act prohibit making misrepresentations or omitting material facts in connection with soliciting investors.

Conclusion

The comment period for the Exemptive Order has concluded. Whether, or in what form, the final Exemptive Order will be issued remains unknown. If adopted, it will offer much more clarity on the activities that are permitted for individuals who raise funds from investors but are not registered as broker-dealers or associated with those firms.

More importantly, the Exemptive Order creates a new and clearly defined category of persons who may be enlisted by investment funds, in particular, to identify potential investors. Because those persons are not required to be employed by a registered broker-dealer or have licenses issued by FINRA, the Exemptive Order opens investment funds to a much larger pool of potential "finders," including financial advisers, family offices, high net worth individuals, as well as persons who are already investors in such funds, to identify and refer potential investors to the funds.

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