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The State Of Unregistered Intermediary Regulation

Law360, New York (December 03, 2008) -- For years, unregistered intermediaries (finders) in securities transactions have adeptly and, at times, daringly navigated through the maze of federal, state and self-regulatory rules and regulations.

However, recent U.S. Securities and Exchange Commission (SEC) actions and court rulings have reinvigorated long-standing concerns that these finders may be violating securities laws by failing to register under federal and state securities laws, and that increased judicial scrutiny and SEC enforcement actions will be forthcoming.

This article examines these regulatory actions against the backdrop of the overall investor protection objective of the federal securities laws, and offers practical tips for issuers seeking to raise capital in this challenging market environment with the assistance of unlicensed intermediaries.

Understanding Broker-Dealer Activities

Section 3(a) of the Securities Exchange Act of 1934 generally defines a broker broadly as "any person engaged in the business of effecting or facilitating transactions in securities for the account of others."

The same section defines a dealer as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise," i.e. a dealer acts as principal.

The activities must also be characterized by a certain degree of regularity in participation in securities transactions as key points in the chain of distribution. Individuals who meet these criteria are required to be registered under Section 15(a) of the Exchange Act.

A broker must pass and maintain various licensing tests and other requirements, and be associated with a brokerage firm which, in turn, must be registered with the SEC, Financial Industry Regulatory Authority (FINRA) and state regulatory authorities in states where such firms engages in securities activities.

Compliance with such requirements is an increasingly costly and time-intensive proposition, but the underlying purpose for the complex fabric of regulations for all broker-dealer activities is to protect the investing public.

The SEC liberally views and interprets various activities in connection with the concept of "effecting a securities transaction."

Consistently, activities such as receiving transaction-based compensation, handling/taking custody of the funds of transaction participants, recommending a particular security, negotiating terms of a securities transaction, engaging in securities transactions on a frequent basis, providing valuation analyses, engaging in due diligence analysis, etc. have been deemed to be integral to the broker-dealer activities requiring appropriate registration.

The crucial inquiry is into the role the transaction intermediary plays at each stage of the securities transaction. As is the case with other similar analyses, the SEC has repeatedly stated that none of these factors is dispositive in determining whether one is a "broker" and, thus, is required to register.

Defining Finders

Not surprisingly, the Exchange Act does not contain an exemption from registration for finders. In essence, finders are unregistered intermediaries who refer investors, individual or institutional, to a securities investment or help companies in their capital raising activities and are compensated for their services.

Generally, finders do not, among other things, engage in due diligence, participate in investment price and other key material negotiations and, thus, did not see any need to register as "brokers" under the regulatory scheme.

If one engages in financial intermediary and related activities on a rare, infrequent basis, it makes little practical sense to subject oneself to burdensome registration, educational and licensing requirements imposed by the broker-dealer rules.

In practice, there are different categories of finders, including, without limitation, finders referring investors to registered broker-dealers (e.g. licensed professionals), finders referring investors to issuers (e.g. promoting sales of new securities, providing consulting services, etc.), finders facilitating merger and acquisition transactions, etc.

Over time, the SEC has issued a number of no-action letters that provide sets of parameters that may be used to ascertain the nature and degree of one's involvement in bringing transaction-minded entities together in a securities transaction.

The key take-away point that permeates all of these decisions is that the regulators have been applying (with various degrees of success) a functional approach to this issue, focusing on what the intermediary actually does in a particular securities transaction.

Finders consistently argued to the SEC staff (sometimes, to the SEC) that they do not engage in effecting securities transactions, but merely referred various transaction-minded persons/entities to each other that, in turn, effected the resulting transactions.

Historically, the SEC staff's tolerance for this argument has steadily decreased, thus, narrowing the universe of permissible conduct for finders in securities transactions.

Consequences Of Using A Non-Registered Intermediary In A Securities Transaction For Issuers

A company that has engaged an unregistered broker-dealer may be subject to a number of regulatory sanctions. From the investor's standpoint, there is a cause of action for rescission under Section 29(b) of the Exchange Act, i.e. the investor may seek the return of his

investment in the company, including the return of fees paid to the finder. In addition, the company may also lose its exemption for its securities offering.

From a regulatory standpoint, the SEC (and state securities authorities) can bring an enforcement action against (i) the unregistered broker-dealer for failure to register, and/or (ii) the company, for aiding and abetting with the violations of the Exchange Act registration provisions. These sanctions contemplate civil penalties, disgorgement with interest and future injunctions.

Recent Developments In The Regulation Of Finders

Since the withdrawal of Dominion Resources, Inc., a pivotal SEC No-Action letter in the finder area, the SEC staff has indicated that it was actively monitoring finders' activities in the private capital marketplace and that violations of Exchange Act registration requirements would not be tolerated.

The staff expressed its concern with the nature and extent of finders' engagement in securities negotiations, sales and delivery processes in addition to the traditional issue with continent-based compensation. Consistent with their renewed interest in the area, the federal regulators and the judiciary issued the following recent decisions.

On April 1, 2008, the Supreme Court of New York County found against an unregistered broker who sued an affiliate to collect a fee for performing brokerage services (Torsiello Capital Partners v. Sunshine State Holding, 600397/06,).

The plaintiff, Torsiello Capital Partners, entered into an agreement with Sunshine State Holding Corporation to act as sole placement agent in connection with a sale of Sunshine's securities for a (i) a retainer fee, and (ii) a cash fee equal to 3.5 percent of the transaction's total purchase price. Torsiello failed to locate a purchaser for Sunshine, but nevertheless sued the company to enforce the contract and collect its fee.

The primary issue addressed by the court was whether Torsiello was required to be registered as a broker under federal securities laws in order to perform its obligations under the contract with Sunshine.

The court found that the record clearly demonstrated Torsiello "was retained to act, and did act, as a securities broker with regard to the marketing and proposed private sale of Sunshine's securities."

Accordingly, the court held that the contract between the parties was void and rescindable by Sunshine because Torsiello was not registered as a broker, and, therefore, could not legally perform its contractual obligations under the contract.

A few days after the Torsiello decision, the SEC sanctioned a finder for violating registration requirements of the Exchange Act. On April 30, 2008, the SEC issued an Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions against Robert MacGregor. The order found that from Nov. 2003 through at least Jan. 2005, MacGregor was employed by and associated with Duncan Capital LLC, a registered broker-dealer.

During his employment and association with Duncan, MacGregor conducted brokerage activities in connection with private investments in public equity.

As compensation, MacGregor received commissions based on the dollar amount of the placement. At no time during his employment and association with Duncan was MacGregor registered with the FINRA as a broker, nor had he passed the examinations required in order to conduct the activities he was performing for Duncan.

On April 11, 2008, the SEC entered a final judgment against MacGregor barring him from association with any broker or dealer for at least one year, and requiring him to disgorge all ill-gotten gains obtained in connection with his violations of the registration requirement.

Recent Regulatory Efforts In The Finder Area

There has been a long-standing need for a holistic approach to the regulation of finders. For instance, in its final report, the 22nd Annual SEC Government-Business Forum on Small Business Capital Formation issued a number of recommendations urging various federal, state, trade and other regulators, including the SEC, FINRA, NASAA and others, to work together to address and facilitate appropriate role for finders in the capital raising process.

In June 2005, the ABA Task Force on Private Placement Broker-Dealers released a report containing recommendations for expanded finders' activities. One critical recommendation was for federal, state and FINRA regulators to move toward a simplified regulatory schedule for finders to be licensed, permitting them to engage in activities similar to those of conventional broker-dealers. Other specifics included:

- no participation in public offerings registered pursuant to the Securities Act of 1933, but can receive referral fees for introducing such offerings to full service broker-dealers.

- no statutory disqualification of the firms or its principals.

- offerings by finders could be made only to accredited investors and other "qualified purchasers" when the SEC defines such term. Issuers, however, could separately offer to any investors qualified by the type of exemption.

- the finders may not handle or take possession of funds or securities.

- all offerings would be done on a best-efforts basis.

- all funds from offerings will be placed in escrow in an unaffiliated financial institution in accordance with escrow requirements in SEC Rule 15c2-4.

- the finders may not engage in secondary market or trade activity, including assisting with maintenance of "desk drawer" markets at the issuer or the broker-dealer.

- finders shall have successfully completed simplified NASD examinations appropriate to the scope of activities of the finders.

The SEC returned to these efforts in 2007 and 2008 to revise and develop new rules overseeing finders' activities. For example, effective Sept. 15, 2008, the SEC amended Form D (an SEC filing under Regulation D), requiring an issuer to, among other things, separately list fees paid to both finders and broker-dealers, permitting greater enforcement. New SEC rules may provide a finder registration process and address current ambiguities in working with finders. As of this writing, they are still in the works.

What To Do In The Meantime

In this current, less than predicable, regulatory environment, companies considering engaging intermediaries should be mindful of the following practice points to minimize the risk of regulatory inquiry or action:

- Conduct a thorough due diligence review or, at a minimum, seek to obtain information that would be helpful in assessing such intermediary's prior transaction and engagement record, e.g. past securities transactions, frequency, nature of compensation received, etc.

- Structure the finder's compensation as flat-fee or hourly based and vvoid any performance-based compensation altogether.

- Narrowly prescribe the universe of the permitted actions for the finders in their engagement agreements, e.g. the number and nature of potential investors to be contacted, etc., and proscribe the finders from structuring, negotiating, researching, etc. the terms and provisions of the investment. This can be accomplished by requiring express representations and warranties from the intermediary. In addition, the finder should be required to make similar representations in the subscription agreement between the issuer and the investor.

Nowadays, it is no mystery that the traditional financing sources for small to medium-cap issuers, especially in the current market, are severely limited. The need for finder services will most likely hit its peak in the months and years to come.

Therefore, the corresponding need for a clearly delineated regulatory scheme for the securities transactions intermediaries is more pronounced than ever.

Until they see such regulatory developments, however, companies seeking to raise capital should be vigilant in their due diligence and review efforts to avoid pitfalls of engaging unregistered intermediaries and subjecting themselves to regulatory attention.

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