Regulating Unregistered Finders: New York Dips its Toe in the Murky Waters

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This alert provides a brief discussion of the practice of using unregistered "finders" in the context of a private securities offering. We provide background on the process, discuss various risks and considerations, and address how recent developments in New York may change private issuers' approaches in this murky area of the regulatory landscape.

BACKGROUND

Raising capital can be a significant challenge for private companies, especially issuers that typically would not draw the attention of investment banks such as early stage or emerging growth companies. One of the highest hurdles these companies face is simply identifying prospective sources of capital. Registered securities brokers can assist in this task. Unfortunately, issuers often find it difficult to pay the fees charged by brokers or even to find a broker with prospective investor contacts likely to bear fruit for the offering. It may be permissible for an issuer's personnel to assist it with its securities offering or for unregistered "M&A brokers" to assist in the purchase and sale of a company, but available exemptions or relief from broker status are limited in scope.[1]

Instead of using a registered broker or in-house personnel, private companies often consider using a so-called "finder." Typically, a finder will help private companies identify prospective investors in return for compensation. Ideally, finders simply provide an issuer with the names and contact information for prospective investors and perhaps an introduction, though finders often try to do more. Typically, the compensation paid to a finder is less than what the issuer would pay a registered broker. Often, all the issuer really needs or wants is the introduction — the other services provided by a broker might not be necessary.

At first glance, this sounds like a great alternative for a private company seeking to raise capital. However, the regulatory status of finders is a longstanding murky area under the U.S. federal securities laws. This stems from the possibility that the U.S. Securities and Exchange Commission (SEC) or the courts may view these finders as unregistered securities brokers. Various states also treat finders differently from a regulatory standpoint. As a result, these arrangements can be problematic for the issuer and the exempt status of the private offering.

The SEC has not formally addressed this issue, despite decades of prodding from private issuers, industry practitioners,[2] and more recently the SEC's own Small Business Capital Formation Advisory Committee.[3] Rather than publish clear guidance, rules, or exemptions (or related requirements and limitations), the SEC has left issuers and the legal community to interpret a patchwork of SEC staff letters and various court decisions, many of which present similar but different facts and circumstances and that, at times, have resulted in incongruent conclusions. SEC staff also maintains a "Guide to Broker-Dealer Registration" that briefly mentions finders, but neither forms a view on regulatory status nor provides any practical guidance in this area.[4] This creates uncertainty for issuers, and with uncertainty comes risk.

In the midst of the SEC's inaction on this issue (and, not to mention, a global pandemic) the New York State Attorney General (NYSAG) unveiled a package of related reform proposals intended to protect the public from fraudulent exploitation in the offering and sale of securities.[5] Among other things, if adopted, the proposals would define "Finder" and would impose registration and exam requirements on these individuals.[6] If adopted, the proposals could significantly affect capital raising in and from New York.

WHAT IS A BROKER?

Section 3(a)(4) of the Exchange Act generally defines a broker as any person engaged in the business of effecting securities transactions for the accounts of others.[7] On its face, the definition seems straightforward enough, especially in the context of a retail securities transaction (e.g., through an online broker). But the definition is difficult to square in a private offering, where the notion of "effecting a transaction" does not fit the practical reality of the mechanics of the private sale and the meaning of "engaged in the business" also lacks clarity.

The SEC has long taken the position that broker status depends on the specific facts and circumstances in question. Court decisions have noted that activities of a broker are characterized by "a certain regularity of participation in securities transactions at key points in the chain of distribution."[8] Other court decisions have yielded various factors that may be relevant, including handling or possessing investor funds or securities, actively (rather than passively) soliciting prospective investors (including advertising), negotiating on behalf of a buyer or seller, and receiving commissions or other forms of transaction-based compensation.[9] It is this last factor that the SEC often cites in determining whether activity is that of a broker. According to many SEC staff letters, an individual who receives transaction-based compensation often is considered to have a "salesperson's stake" in the transaction and is likely to be deemed a broker.[10] However, one recent court decision focused on a plain reading of the statutory elements of Section 3(a)(4), determining that the finder in that case was merely facilitating securities transactions rather than performing the functions of a broker.[11] And before that, another court ruled against the SEC's allegations of unregistered broker activity, finding that the individual's receipt of transaction-based compensation, without evidence that (among other things) he participated in purchases and sales or provided advice or other information about the investment, did not cause him to be a broker.[12]

RISKS IN USING A FINDER

Using a finder can create risk for the issuer and the offering itself. For example, Exchange Act Section 15(a)(1) makes it unlawful for a person to "effect a transaction in securities" or "attempt to induce the purchase or sale of, any security" unless registered as a broker or dealer. Exchange Act Section 29(b) provides that any contract in violation of broker-dealer registration requirements "shall be void." This means that investors could have the right to rescind their purchase – essentially, a put right to the investor as a voidable transaction. However, investors are not typically parties to the contract between the issuer and finder, so it is not clear whether a subscription agreement is voidable based on the involvement of a finder. Exchange Act Section 20(e) also allows the SEC to impose aiding-and-abetting liability on any person who knowingly or recklessly provides substantial assistance in a violation of the Exchange Act – in other words, if the issuer knew or should have known that it was utilizing an unregistered broker.[13] Additionally, an issuer may not be able to rely on a securities registration exemption, or it could unknowingly result in the issuance of unregistered securities in violation of Section 5 of the Securities Act of 1933. In this scenario, the issuer could be responsible for reimbursing investors for the investment, interest, costs and attorney fees. Importantly, the SEC has continued to pursue enforcement action against unregistered brokers.[14]

WHAT SAY THE SEC?

SEC staff has addressed the finder issue from time to time in the form of staff "No-Action Letters."[15] However, the Commission itself has not, nor have most states. Below we discuss the New York proposals and certain other states' existing requirements. We were somewhat encouraged by a statement in the June 2019 SEC Concept Release on the Harmonization of Securities Offerings, in which the SEC noted that "[t]he Division of Trading and Markets is reviewing the status of finders."[16] Our proclivity for optimism led us to speculate that, after so many years, we might formally hear the SEC's views on finders – perhaps SEC rulemaking after a

recommendation from Trading and Markets. But that was over a year ago and, as our optimism waned, so too perhaps has the runway for rulemaking under the current administration.

That leaves us with the staff No-Action Letters. Likely the most oft-cited letter is *Paul Anka* way back in (wait for it) 1991.[17] In *Paul Anka*, SEC staff essentially blessed an arrangement whereby the named pop singer would provide an issuer with names and contact information for prospective investors in the Ottawa Senators hockey team in return for a finder's fee calculated as a percentage of funds raised from his investors. That blessing was based on several conditions and representations, including that Anka (1) had a pre-existing, substantive relationship with the investor prospects, (2) reasonably believed the prospects were accredited investors, and (3) would not solicit prospective investors, make any investment recommendations to them, or have any contact with them concerning the prospective investment, either before or after the issuer contacts them.[18] It was, no doubt, an important additional factor that Anka was involved in the music business rather than a securities, financial, or adjacent business, and, according to the facts on which the SEC staff relied, that Anka had not previously acted as a broker.

However, without formal guidance or rulemaking from the SEC, issuers and practitioners are left to wonder, interpret, and speculate as to the permissibility of using finders in a private offering. Contributing to the uncertainty surrounding finders is that SEC staff views change over time – as does the views of the SEC itself. A prime example is the less-nuanced views of SEC staff in other letters, which instead focused simply on whether the finder receives transaction-based compensation. In *Brumberg, Mackey & Wall, P.L.C.* ("BMW"), SEC staff was not convinced that broker-dealer registration was not required when BMW (a law firm) sought to introduce a company to a limited number of BMW's contacts as a source of financing for the company's operations, in return for compensation to BMW based on a percentage of the amounts raised from those contacts.[19] The staff focused on its belief "that the receipt of compensation directly tied to successful investments in [the company's] securities by investors introduced to [the company] by BMW (i.e., transaction-based compensation) would give BMW a 'salesman's stake' in the proposed transactions and would create heightened incentive for BMW to engage in sales efforts."

NEW YORK PROPOSAL

The NYSAG proposal is interesting for several reasons. First, it seeks to address a regulatory gap that the SEC has been reluctant to address. Second, it may pave the path for what to expect in state securities regulation on the issue going forward. Third, if adopted, it would likely create dilemmas for issuers, not the least of which being whether issuers will need to consider excluding prospective investors in New York. Finally, it builds on related requirements in other states, including California and Texas. Below, we discuss (i) the proposed definition of a Finder, and (ii) key considerations going forward.

What is a "Finder" in New York?

As proposed, a "Finder" would be a person, firm, association, or corporation who as part of a regular business, engages in the business of effecting transactions in securities for the account of others within or from New York, to the limited extent that such person, firm association, or corporation, receives compensation for introducing a prospective investor or investors to any broker, dealer or salesperson.

What Would New York Require of Finders?

Finders would be subject to all of the filing and exam requirements applicable to brokers, dealers, and salespersons in New York.[20]

Key Considerations

The comment period for the NYSAG proposals has closed. As we await any updates or movement, it is important for issuers and those who could be considered Finders to consider how the proposals may affect their future capital raising efforts (and efforts that might be ongoing).

1. More than ever, issuers will need to be aware of the status of those they engage as finders. One potential outcome to consider is whether the issuer can engage a registered New York Finder and also reasonably conclude that the Finder is not engaged in broker activity. This could call into question the Finder's role for the offering more broadly. This relates to the risks we discussed above.

2. The proposal is not clear regarding how New York could view potential Finders as engaged in the covered activity "in or from" New York. We suspect that a Finder who is physically present in the state would satisfy the definition, but beyond that we cannot be certain. For example, if a Finder's permanent residence or principal place of business is in New York, but the Finder operates from outside the state, will that satisfy the "in or from" element of the definition? This nuance is particularly relevant in the COVID-19 era, during which many individuals are working remotely and often have travelled outside of their resident state for significant periods of time.

3. A related question is whether someone who serves in a Finder role from outside of New York, but calls or emails an individual present in New York, would satisfy the "within or from" element, although it seems likely that the NYSAG will consider a person who directs communications to issuers, brokers or investors located in New York to be acting within the state.

4. The proposal references the "regular business" engaged in by a Finder, but makes no mention of the frequency on which this standard will be based. Would one instance of this activity trigger the requirements? What about two or three times in a calendar year? Monthly?

5. The proposal references a Finder introducing prospective investors "to any broker, dealer or salesperson" However, as we noted above, in a typical finder relationship, the finder introduces investors to issuers – not to a broker-dealer or its personnel. Does this mean that an individual who introduces prospective investors directly to issuers falls outside of the proposed Finder definition and requirements in New York?

6. And finally, the scope of the proposed Finder definition includes any "person, firm, association, or corporation." This seems to indicate that a Finder could function as such through an entity established to carry out the role, rather than simply in an individual capacity. Finders may find this helpful, including to shield themselves from personal liability. Yet, issuers may find this problematic for the same reason.

OTHER STATES' REQUIREMENTS

New York is not the first state to take its own approach to regulating this corner of the market. For example, California enacted rules governing "finders" in 2015. California permits (subject to numerous limitations and affirmative obligations) issuers to pay a finder's fees in transactions involving California-based issuers, finders, and purchasers of securities, in transactions conducted in California.[21] The relevant statute exempts finders, as defined, from the requirement to register as securities brokers in California. However, California law also provides for rescission rights or damages for investors who purchase or sell a security through an unregistered broker.[22]

Texas takes yet a different approach by allowing finders to legally receive compensation if they register as a finder, which is less onerous than broker-dealer registration.[23] But under Texas law, unregistered persons cannot enforce commission contracts relating to the sale of securities. The Texas State Securities Board limits the activities of finders by prohibiting them from providing investment advice or receiving a percentage based

on the securities purchased or the investor's profits. However, a finder who connects investors and securities issuers is allowed to receive a fee solely for the finding process.

CONCLUSION

Goodwin will monitor the status of the NYSAG proposal for any developments. We will also keep our fingers firmly crossed (as we have for many years) in hope that the SEC itself (rather than the staff) takes action to clarify its views and expectations regarding finders. With this being such a longstanding murky area, one can only ask whether the lack of action by the SEC has encouraged continued utilization of finders by the private issuer community and, as a result, a cottage industry of individuals serving in the finder role. With several states now implementing their own requirements, issuers are faced with potential disparate regulatory results based on the same, basic action of using a finder.

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[1] *See, e.g.*, Rule 3a4-1 under the Securities Exchange Act of 1934 (Exchange Act). *See also M&A Brokers*, SEC No-Action Letter (Jan. 31, 2014; rev. Feb. 4, 2014), *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[2] *See, e.g.,* American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker-Dealers," June 20, 2005, *available at* https://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf; *see also* U.S. Securities and Exchange Commission Advisory Committee on Small and Emerging Companies. "Recommendation Regarding the Regulation of Finders and Other Intermediaries in Small Business Capital Formation Transactions" (May 15, 2017), *available at* https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-051517-finders.pdf.

[3] Meeting of the Securities and Exchange Commission Small Business Capital Formation Advisory Committee Meeting (Friday, May 8, 2020 at 1:00 pm EST) Transcript, at 112:16-117:6, *available at* https://www.sec.gov/info/smallbus/acsec/sbcfac-transcript-050820.pdf.

[4] U.S. Securities and Exchange Commission, Division of Trading and Markets, "Guide to Broker-Dealer Registration" (April 2008), *available at* https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html.

[5] *See* New York Attorney General, "Attorney General James Moves to Modernize and Streamline Securities Filings in NYS" *Press Release*, April 6, 2020, *available at* https://ag.ny.gov/press-release/2020/attorney-general-james-moves-modernize-and-streamline-securities-filings-nys; *see also* New York, Department of Law's revisions to 13 N.Y.C.R.R. Part 10, *available at* https://ag.ny.gov/sites/default/files/full-text-13nycrr10.pdf. Official Compilation of Codes, Rules and Regulations of the State of New York ("NYCRR"), Title 13, Chapter II Part 10 (13 NYCRR §10). NYCRR, Title 13, Chapter II Part 11(13 NYCRR §11).

[6] This alert focuses on the use and status of finders. The NYSAG proposals also address the use of "Solicitors" in regard to investment advice. As proposed, a "Solicitor " would be a person who as part of a regular business, engages in the business of providing investment advice to the limited extent that such person receives compensation for introducing a prospective investor or investors to an investment adviser or a federally covered investment adviser, unless such person would be excluded from the definition of investment adviser under an enumerated exception. Solicitors would be subject to the same registration and examination requirements as investment advisers in New York, and principals and representatives of Solicitors would be subject to the same registration and examination requirements as investment adviser representatives in New York.

[7] Exchange Act Section 3(a)(4).

[8] *See, e.g.*, *Mass. Fin. Servs., Inc. v. Secs. Investor Prot. Corp.*, 411 F. Supp. 411, 415 (D. Mass. 1976), *aff'd*, 545 F.2d 754 (1st Cir. 1976).

[9] *See, e.g.*, *S.E.C. v. Margolin*, No. 92-civ-06307, 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992); *S.E.C. v. Hansen*, No. 83-3692,1984 WL 2413, (S.D.N.Y. Apr. 6, 1984); *S.E.C. v. M & A West, Inc.*, No. 01-3376 VRW, 2005 WL 1514101 (N.D. Cal. Jun. 20, 2005).

[10] *See 1st Global, Inc.*, SEC No-Action Letter (May 7, 2001); *see also Herbruck, Alder & Co.*, SEC No-Action Letter (May 3, 2002); *Brumberg, Mackey & Wall, P.L.C.*, SEC No-Action Letter (May 17, 2010).

[11] *See S.E.C. v. Mapp*, 240 F.Supp.3d 569, Fed. Sec. L. Rep. P 99,641 (E.D. Tex. 2017). Mapp was a decision on the motion by Warren K. (Ken) Paxton (later the Attorney General of Texas) to dismiss the allegations of the SEC that he acted as an unregistered broker in the sale of securities. The court rejected the SEC's factors test and held that the proper test of whether a person was acting as a broker and required to register was whether the elements of the statutory requirement were met. The court then found that, although Paxton acted as a finder and was paid compensation based on investments made by investors he introduced, Paxton had not "effected transactions in securities," an element of the definition of broker in Section 3(a)(4) of the Exchange Act.

[12] *See S.E.C. v. Kramer*, 778 F..Supp.2d 1320 (2011). In *Kramer,* the court noted that "[t]he full measure of Kramer's 'advice' to, or 'solicitation' of, [] Kramer's intimate friends and family consisted of Kramer's (1) sharing his opinion that [the company] was a good company and a good investment and (2) directing attention to the [the company's] web site and press releases." The court further noted that the Commission presented no additional, admissible evidence that Kramer either (1) sold a share of the company; (2) participated in the purchase and sale of a company security; (3) provided advice or other information about the investment; (4) advertised or distributed promotional material for the company; (5) sponsored a seminar or social event at which Kramer promoted the company; (6) sold the security of another issuer; (7) hired employees to contact potential investors about the company; (8) called a potential investor (i.e., someone other than one of Kramer's intimate friends); or (9) encouraged a broker to sell the company's securities.

[13] *See, e.g., In the Matter of Ranieri Partners LLC and Donald W. Phillips,* SEC File No. 3-15234, SEC Rel. Nos. 34-69091; 40-3563 (Mar. 8, 2013).

[14] *See e.g., S.E.C. v. ICOBox, et al.*, No. CV-19-8066 (DSF) (C.D. Cal. Mar. 5, 2020); *In the Matter of Edwin Shaw LLC*, SEC File No. 3-1838, SEC Rel. No. 34-82805 (Mar. 5, 2018); *In the Matter of Retirement Surety LLC et al.,* SEC File No. 3-18061, SEC ID Rel. No. 1250 (Apr. 18, 2018); *In the Matter of Gregory J. Smith,* SEC File No. 3-17657, SEC Rel. No. 34-80083 (Feb. 22, 2017).

[15] *See e.g., Woodtrails-Seattle, Ltd.*, SEC No-Action Letter (Aug. 9, 1982); *Russell R. Miller & Co., Inc.*, SEC No-Action Letter (Aug. 15, 1977); *Victoria Bancroft*, SEC No-Action Letter (Aug. 9, 1987); *Wesco Equity Funding*, SEC No-Action Letter (Aug. 10, 1985); *Garrett Kushell Associates,* SEC No-Action Letter (Sept. 7, 1980); *Castagana Business Brokerage*, SEC No-Action Letter (May 15, 1980); *Bay Business Service* SEC No-Action Letter (Mar. 14, 1977); *Gary L. Pleger, Esq., SEC No-Action Letter* (Sept. 9, 1977); *Ruth Quigley*, SEC No-Action Letter (June 14, 1973); *May-Pac Management Co.*, SEC No-Action Letter (Dec. 20, 1973); *Hallmark Capital Corporation*, SEC No-Action Letter (June 11, 2007); *Brumberg, Mackey & Wall, P.L.C.*, SEC No-Action Letter (May 17, 2010); *John W. Loofbourrow Associates, Inc.*, SEC No-Action Letter (June 29, 2006); *Herbruck, Alder & Co.*, SEC No-Action Letter (June 4, 2002); *Richard S. Appel*, SEC No-Action Letter (Feb. 14, 1983); *Mike Bantuveris*, SEC No Action Letter (Sept. 23, 1975); *Paul Anka*, SEC No-Action Letter (July 24, 1991); *Corp. Forum., Inc.,* SEC No-Action Letter (Dec. 10, 1972); *Int'l Bus. Exch. Corp.*, SEC No-Action Letter (Dec. 12, 1986).

[16] U.S. Securities & Exchange Commission, Rel. Nos. 33-10649, 34-86129, IA-5256, IC-33512, Concept Release on Harmonization of Securities Offering Exemptions, Concept Release, Request for Comment, Jun. 18, 2019, p. 29 FN 55, *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[17] *See Paul Anka*, SEC Staff No-Action Letter (July 24, 1991).

[18] The other conditions and representations were that Anka (A) would not participate in any advertisement, endorsement or general solicitation in the U.S. regarding the investment; (B) would not participate, in (i) the preparation of any materials, including financial data or sales literature, relating to the offering or (ii) the distribution of these materials to any potential investor; (C) would not perform any independent analysis of the sale, engage in any "due diligence" activities, assist in or provide financing for such purchases, provide any advice relating to the valuation of or the financial advisability of such an investment; (D) would not handle any funds or securities; (E) had not previously engaged in any private or public offering of securities, other than buying and selling securities for his own account through a broker-dealer; (F) had not acted as a broker or finder for other private placements of securities; (G) did not intend to participate in any distribution of securities after the completion of the proposed private placement; and that (H) the issuer alone would determine the sales price of the securities to be sold and would prepare all offering materials, and (I) the issuer would disclose to each investor identified by Anka the finder's fee to be paid to him (and related disclosures to other investors).

[19] *Brumberg, Mackey & Wall, P.L.C.*, SEC No-Action Letter (May 17, 2010).

[20] Proposed addition to 13 NYCRR §10.10 "Definitions".

[21] *See* CA Corp Code § 25206.1. The following limitations and affirmative obligations apply: (1) the finder must be a natural person, not an entity; (2) the transaction must be a sale of securities by an issuer of the securities in California; (3) the size of the transactions for which the finder is engaged must not exceed a purchase price of $15 million in the aggregate; (4) the finder must not: (a) participate in negotiating any of the terms of the transaction, (b) advise any party regarding the value of the securities or the advisability of purchasing or selling in the securities; (c) conduct any due diligence for any party to the transaction; (d) sell any securities that are owned directly or indirectly by the finder; (e) receive possession or custody of any funds in the transaction; (f) participate in the transaction unless it is qualified by permit or exempt from qualification under California law; (g) make any disclosure to any potential purchaser of securities other than: (i) the name, address and contact information of the issuer; (ii) the name, type, price and aggregate amount of the securities offered; (iii) the issuer's industry, location and years in business; (5) the finder must file, in advance of taking any finder's fees, a statement of information with the finder's name and address, together with a $300 filing fee, with the California Bureau of Business Oversight, and thereafter file annual renewal statements with a $275 filing fee and representations that the finder has complied with the exemption conditions; (6) the finder must obtain a written agreement signed by the finder, the issuer and the person introduced by the finder, disclosing: (a) the type and amount of compensation that has been or will be paid to the finder; (b) that the finder is not providing advice to the issuer or any person introduced to the issuer as to the value of the securities or advisability of purchasing or selling them; (c) whether the finder is also an owner of the securities being sold; (d) any conflict of interest in connection with the finder's activities; (e) that the parties have the right to pursue any available remedies for breach of the agreement; and (f) a representation by the investor that the investor is an "accredited investor" as defined in SEC Regulation D and consents to the payment of the finder's fee; and (7) the finder must preserve copies of the notice, the written agreement and all other records relating to the transactions for a period of five years.

[22] See CA Corp Code § 25501.5, which provides, in part, that a person who purchases a security from or sells a security to a broker-dealer that is required to be licensed and has not, at the time of the sale or purchase,

applied for and secured a certificate that is in effect at the time of the sale or purchase authorizing that broker-dealer to act in that capacity, may bring an action for rescission of the sale or purchase or, if the plaintiff or the defendant no longer owns the security, for damages.

[23] Rule 115.1(c)(2)(B)(v) of the Texas State Securities Board.

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