

**GOVERNMENT-BUSINESS FORUM  
ON  
SMALL BUSINESS CAPITAL FORMATION**

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**Second Roundtable Discussion:**

**Current Challenges to Smaller Companies Under  
Disclosure and Corporate Governance Rules**

**CAPITAL FORMATION  
MAKING "FINDERS" VIABLE**

**Hugh H. Makens  
WARNER NORCROSS & JUDD LLP  
900 Fifth Third Center  
111 Lyon Street NW  
Grand Rapids, Michigan 49503-2487  
616.752.2117  
[hmakens@wnj.com](mailto:hmakens@wnj.com)**

## CAPITAL FORMATION

Individuals or entities acting as unregistered financial intermediaries, "finders" or "investment bankers" (hereinafter "finders") constitute a major problem in corporate finance transactions and in the area of mergers and acquisitions. The vast majority of these persons are unregistered broker-dealers under federal and state securities laws, and accordingly transactions in which they are involved jeopardize the issuer, its officers and directors, and other investors because of the use of the unregistered/non-exempt person. Further, some of the individuals have adverse regulatory histories or were closely affiliated with those who had, and some even had been barred or suspended from broker-dealer or agent registration by regulators or convicted of financial fraud. The bad ones too often bring financial arrangements that do not work to the advantage of the entity seeking a merger or needing financing, and taint the legality of transactions in which they are involved. Some are purveyors of "shell corporations," which almost invariably involve significant fraud both on those who purchase or merge with the shells, and in the subsequent after-market for the stock of the entity into which the shell is merged.

In contrast, many of the finders are otherwise reputable people, who provide a major service in locating and referring capital to small businesses who without this assistance would be largely shut out from obtaining sufficient capital. There are significant positive aspects to the use of competent finders. They can provide the right candidate for a merger or acquisition; they can find an angel for an emerging company; they can locate mezzanine financing; and they can open doors to venture capitalists and other financial resources otherwise not available to an entity seeking capital. They may bring strong committed investors to an emerging company.

The Final Report of the 22<sup>nd</sup> Annual SEC Government-Business Forum on Small Business Capital Formation (December 2003) recognized the need for a new approach to the regulation of finders. Their top recommendation stated:

1. The SEC should work with NASAA and the NASD to undertake the following:
  - (a) address the regulatory status of finders;
  - (b) facilitate an appropriate role for finders in the capital-raising process; and
  - (c) clarify the circumstances under which issuers and others can legally compensate finders and other capital formation specialists who meet minimum standards.

In undertaking this effort, the SEC staff should focus specifically on whether to create an exemption from broker-dealer and/or investment adviser registration requirements for certain finders or instead issue a new regulation enabling these finders to register under a simplified regime aimed at regulating finders engaging in a defined category of activities. Factors that should be considered in crafting such an exemption or regulation should include:

- (a) whether NASD membership should be required;
- (b) the form of the application (such as the one proposed by the ABA Task Force Draft Form 1010EZ dated July 9, 2002, referred to as “Form 1010-EZ - Private Placement Broker-Dealer”);
- (c) lower fees for application and (annual) renewal;
- (d) appropriate testing requirements;
- (e) certification as to no “bad boy” disqualifications;
- (f) no custody of client funds or securities permitted;
- (g) no minimum net capital requirements;
- (h) appropriate bonding requirements;
- (i) explicit recognition that transaction-based remuneration is permitted;
- (j) no discretionary authority permitted for investments;
- (k) appropriate record-keeping requirements; and
- (l) applicable sales practice rules.

Further to this initiative, the SEC staff should:

- (a) consider the findings and recommendations in the upcoming final report on the subject of finders of the Subcommittee on Small Business Issuers of the Federal Regulation of Securities Committee of the ABA Section of Business Law; and
- (b) within the next 12 months issue a concept release addressing the adoption of a finder exemption and soliciting comment from the small business community and other interested parties.

Federal and state securities laws prohibit a person from being engaged in the business of effecting transaction in securities unless registered under applicable laws. These persons must attain membership in the National Association of Securities Dealers ("NASD") as well, and the individuals associated with the firm must hold a series of registrations relating to the right to sell, to supervise and to provide financial information. There is a broad misperception in the market that there is an exception for a person who merely introduces a potential purchaser to an issuer and accepts a transaction-based fee for that introduction. This misperception, to the extent that it is supported by legal research, is usually based on incorrect

interpretations of what constitutes doing business as a broker-dealer and certain no-action letters discussed below. There is a further perception that if one does a small number of these transactions, even for separate issuers, it is "okay." While that is true in some states, it is not true at the federal level.

Problems relating to unregistered finders have been particularly prominent in the raising of early stage capital for smaller business. I believe that there is a vast "gray market" of unregistered brokerage activity where the funding for these companies, who generally can't access traditional brokerage firms for underwritings, is often obtained through unregistered financial intermediaries. This opinion is based on discussions with many lawyers, accountants and issuers, as well as my experience with many of these individuals or entities who propose to act as "finders" without broker-dealer registration.

The same laws and regulations govern the activities of those persons whose business involves introduction and assistance in consummation of merger and acquisition ("M&A") transactions. In some instances there is cross-over by this group with a quasi-retail function in that they are involved in raising capital (normally on a very limited basis) in order to accomplish the M&A transaction. A significant number of M&A transactions occur using unregistered finders who receive transaction based compensation.

Many finders, including accounting firms, law firms, nationally recognized consultants, retired executives from the brokerage industry and major corporations, and a long list of others, have avoided broker-dealer registration, arguing that the examinations they face have little to do with the way that their business is run; that the regulatory structure makes little sense for the nature of their business; that the process for getting registered is slow and arcane; that they may do only one or two transactions a year or even less; and that regulators are unable to adequately differentiate between the obligations of a retail broker-dealer and their activities.

Issuers face a dramatic lack of understanding of the interpretive positions taken by the Securities & Exchange Commission (the "SEC" or the "Commission") in no-action letters. Attorneys for unregistered financial intermediaries may extrapolate SEC no-action letters into broad grants of authority and the cases brought by the SEC and the states have tended to focus on the fraud and unregistered status, without commenting on the nuances of the specific acts that differentiate types of conduct. This contrasts with the no-action letters where multiplicities of factors are analyzed in lengthy detail. Cases involving allegations against unregistered broker-dealers are frequent; cases discussing the nuances of finders are few. There is no general guidance on this subject from the SEC.

The regulatory system also fails in another respect. The broker-dealer registration process and ongoing compliance requirements are not well designed for those whose primary role is to provide introductions and have a very limited role in the actual funding process. Much of the system is presently designed for a full service broker-dealer, or a specialist in particular segments far beyond finder activity. None of those segments presently meets the needs of those who engage in the kind of financial intermediary activity. If we are to encourage compliance, reform of that system by the SEC, states and the NASD is an essential first step.

Finders must be viewed from multiple perspectives. They are involved in transactions ranging from active solicitation of investors in private offerings to passive introduction in sale of asset transactions. This is not an environment in which one size fits all. That dichotomy requires an analysis of the different aspects of financial intermediaries' activity, and suggests that solutions should be modeled to address the components of activities rather than attempting to create a single solution.

The perception of many ABA Business Law Section members, representatives of state bar association securities law committees and state regulators with whom I have discussed this issue is that the vast preponderance of finders in private corporate or similar finance transactions are in reality unregistered broker-dealers. Most surprising has been the large number of attorneys who have expressed interest in our project and concern over the frequency with which they encounter unregistered finders in their practices on a routine basis in private offering transactions. They strongly echo the need to take effective action create a system that will "really work" and lament the failure of the present regulatory procedures to competently address the finder problem. In addition to concern for their clients, attorneys often expressed frustration over the ability of promoters to obtain advice by attorneys that finder activity involving negotiation and transaction-based compensation was lawful rendered. These attorneys were either unaware of the SEC's interpretations or chose to ignore them. These individuals and entities avoid registration for a variety of reasons expressed to many members of our Section over time, including:

- Forms and rules required of conventional broker-dealers that have little to do with their activities.
- Required tests have even less to do with their activities.
- Belief that regulators have little or no enforcement interest in their activities.
- Little fear of loss of commissions in legal action, based on the "good deal" defense or lack of understanding of the provisions of the Securities Exchange Act of 1934.
- Misinformation provided by counsel with lack of understanding of, or indifference to, securities laws and the interpretations of the SEC and the states.
- Inability to comply because of regulatory orders or other disqualifying events preventing entry into the business in a legitimate fashion.
- Past transactions which would result in punishment and adverse publicity if one now seeks to register with state securities regulators.
- No-action letters appear or are read to grant, adequate comfort that registration is not necessary.

There is a legitimate concern that there is no effective way for small businesses to locate assistance in capital formation from ethical financial intermediaries. Congress and the SEC have carved out areas of regulation in which the SEC defers primarily to the states for regulation, such as Regulation D, Rule 504; the intra-state offering exemption under 3(a)(11) and Rule 147; the division of responsibility between the SEC and the states for the regulation of investment advisers; and the regulation of registration of brokerage firms and registered representatives. I believe that there is a five part solution to this problem that regulators can successfully adopt:

1. Provide for a simplified broker-dealer registration for those who engage in private placement transactions under Regulation D, Rule 506 or separately under Section 4(2). Through the registration process, it will be possible for small businesses to locate registered intermediaries, review their regulatory histories, and ascertain their experience. This involves the need for cooperative efforts by the SEC, NASAA, individual states and, most importantly, the NASD.

2. Provide for a federal exemption for intra-state finders, and couple this with state registration for such finders. This will involve cooperation between the SEC and the states.

3. Provide for an exemption from broker-dealer registration for merger and acquisition transactions which involve the purchase or sale of stock only to the entity which is the major party to the transaction. This the SEC can do unilaterally or in consultation with the states. Some states will need to address through rules or interpretations of existing rules.

4. The SEC has brought few cases specifically targeting finder activity other than that which involves substantial fraud (Ponzi schemes, prime bank fraud, promissory note fraud, etc.), and while the rhetoric of the Division of Market Regulation has been strongly adverse to the use of unregistered financial intermediaries receiving transaction-based compensation, there has been too little effective communication to either the bar or the business world in general on this subject. This lack of effective communication serves as an encouragement for those who would avoid the law. Simply putting out a no-action letter does very little for those who do not use experienced securities counsel. The final step in this process should involve a general pronouncement from the SEC and NASAA clearly enunciating their position on when transaction based compensation can be received, directly or indirectly, discussing the alternative means of compliance, and advising of the consequences for non-compliance.

5. Finally, the SEC should recognize the nearly 100 year old practice of the states permitting registration of agents of issuers, and validate that process as it presently is used in the states. Presently those persons may be deemed broker-dealers under federal law, since they often do not fit the federal safe harbor, yet there has been no coordination on that issue in my 38 years of experience in this field.

We are seeing a continual transition to a more global economy. One consequence of that transition has been the movement of jobs abroad, and the existence of an abnormally high

unemployment rate for the present stage of recovery from a recession. The present regulatory structure is a very serious impairment to small companies seeking capital. The hurdles to capital formation inevitably must inhibit innovation and adversely affect productivity. One friend notes that small business has been "over-regulated into a corner." It is easy to ignore the growing plight of small business in seeking capital, but the problem will only get worse and our economy will suffer the consequences. It is time to seek out a way to permit the capable, honest financial intermediaries who are not presently registered, to find a means to attain compliance. There is no other avenue to finance small business start-ups and growth.

### **PRECEDENT FOR REGULATING FINDERS**

The Graham Leach Bliley ("GLB") Act identified a number of permissible activities for bank holding companies. The Federal Reserve Board in its GLB implementing rules has recognized the validity of a finder concept in 12. C.F.R. §225.86(d)(1) permitting holding companies to arrange, effect or facilitate financial transactions for the accounts of third parties. The Board defines "acting as a finder" as "bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate." Included within the concept were electronic marketplaces, hosting the website of buyers or sellers, and the ability to place bids, offers or orders. Also permitted is operating a website that gives multiple buyers and sellers the ability to exchange information about products or services they wish to buy or sell, located interested parties, aggregate orders, and enter into transactions between themselves (i.e., the buyer and the seller, not the holding company). There are obviously classes of entities beyond the bank holding companies who should be permitted to engage in this limited activity, and can do so without triggering or creating material risks for investors or the public generally. Consideration should be given to identifying such classifications and to establishing parameters expanding permissible participation without triggering broker-dealer registration requirements.

The State of Michigan in its Uniform Securities Act has provided for registration of finders for 25 years, without experiencing a single regulatory proceeding arising from the activities of those so registered.

### **AMERICAN BAR ASSOCIATION PROJECT**

The American Bar Association, Business Law Section committees on Small Business, Federal Regulation of Securities Committee, State Regulation of Securities Committee and Negotiated Acquisitions Committee have been working to develop a set of recommendations to the SEC, the NASD, NASAA and the states which will address the "finders" issue. Mary Sjoquist, Special Counsel to Board Member Bill Gradison, Public Company Accounting Oversight Board, 1666 K Street, NW, Suite 800, Washington, DC 20006, telephone number 202.207.9084, chairs this project. It is preparing a comprehensive report with two primary objectives. The first is to present a comprehensive overview of the relevant issues relating to this finder "gray market" and to propose solutions that will provide a reduced, but approved level of regulation.

## PUTTING THE PROBLEM INTO PERSPECTIVE

Often in both acquisitions and business financings lawyers learn that finders are present. They can be both a blessing and a curse. As a source of funds otherwise unavailable to a client, or as the catalyst that leads to a successful acquisition, they are a boon to finance. As a purveyor of bad deals, bad relationships, securities law violations and the potential for rescission, they represent a major threat not only to the client but also to the professionals working with the client. Any system developed must screen out the undesirable individuals and entities while encouraging the legitimate ones.

At their worst, unregistered financial intermediaries are the bane of the financing business. They appear at the beginning of an offering (but sometimes aren't discovered until later in the offering) and may have engaged in general advertising or solicitation before the attorneys arrive. They can be making offerings that violate the antifraud provisions of the federal and state securities laws. They can be the purveyors of that most worthless product in the securities industry - the "clean public shell."<sup>1</sup> They can bring to the transaction the market manipulators and profiteers whose only interest is the trading profit from dumping their secretly accumulated shares, regardless of the consequences to the company or its investors. They can cause offers or sales to occur without regard to compliance with the very requirements of the securities offering exemptions they purport to rely on when advising an issuer.

The definition of an unregistered financial intermediary characterized as a "finder" is elusive and, indeed, it varies under the circumstances. In *Use and Compensation of 'Finders' To Locate Purchasers in Private Placements*,<sup>2</sup> the term is defined as "a person, be it a company, service or individual, who brings together buyers and sellers for a fee, but who has no active role in negotiations and may not bind either party to the transaction." In my view, the definition should be expanded to state "that the person should neither offer nor sell the security, nor solicit an offer to buy, but rather act strictly as an intermediary for the purpose of introducing the parties" to underscore this all too common problem of "finders" who are in reality nothing more than salespersons for an issuer. The SEC's Division of Market Regulation views even this suggested limited activity with skepticism when the activity is coupled with transaction-based compensation.

The State of Michigan is the only state to register a finder, defining a finder as "a person who, for consideration, participates in the offer to sell, sale or purchase of securities by locating, introducing or referring potential purchasers or sellers."<sup>3</sup> Michigan presently requires a finder to register as an investment adviser and imposes minimum requirements on the finder's method of operations.<sup>4</sup> Michigan generally expects the finder to perform the introduction,

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<sup>1</sup> Richard H. Rowe, *Securities Enforcement, Clean-up of a Legitimate Business Caught in the "Shell Game,"* INSIGHTS, June 1991, Vol. 5, No. 6, pp. 20-25. See also, *Proposed Rule: Use of Form S-8 by Shell Companies (April 15, 2004)*.

<sup>2</sup> Alan J. Berkeley and Alissa J. Altongy, *Regulation D Offerings and Private Placements*, SF71, ALI-ABA (2001) at 51. (Hereinafter "Berkeley".)

<sup>3</sup> Michigan Uniform Securities Act, Section 401(u). INSERT COMMENTARY ON MASSACHUSETTS.

<sup>4</sup> Michigan Uniform Securities Act, Section 102(c) sets forth seven requirements applicable to finders, including a prohibition on taking possession of funds or securities; failing to disclose the finder relationship and compensation as well as any beneficial interest in the offering or issuer; knowing participation in an offering in violation of the

possibly deliver the offering materials, and then step away from the transaction. This may be an acceptable model for many states, though logically a short-form state broker-dealer registration is more appropriate than the investment adviser model presently used in Michigan. Legislation was introduced last year to move the "finder" registration in Michigan to a broker-dealer status. Some view the "step-away" as problematic, but no study has been done to determine actual involvement of such finders.

The principal risk to the finder and the issuer is that the finder is in reality acting as an unlicensed broker-dealer. The SEC has issued several no-action letters outlining the parameters of a financial intermediaries' acceptable conduct, or declining to find conduct acceptable, in conjunction with the offer or sale of a security. Alan Berkeley<sup>5</sup> lists the factors which move one to the status of a broker-dealer as involvement in negotiations, discussing details regarding the transaction or making a recommendation, receiving transaction-based compensation, and previous involvement in the sale of securities.

On March 7, 2000, the staff of the Division of Market Regulation withdrew its 1985 no-action letter in *Dominion Resources*, which had permitted Dominion to engage in a bundle of activities. The activities previously acceptable to the SEC in that letter included analyzing the financial needs of an issuer, recommending or designing financing methods and securities to fit the issuer's needs, recommending the lawyers to prepare documentation and broker-dealers to distribute the securities, participating in negotiations, and introducing the issuer to a commercial bank to act as the initial purchaser and as a stand-by purchaser if the securities could not be readily marketed. In return for these services, *Dominion* received a transaction based fee. The withdrawal letter did not fully articulate what factors in the 1985 letter are now considered sufficient to result in a finding of unregistered broker-dealer status.

The SEC recently addressed the unregistered broker-dealer issue in its revisions to the rules on accountant's independence under Sarbanes Oxley Section 201. Rule 10A-2 under the Exchange Act now states generally that a certified public accounting firm is prohibited from acting as a promoter or underwriter, or making investment decisions on behalf of an audit client, among other things. The amendment expanded the scope of the prohibition to address situations where a CPA firm acts as an unregistered broker-dealer. In the commentary the SEC notes that selling - directly or indirectly - an audit client's securities presents a threat to independence, regardless of whether the broker-dealer affiliated with the CPA firm was registered as such or not.

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registration requirements for securities, after reasonable inquiry; participation without obtaining information relative to the risks of the offering, compensation, financial condition and use of proceeds, and failure to review offering materials provided by the issuer prior to recommendation; failure to disclose material information which the finder knows or should have known based on material information available to the finder; and making an introduction of a person who is not suitable for the investment. The finder is not required to independently generate information.

<sup>5</sup> Ibid. at n. 1

More importantly is the pronouncement, buried in FN 82 of Release 33-8183 states that:

"Accountants and the companies that retain them should recognize that the key determination required here is a functional one (i.e., is the Accounting firm or its employee acting as a broker-dealer?). The failure to register as a broker-dealer does not necessarily mean that the accounting firm is not a broker-dealer. In relevant part, the statutory definition of 'broker' captures persons 'engaged in the business of effecting transactions in securities for the account of others.' Unregistered persons who provide services related to mergers and acquisitions or other securities-related transactions by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions, should limit their activities so they remain outside of that statutory definition. A person may 'effect transactions,' among other ways, by assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchaser of securities, or by soliciting securities transactions. A person may be 'engaged in the business,' among other ways, by receiving transaction-related compensation or by holding itself out as a broker-dealer...."

The Commission will undoubtedly apply this same standard whether dealing with a Certified Public Accounting firm or not.

Further, in footnote 86, the Commission notes that broker-dealers provide an array of services that may include certain analyst activities, suggesting that when one provides analytical services to an issuer or investor, the question of broker-dealer registration is raised even beyond the concerns in expressed in footnote 82. While these footnote pronouncements further focuses the concern, they do so only in a release which is likely to be read, or even found, by those concerned with permissible activities of auditors. It illustrates the problem of the need for clearer communication on the financial intermediary question generally, but it also leaves the interpretive door open for those who want to avoid its consequences outside of the public company auditing area.

### **WHY PRIVATE PLACEMENT BROKER-DEALERS AND FINDERS ARE NEEDED**

A variety of factors drive the need for action. The broker-dealer universe for equity financing has been dramatically shrinking both in terms of the number of firms and the scope of services that they render. With bank acquisitions, consolidations of regional firms, and loss of firms in the current economic downturn, the scarcity of investment banking services, particularly for mid to small size issuers, has dramatically worsened. Many smaller brokerage firms are focusing on mutual funds and variable products, especially after the economic bath that many took if they promoted technology, communications and .com stocks. The self-imposed thresholds for doing private deals are rising for economic reasons. The result is that too few brokerage firms are willing to do offerings, public or private, under \$25 million. There are several rationales for this position. The risk of doing a small deal is often similar to a large one. The legal costs are often comparable to a larger transaction because of the lack of sophistication and systems of smaller issuers. The issuer's financial and other information may not be as

complete or accurate. Smaller issuers often lack the expertise and experience to adequately deal with 1934 Act financial and other reporting issues. Finally, the smaller the company, the less diversification it can provide to an investor in terms of product range and depth of personnel and markets.

Venture capital is not able to fill this void. Venture firms are trending to investment in profitable businesses and there has been a drop in available funds. They are looking more at mezzanine financing, and less in pure equity investment. Many venture capitalists got burned in tech and related stocks and their investors are more risk-averse. Two years ago, some venture capital funds were returning their investors' monies due to inability to find enough satisfactory investments under their criteria. Further, the high yield requirements for venture capitalists are frequently incompatible with the growth potential of the preponderance of smaller issuers. Smaller issuers often lack the expertise and experience to adequately deal with 1934 Act reporting issues, and that was the case before the complexities introduced by Sarbanes Oxley. Finally, there are too few venture capital funds to have even a remotely significant impact on fulfilling the need for funds.

The traditional financing sources for smaller issuers remain limited. Most issuers engage in "cup of gas" financing, seeking enough funds to move their project down the road, but not getting the funds to really develop their business. These issuers run through the chain of friends and family, to customers, to suppliers, to extended contacts, and then often run out of alternatives for growth.

Lying in wait for these small issuers, amidst the dark side of the securities business, are the purveyors of shell corporations, the front-end fee con artists, the purported Reg S specialists who send the stock off-shore and wait to dump it back into the U.S. through unscrupulous brokerage firms or representatives who are receiving under-the-table payments for promoting stocks, the micro-cap manipulators, and the representatives who have been barred from the securities business. All of these options are likely to cost the issuer dearly, even if promised funding is received from them. Often these individuals and entities hold themselves out as finders, investment bankers, or merchant bankers and aren't registered as broker-dealers. The cost to the issuer and insiders of the company of what these finders bring to the table often far exceeds any funds they produce.

It is not possible to quantify the number of persons who engage in this activity, since there is no effective measuring device. For several years the Small Business Capital Forum has recommended action on creating a better method to get persons registered or exempt to provide fund raising services for small business. Traditionally the Form Ds filed by issuers under Regulation D have been used for statistical purposes at the SEC. To the extent that reporting is accurate on these forms, I believe that an analysis of Form Ds will reveal the existence of a significant number of unregistered persons who receive compensation. This issue appears not to be considered a matter of concern by the SEC presently. My informal survey of the states suggests that about 1/3 of state securities agencies have identified this issue and now routinely examine the Form Ds to detect and initiate inquiries as the result of the disclosures on the Form D. The number of states engaged in screening has been trending upwards. Disclosures in 1934 Act filings also disclose payments to unregistered persons in M&A transactions for

reporting companies, but these transactions are rarely reported on a Form D, since they are traditionally done solely on a 4(2) exemption claim.

### **WHO ARE THE UNREGISTERED FINDERS?**

Finders come from a variety of sources. They include CPAs and, to a lesser extent lawyers, M&A specialists, business brokers, local "monied people" (the country club set), consultants (who take a variety of forms), insurance agents and real estate brokers, registered representatives illegally selling away from their firms, individuals who have substantial investor networks or the people that work for such individuals, individuals hired by entities seeking capital, angel networks, retired executives and community leaders. They also include unregistered individuals or entities who hold themselves out as finders or investment bankers and do this for a living by providing business plans, private placement memoranda, and who may remain thereafter as paid consultants.

Members of the Business Law Section and state bar association business law committees have observed a significant number of attorneys who provide opinions giving comfort to these unregistered financial intermediaries, while ignoring SEC no-action letters and federal and state enforcement actions leading to a different conclusion. They are frustrated with the "opinion shopping" that some issuers use to find an attorney who will give them a favorable opinion after experienced securities counsel has declined to do so. Generally these attorneys providing questionable opinions are solo or small firm practitioners with very limited securities experience and either no appreciation for the complexity of the analysis or a willingness to render opinions to accommodate a client.

### **WHAT PROBLEMS DOES ONE CONFRONT USING A FINDER?**

Unregistered financial intermediaries can cause major problems for an issuer. They can taint an offering by creating the basis for rescission rights, raise enforcement concerns, make fraudulent representations and engage in general solicitation. They can be individuals who have been suspended or barred from the securities business or fired by firms for fraudulent misconduct. There are those who act in collusion with market manipulators and those who bribe registered representatives to act as touts. Use of these individuals often lead to litigation when the stock prices drop, as they frequently do.

These financial intermediaries can provide encouragement to cut legal corners. They often under-price legitimate brokerage firms or deter issuers from going to legitimate firms. For an attorney, they are a major concern, since their actions adversely affect our ability to render customary legal opinions in transactions and harm our clients.

These individuals often lead the issuer down a primrose path with false promises. They may add to the issuer's existing problems, create significant litigation or raise an enforcement action risk. The unregistered financial intermediaries' contracts can be incredibly over-bearing, significantly hampering future financing for the issuer. After funding, issuers may find themselves faced with very unhappy investors who are angry over misrepresentations by the finders or drop in an artificially inflated price, and who demand rescission or the buy-out of their

shares. Those investors may also apply pressure to the issuer to make a corporation "go public" if it is traded on the Pink Sheets or qualify its shares for trading on the Nasdaq Bulletin Board or Small Cap market before the company is prepared to take that step from a financial, management sophistication, or regulatory filing capability perspective. With the heightened cost of public status as the result of Sarbanes Oxley, this step is insane for many small issuers, but no one tells them the hard truth until it is too late.

Issuers who later desire to go public don't appreciate the difficulties which can be attached to prior offerings that violate securities laws.<sup>6</sup> The issuer must describe prior securities offerings as part of the registration process. The SEC Division of Corporate Finance staff may well ask for a rescission, or at a minimum disclosure of contingent liability. Under such circumstances, the firm's auditors will also request disclosure, or perhaps a reserve which would have the effect of destroying the credibility of the balance sheet of the issuer. Further, the matter may be referred to the Enforcement Division at the SEC, and states who review the offering will likewise pick up on the disclosure and may commence investigations and demand rescission.

A consistent theme in the SEC proceedings against unregistered broker-dealers has been the lack of disclosure of compensation paid to such individuals or entities. While an issuer may have a belief that their offering complies with Regulation D, Rule 506, the failure to disclose that compensation in the presence of even a single non-accredited investors destroys the exemption for failure to meet the Rule 502 disclosure requirements. Further, almost all state laws contain a prohibition against payment of compensation to unregistered broker-dealers as a condition of their private offering exemption. Some states have gone further and expressly deny compensation to finders. If the finder is acting as an unregistered broker-dealer, that addition is surplusage, but to the extent that a role for finders remains, the prohibition reaches that compensation as well. The consequence of failure of improper payment is loss of the exemption, and the issuer may face a demand from the state securities agency for rescission, or any investors may be able to take advantage of the "put" that is provided by an illegal sale, and require rescission under Section 410 of the Uniform Securities Act, together with interest at the rate prescribed by the state. Finally, most such acts provide for attorney's fees to the person seeking rescission. The persons liable under state law include not only the issuer, but its officers and directors, as well as those involved in selling the securities.

The entity with these problems is also less likely to be looked on favorably as an acquisition candidate, or the price offered for an acquisition may dramatically decrease.

Regulators have a substantial concern over the "finders" who flout the securities laws. I estimate that the various states bring well over 100 enforcement cases against unregistered finders on an annual basis (and probably a great deal more because statistics are not available from NASAA or the states to identify the full extent of state action). The NASD brings a large number of cases against individuals who are engaged in selling away from their brokerage firms for acting as unregistered financial intermediaries, often barring them from the business or imposing long suspensions. This is the second most frequently cited grounds for sanctioning registered representatives and has been for the past several years. The NASD asserts that Code of Conduct Rule 3040 includes situations where the associated person's role in a

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<sup>6</sup> Virginia K. Kapner, *When Finders Bring Trouble*, 47 Feb. B. B.J. 14 (Jan/Feb 2003).

transaction is limited to a client introduction and to eventual receipt of a finder's or referral fee.<sup>7</sup> The NASD monthly Notice To Members which lists enforcement actions contains "selling away" allegations in virtually every issue. These actions represent only the tip of the iceberg of that problem. The SEC brings dozens of these cases annually, but the manner of description of the cases circulated to the public focuses almost exclusively on the fraudulent conduct that occurs, and mentions only in passing the unregistered broker-dealer issue without details or explanation of the basis for the charge. These cases provide a great opportunity for better guidance, but the message is lost in the present descriptions of cases published in Exchange Act Releases.<sup>8</sup> However, it is worth noting that among the allegations of fraud in such cases are the failure to disclose compensation paid to the unregistered broker-dealer, misrepresenting the cost of the offering and lying about the amount of commissions paid.<sup>9</sup> The SEC has also barred persons from acting as finders.<sup>10</sup> In one of its better publicized cases, the SEC alleged that a former Tyco Lead Director and Chairman of the Compensation Committee collected a secret \$20 million finder's fee in conjunction with Tyco's 2001 acquisition of the CITI Group, Inc.<sup>11</sup>

The illegitimate financial intermediaries, who are really unlicensed broker-dealers, were a direct cause of the SEC action in restricting the scope of Regulation S and Rule 504 in 1999. Regulators are also unhappy to find that the people that they have expelled from the business have resurfaced in a new guise.<sup>12</sup>

Today so-called "finders" are active in soliciting investors for a range of products which have been held to involve securities, including pay phone leases, viatical or life settlement contracts, promissory notes, foreign CDs, and "prime bank" scams. These areas of concern appear regularly in NASAA's Top Ten Investment Frauds which is published annually.

Unregistered financial intermediary make it very difficult for smaller registered, reputable broker-dealers to become involved in raising funds. Unscrupulous entities and individuals can make exorbitant promises, enter into exclusionary contracts with unconscionable terms, and abuse the unsophisticated small businessman without much difficulty.

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<sup>7</sup> See, e.g., Gilbert M. Hari, 51 SEC 374, 378 (1993); *In the Application of John P. Goldsworth*, 2002 SEDC LEXIS, May 15, 2002.

<sup>8</sup> The SEC expressed a strange ambivalence on the subject in *In the Matter of Charles K. Seavey*, 2002 SEC LEXIS 398 (Feb 20, 2002) when the Administrative Law Judge on several occasions discussed the role of "finders" who helped fund a hedge fund, but did so without any discussion of the impropriety of the use of finders. Contrast this with *SEC v. Terry L. Dowdell, et al*, 2003 SEC LEXIS 1180 (May 19, 2003) where the SEC obtained an order of disgorgement for over \$1.6 million from a marketer for a Ponzi scheme.

<sup>9</sup> See, e.g., *SEC v. North American Medical Products, Inc. et. al.*, 21003 SEC LEXIS 572 (March 11, 2003); *SEC v. Von Christopher Cummings, et al.*, 202 SEC LEXIS 2907 (November 15, 2002).

<sup>10</sup> See, e.g., *In the Matter of Vadim "Steven" Shapiro*, 203 SEC LEXIS 1160 (May 14, 2003); *In the Matter of Michael Danilovich*, 2003 SEC LEXIS 1163 (May 14, 2003); and *In the Matter of Justin Marvul*, 2003 SEC LEXIS 1164 (May 14, 2003), but there is no pattern that emerges from the regulatory orders widely adopting this practice.

<sup>11</sup> *SEC v. Frank E. Wash, Jr.*, 2002 SEC LEXIS 3193 (December 17, 2002). He was ordered to repay the \$20 million subject to certain rights of set-off from other litigation.

<sup>12</sup> See, e.g. *SEC v. Gratz*, 2003 SEC LEXIS 912 (April 18, 2003) where Gratz was subject to a criminal contempt action for disobeying the permanent injunction against him in *SEC v. Delta Rental Systems*, (March 25, 2003).

## LITIGATION CONCERNS

So what if one uses a finder? What are the consequences of participation by a non-registered broker-dealer in a transaction?

### **A. Federal Securities Law.**

The starting place in the analysis is with the potential for action by the SEC. From the case law to date, it appears that if the Division of Enforcement staff at the SEC identifies an unregistered broker-dealer and there has been no fraudulent act committed, the staff is likely to urge registration and if that is forthcoming, close the matter. If there is fraud, it is far more likely that an enforcement action will be commenced.

The SEC Divisions of Enforcement and Market Regulation do not have the staff to conduct the level of surveillance necessary to detect even a remote percentage of financial intermediary activity. An examination of websites for many of the unregistered financial intermediaries clearly discloses the activity, but there has been no sweep aimed at addressing the issue.

A review of SEC enforcement cases indicates that most relevant cases name the issuer as well as the broker-dealer in the suit. However, these suits rarely deal exclusively with using an unregistered broker-dealer. On the contrary, the lawsuits generally involve multiple counts, including violations of the registration provisions for the securities themselves as well as violating the requirement that a broker-dealer be registered. The results of the lawsuits are driven primarily however, by the allegations of fraud and misrepresentation.

Often the cases deal with a situation where an individual creates a scheme, and then sells the idea to unwitting investors. The investor's money is then used to pay off previous investors in a Ponzi scheme or to pay for personal purchases. I found no cases where a finder crossed the line into broker-dealer activity for which the issuer was then punished in the absence of such fraud.

Finders and unregistered broker-dealers have been subject to permanent injunctions for failing to register and then selling securities. When fraud is involved, the SEC pursues disgorgement of the funds as well as civil penalties. These civil penalties are allowed pursuant to the 1990 Civil Remedies Act, the point of which was to punish perpetrators of fraud rather than simply putting them back in the position they would have been in had they not committed the fraudulent act. In one case, an individual who was not found to be a part of the fraudulent operations was still required to pay disgorgement on a theory of unjust enrichment. *See, e.g. SEC v. Cross Financial Services*, 908 F. Supp. 718 (1995).

### **B. Civil Liability Under Federal Securities Laws.**

Unlike many state limited offering or equivalent exemptions, federal private offering exemptions do not condition the use of the exemption on the absence of payments to unregistered broker-dealers or finders. Thus, the issuer does not automatically lose its exemption

pursuant to a violation of the securities registration provisions of federal securities laws. Instead, one must look to a three part analysis in determining potential civil liability.

### **1. Is the person engaging in the activity a broker-dealer?**

Section 3(a)(4) of the Exchange Act defines the term "broker." In the Division of Market Regulation October 1998 *Compliance Guide to the Registration and Regulation of Broker-Dealers* found on the SEC website, there is ambivalence about "finders." This is surprising in light of the history of no-action letters. The guide suggests that the determination of whether one is or is not a broker depends a number of factors, and suggests that "'finders,' or those who find buyers and sellers of securities of business or find investors for registered-broker-dealers and issuers need analyze three issues:

- a. Do you participate in important parts of a securities transaction, including solicitation, negotiation or execution of the transaction?
- b. Does your compensation for participation in the transaction depend upon the amount or outcome of the transaction? In other words, do you receive transaction-based compensation?
- c. Do you handle the securities or funds of others?

If the answer to any of these is "yes" that the reader is cautioned that *you may* need to register as a broker. Those who are uncertain are told that they may want to review SEC interpretations, consult with private counsel, or ask for advice from the SEC. This is far more ambivalent than the no-action letters suggest is appropriate. In those letters, there is little equivocation.

Assuming that the presence of transaction based compensation coupled with any active involvement with the issuer or a broker-dealer, will trigger registration requirements absent an exception or appropriate no-action ruling from the SEC's Division of Market Regulation. I believe that fairly characterizes the Division of Market Regulation's present position.

If a person is required to register as a broker-dealer, and fails to do so while having active participation coupled with transaction based compensation, what are the consequences?

Section 29(b) of the Exchange Act provides that "Every contract made in violation of any provision of this title or any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of . . . (the Exchange Act) or any rule or regulation thereunder, shall be void: (1) as regards the rights of any persons who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract." A maximum three year or one year from date of discovery statute of limitations is applied.

This section suggests that in any civil litigation an unregistered agent acting on behalf of the issuer will be compelled to return their commissions, fees and expenses; and that the issuer may justifiably refuse to pay commissions, fees and expenses at closing or recoup them at a later time.<sup>13</sup> It also raises the question of whether the issuer can be compelled to repay these funds to an investor, since the unregistered broker-dealer is acting on behalf of the issuer.

The investor may also be entitled to return of his or her investment, since the purchase contract between the issuer and the investor is a contract which is part of an illegal arrangement with the unregistered financial intermediary, and that intermediary is engaged in the offer and sale of the security to the investor. The language to Section 29(b) is broad enough to permit such an interpretation.

My research found little guidance on this type of case. Experience tells us that litigation involving unregistered broker-dealers or agents is often quickly settled. Furthermore, a reference to a state regulatory authority or the SEC will often produce compelling pressure for prompt return of the funds.

### **C. Civil Liability Under State Securities Law.**

Section 402(b)(9) of the Uniform Securities Act as roughly adopted in most states provides generally that the exemption for a limited offering (usually to a small maximum number of persons) is exempt if no commission or similar remuneration is paid for the offer or sale of the securities other than to a registered broker-dealer or agent of the issuer. Some states have added a specific prohibition for payments to "finders." Thus a multi-state transaction done under Sections 4(2) or 3(b) of the 1933 Act will often require use of the 402(b)(9) state exemption to meet state law requirements. Thus, the ability of either the state or an investor to sue to recover or prevent payment of commissions is clear. Likewise, many states have adopted the Uniform Limited Offering Exemption which applies to offering under Rule 505 of Regulation D, and the ULOE precludes payments in a manner similar to 402(b)(9). While Rule 505 is rarely used for offerings today, the state *animus* toward finders is reflected in the rules which incorporate the prohibition. Exemptions are also available under state law for sales to institutional investors (the definition varies somewhat from state to state); existing securities holders (in some states there is a numerical cap on the number of persons to whom sales can be made under this exemption); and in some states under the Model Accredited Investor exemption developed by NASAA.

The principal problem for aggrieved investors under state law arises in transactions done under Rule 506 of Regulation D. Since Section 18(b)(4)(D) of the 1933 Act preempts much of state law relating to requiring registration of or an exemption for certain classes of securities, including offerings under Rule 506, the states lack the power to impose the prohibition of the payment of commissions to unregistered persons as a condition of the exemption which is found in several Uniform Act exemptions.

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<sup>13</sup> See *Boguslavsky v. Kaplan*, 159 F.3d 715, 722 (2nd Cir. 1998); *Regional Properties, Inc. v. Financial and Real Estate Consulting Co.*, 752 F.2d 178, 182 (5th Cir. 1985); *Eastside Church of Christ v. National Plan, Inc.*, 391 F.2d 357, 362, (5th Cir.) cert. denied, 393 U.S. 913 (1968); *Couldock and Bohan, Inc. v. Societe Generale Securities Corp.*, 93 F. Supp. 2d 200, 223 (D. Conn. 2000).

The states still have a window under Rule 506 however. Generally under Section 18(b)(4)(D) the states may receive a form, get a fee, and continue to police fraud. However, if an issuer fails to comply with the disclosure requirements of Rule 502, the exemption under Rule 506 is lost, and the issuer must then frequently fall back on the Section 402(b)(9) exemption. Hence even in a purported Rule 506 exemption, there is risk of state proceedings for failure to meet the information requirements. Further, the failure to accurately disclose compensation to an unregistered financial intermediary will almost certainly be found to be a material non-disclosure, and a fraud claim will lie for that omission. As noted previously, states are now examining the Form D's to spot payments to unregistered finders.

Another consideration under Regulation D is the issue of establishing a prior relationship with investors. There are several letters giving comfort to registered broker-dealers in developing relationships which can serve as the basis for establishing a "pre-existing relationships" but those letters do not extend to unregistered financial intermediaries.

Sales in violation of the registration provisions of Section 101 of the Uniform Securities Act and sales by unregistered broker-dealers or agents are also voidable pursuant to an action under Section 410 of the Uniform Securities Act.

#### **D. Research.**

##### **1. Sample State Cases.**

###### **a. *State of West Virginia v. Fairchild; State of West Virginia v. Damron, 171 W. Va. 137 (1982).***

Defendant Damron was convicted of soliciting the sale of securities without being registered as a broker-dealer, selling unregistered securities, and the sale of securities by fraud or deceit. Defendant Fairchild was convicted of aiding and abetting in the sale of unregistered securities, and aiding and abetting by fraud and deceit. Both appealed the conviction; only Damron's appeal is relevant.

The appellant Damron purchased the exclusive rights to market film packages in the state of Kentucky. The franchise agreement was made in Damron's personal capacity, but he later incorporated the business. His plan was to seek investors. He contacted Fairchild, who agreed to provide a list of potential investor's names and show Damron where they lived. Damron solicited funds several times from two brothers. The brothers were told that dividends would be paid within four months, and they would recoup their investment within a year. One of the brothers became suspicious about the apparent lack of progress in the venture after Damron's continued solicitation of funds, so he contact the Securities Division of the State Auditor's office. An investigation began.

The count relevant to this Report is a small part of the overall case. Essentially, on Damron's conviction for being an unregistered broker-dealer, Damron tried to argue as his defense that he was not a broker-dealer, but an issuer. The Court disagreed, holding

that the sales solicited by Damron were for stock to be issued by the company Home Movies, Inc., not by Damron in his personal capacity. The Court found this sufficient enough evidence for impartial minds to conclude that Damron was acting as a broker-dealer.

**b. *State of Colorado v. Milne, 690 P.2d 829 (1984).***

Defendant acquired an interest in and became president of a small corporation, Valley Loan Association, in 1963. In 1968, he acquired complete ownership. The corporation issued 'investment notes' to purchasers. The revenue from these notes was used to finance consumer purchase money loans. When VLA was suffering financial problems, these proceeds also went to meet interest payments on outstanding notes. Ultimately, VLA declared bankruptcy. Unpaid note holders complained to the district attorney, and criminal charges were filed which charged Milne with failure to register securities, selling securities without a license, fraud by check, and violations of the Colorado Savings and Loan Act. The only guilty verdict was on the licensing charge.

Defendant was convicted of selling securities without a license. He appealed, arguing that he had no obligation to become licensed because he was dealing in exempt securities or exempt transactions. The Court affirmed the conviction, finding that the relevant statute did not expressly exempt sellers of exempted securities from the licensing requirements.

**c. *Deets v. Hamilton Management Corp., 2 Kan. App. 2d 452 (1978).***

Financial Programs, Inc. sold its nationwide capital sales organization to the defendant corporation, Hamilton. The sales agreement authorized Financial employees to sell Hamilton funds, commissions from which were to be paid directly to each agent by Hamilton. Defendant Peggy Dailey accepted employment with Hamilton as part of this agreement. Dailey had been convicted of forgery and had falsified her registration applications to the Kansas Securities Commission and NASD by denying she had any convictions. She had been suspended for selling securities for six months by both agencies because of this. At the time of the transactions at issue in this case, Dailey was not a duly registered agent. The issue was whether the corporation was liable for the acts of Dailey.

The court held that Hamilton controlled Dailey as an employee. In fact, the court was of the opinion that Hamilton had materially aided Dailey in the fraudulent transactions by supplying her with forms and brochures. This made it appear to the plaintiff that Dailey was authorized to offer the special 'deal' that was a part of her fraud. The court found that 'there is substantial competent evidence to support the trial court's finding as to the defendant corporation's liability.'

**d. *Bramblewood Investors, Ltd. v. C&G Associates*,  
262 N.J. Super. 96 (1992).**

Plaintiff Bramblewood sought summary judgment for the amount allegedly owed by the defendant. Bramblewood offered limited partnerships in an apartment complex in High Point, North Carolina. C&G executed promissory notes for three partnership interests in 1985. In 1989, C&G allegedly defaulted on the loans. Among other claims, C&G argued that it had the right to rescind because United Capital Securities, the general partner of Bramblewood, failed to register as an agent under the New Jersey Uniform Securities Law.

The court found that all of C&G's counterclaims were time-barred. Even if the allegations surrounding the failure to register as an agent were true and not time-barred, the court pointed out that the facts alleged did not have any nexus to the defendant's claims. Defendants refer to two individuals who were not defendants in this case and their contact in New Jersey with a United Capital representative. The court pointed out that, while those two individuals may be entitled to rescission, the defendants in this case were not. They had no claim under the statute for sales by an unregistered broker because they did not purchase from one.

**2. Federal Case Law.**

**a. *SEC v. Alliance Leasing Corporation*, 2000 U.S.  
Dist. LEXIS 5227(2000).**

This case involved the sale of equipment leases. The leases were considered investment contracts, and securities within the definition of the Securities Act of 1934. The significant parties to the suit were the leasing corporation, the entity that acted as broker-dealer (Prime Atlantic), and the principal shareholders of the leasing company (the Brownes).

Alliance Leasing Corporation was based in San Diego, California. It recruited over 1,500 individuals throughout the country to invest in its venture. The idea was to purchase commercial office and kitchen equipment with investor funds, and then lease that equipment out to third-party lessees. The lease payments were to be paid out to investors monthly for two years, with a balloon payment at the end of the two years. Investors were told that the investment was low risk and that it would garner a 14% per year return.

The SEC brought an action against Alliance, claiming that the package being sold were investment contracts that were unlicensed securities. The parties were also charged with misrepresenting information critical to an investor's informed decision to invest. Prime Atlantic ("Prime") was charged with selling securities as an unregistered broker-dealer, selling unregistered securities, and fraud in failing to report that it received a 30% commission. The case was disposed of on a motion for summary judgment in favor of the SEC.

The charge for violating section 15(a)(1) of the Exchange Act was targeted solely at Prime and its owners. The court granted summary judgment against Prime, as

there was no dispute of material fact that the company was acting as a broker with regard to the investment contracts. All other charges were directed at all defendants, and summary judgment was also granted on each of the other claims.

The owners of Alliance were repeat offenders who were found to have had no remorse for their activities. The court therefore issued a permanent injunction against them. However, it did not feel that Prime deserved such harsh penalties. There were no securities violations in its past. Also, Prime had relied on advice of counsel, who told Prime that the contracts were not securities. Therefore, the court found that there was very little intent on the part of Prime to violate securities laws, with the exception of the lack of disclosure with regard to commissions.

All parties were ordered to pay disgorgement plus interest, as well as the maximum civil penalty. It is hard to isolate exactly how much of the costs for Prime had to do with the fact that it was unregistered. There was no discussion of holding the issuer responsible for using an unlicensed broker-dealer.

**b. *SEC v. Interlink Data Network*, 1993 U.S. Dist. LEXIS 20163 (1993).**

InterLink solicited more than \$21 million from over 700 investors across the country. 908 F. Supp. at 720. They failed to comply with securities registration requirements, misused investor funds, and operated a Ponzi scheme. *Id.* The SEC filed a complaint for temporary and permanent injunctions. The SEC commenced an action against the defendants, complaining that they were operating a nationwide fraudulent scheme. The defendants included InterLink Data Network and its two partnerships, InterLink Fiber Optic Partners, L.P. and InterLink Video Phone Partners, L.P. (the "defendant issuers"). Michael Gartner, a principal officer of InterLink, was also named in his individual capacity. The SEC also alleged that the defendants were conducting an unregistered brokerage operation. The SEC alleged that they had set up a boiler-room operation and were acting as unregistered broker-dealers.

The subject of the InterLink investment scheme was telecommunications. The idea was marketed as a concept to develop "private, fully integrated telecommunication networks and video phone systems." 1993 U.S. Dist. LEXIS 20163 at \*4. The sales pitch was that investor funds would be used to lay fiber-optic cable in Los Angeles, as well as to manufacture video telephones. Neither of these activities actually occurred. Rather, the funds were used to pay previous investors. Subsequent offerings promised much of the same – that the money would be used to invest in telecommunications technology, and that the returns would be anywhere from twelve to eighteen per cent.

There were no registration statements filed for the securities. Defendants attempted to rely on exemptions from registration, including Regulation D. However, defendants were not eligible for these exemptions because the offerings were not limited to accredited investors (in fact, defendants knowingly sold to unaccredited investors), and they had engaged in general solicitations for sales.

There were several material misrepresentations made by the defendants in selling the securities. Potential investors were told that InterLink possessed several patents for the video phone technology though it actually owned none of these patents. Potential investors were also told that fiber optic lines were being run in Los Angeles, that InterLink securities were publicly traded on AMEX or Nasdaq, and they were given unsupported guarantees of investment returns, among other misrepresentations.

Defendants arranged with Portfolio Asset Management ("PAM"), a registered broker-dealer, to provide a shield for the activities of more than 80 unregistered salespersons who were working the phones in the two boiler-rooms the defendants had set up. However, there was little distinction between PAM and Interlink. Interlink paid PAM's overhead, all sales documents were kept by InterLink, Gartner hired the sales force used to sell Interlink securities, and investor checks were sent directly to InterLink and not to PAM.

The court granted the SEC's motion for summary judgment on all issues. Gartner failed to file an answer, and he refused to respond to discovery requests, asserting his Fifth Amendment privilege against self-incrimination. Defendant issuers did not respond to discovery requests, stating that there was no one left at the companies to respond except Gartner, who again asserted his Fifth Amendment privilege. The court found that the defendant issuers and Gartner had engaged in selling unregistered securities, they had engaged in fraud and misrepresentation in the course of those sales, they had used investor funds improperly, and they sold securities without being registered broker-dealers.

The court found that the facts of this case were particularly deplorable. Hundreds of individuals, trusts, and corporations invested funds in InterLink. Many of the investors were retirees living on fixed incomes. The defendants were aware of the impropriety of their activities, and they showed little remorse for their transgressions.

The court granted several forms of relief. First, it granted a permanent injunction, stating that the "defendants' violations were intentional and calculated, and occurred repeatedly for years." All defendants were permanently enjoined from future violations of the Securities and Exchange Act at issue in this case, namely sections 17(a) and 10(b) of the Securities Act and section 15(a) and Rule 10b-5 of the Exchange Act.

The court also ordered disgorgement of the illegally raised monies, amounting to just over \$12 million. Defendants were held jointly and severally liable for the return of all funds raised. Because the violations were so blatant, the court awarded prejudgment interest as well.

Finally, the court also imposed civil penalties against the defendant issuers. Against a non-natural person, the court could impose a fine of \$500,000 or the gross amount of the monetary gain. In this instance, the court fined the defendant issuers another \$12,285,035, the total amount of the gain. The SEC withdrew its request to fine Gartner, but the court noted that it would be warranted in doing so under the facts of the case.

**c. SEC v. Walsh (DC SDNY 12/17/02).**

The SEC sued former Tyco director and the chairman of its Compensation Committee for signing a Tyco registration statement that he knew contained material misrepresentations. The SEC alleged that at the time Walsh signed the registration statement, he knew that Tyco's CEO Kozlowski had proposed that if a merger transaction was successful, Walsh would be paid a finder's fee for having arranged a meeting of the companies' CEOs to discuss the possible merger. At successful conclusion of the merger, Walsh received \$10 million in cash and another \$10 million was donated to a designated charity. Walsh, without admitting or denying the allegations, settled the suit concurrently with the SEC filing.

This case stresses the importance of disclosure of finder's compensation. The SEC noted that Mr. Walsh took secret compensation and kept shareholders in the dark.

### **EXCEPTIONS TO REQUIRED BROKER-DEALER REGISTRATION**

Within a very narrow scope of activities primarily described in SEC no-action letters, a person may perform certain limited activities without triggering broker-dealer registration requirements. In interpreting their own securities laws, states generally, but not always, follow a similar analysis. These limited exceptions to broker-dealer registration are entirely constructions of regulatory interpretation and are not explicitly recognized in federal or state securities laws (Michigan being the only exception). The SEC and state securities regulators are free to modify the scope of these limited exceptions at any time. In fact, in recent years the SEC has been narrowing the permitted scope of finder activities. Indeed, in the last three years the SEC staff has not only expressly limited the scope of one well-established exception, but has withdrawn another significant no-action letter relied upon by many finders in structuring their arrangements with securities issuers citing, among other things, advances in technology that have permitted other types of persons to become involved in securities-related activities.

#### **Financial Intermediaries**

The SEC has by no-action letter defined the contours of financial intermediaries' exceptions, though as discussed below those contours are currently in flux. It is in this context of finders the SEC has articulated many of its guiding policy concerns.

Although no single factor is dispositive of the question of whether a finder is engaged in the activities of a broker-dealer, SEC no-action letters reveal a variety of factors that are typically given some weight by the staff including: (1) whether the finder was involved in negotiations; (2) whether the finder engaged in solicitation of investors; (3) whether the finder discussed details of the nature of the securities or made recommendations to the prospective buyer or seller; (4) whether the finder was compensated on a transaction-related basis; and (5) whether the finder was previously involved in the sale of securities and/or was disciplined for prior securities activities. See Alan J. Berkeley and Alissa A. Parisi, *Frequently Asked Questions About the Resale of Restricted Securities* (ALI-ABA 2002); David A. Lipton, *A Primer on*

*Broker-Dealer Registration*, 36 Cath. U. L. Rev. 899, 914, 927 (1987).<sup>14</sup> A review of these individual criteria provides some guidance as to the range of permissible conduct.

### 1. Transaction-Based Compensation.

Transaction-based compensation has come under intense scrutiny by the SEC. The SEC's Division of Market Regulation has repeatedly noted that:

. . . [T]he receipt of compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer. Absent an exemption, an entity that receives securities commissions or other transaction-based compensation in connection with securities-based activities that fall within the definition of "broker" or "dealer" generally is itself required to register as a broker-dealer. Registration helps to ensure that persons who have a "salesman's stake" in a securities transaction operate in a manner that is consistent with customer protection standards governing broker-dealers and their associated persons. That principle not only encompasses the individual who directly takes a customer's order for a securities transaction, but also any other person who acts as a broker with respect to that order, such as the employer of the registered representative or any other person in a position to direct or influence the registered representative's securities activities.

*Herbruck, Alder & Co.*, SEC No-Action Letter (June 4, 2002); see also, e.g., *Birchtree Financial Services, Inc.* (SEC No-Action Letter Sept. 22, 1998) (registered representative's personal service corporations); *Ist Global, Inc.* (SEC No-Action letter May 7, 2001)(unregistered CPA firms); *Richard S. Appel*, SEC No-Action Letter (Feb. 14, 1983) (1031 exchange transactions; requiring registration because finder would receive commission-based compensation on sales).

Transaction-based compensation triggered a broker-dealer registration obligation in *Mike Bantuveris*, SEC No-Action Letter (Oct. 23, 1975), where the company wished to offer a consulting service in which it would identify companies as possible acquisition candidates and assist its clients in negotiating toward a final agreement. The company proposed to base its fees, in part, on the total value of consideration received by the sellers or paid by the buyers. On these facts, the staff indicated that the company would be required to register as a broker-dealer. The staff noted that its opinion was "based primarily on the fact that the consulting firm would . . . receive fees for its services that would be proportional to the money or property obtained by its

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<sup>14</sup> There is no indication that a transaction's status as a public offering, as opposed to a private placement, has any impact on the Staff's interpretation of the broker-dealer registration requirements. Compare *NFC Petroleum*, SEC No-Action Letter (July 17, 1978) (applying standards discussed herein to finder engaged in public offering), with *Dana Investment Advisors, Inc.*, SEC No-Action Letter (October 12, 1994) (applying same standards in context of private transaction).

clients and would be contingent upon such transactions in securities." See also *John M. McGivney Securities, Inc.*, SEC No-Action Letter (May 20, 1985).

The SEC has left open whether a commission-like fee arrangement, standing alone, will always constitute grounds for registration as a broker-dealer. It is this letter which appears to create the greatest uncertainty for counsel and intermediaries. *Paul Anka*, SEC No-Action Letter (July 24, 1991), provides the unusual case where a commission-like fee has been allowed to stand. The staff's favorable position would appear to be attributable to the uniquely limited duties of the finder involved in the case and to the one-time occurrence of the event. In *Anka*, the Ottawa Senators Hockey Club retained entertainer Paul Anka to act as a finder for purchasers of limited partnership units issued by the Senators. Anka agreed to furnish the Senators with the names and telephone numbers of persons in the United States and Canada whom he believed might be interested in purchasing the limited partnership units. Anka would neither personally contact these persons nor make any recommendations to them regarding investments in the Senators. It is noteworthy that in Mr. Anka's original proposal letter to the SEC he would have made the initial contact with prospective investors, but the SEC would not issue a no-action letter under those facts. In exchange for his services, Anka would be paid a finder's fee equal to 10 percent of any sales traceable to his efforts. Important factors identified in the *Anka* letter include:

- Mr. Anka had a bona fide, pre-existing business or personal relationship with these prospective investors.
- He reasonably believed those investors to be accredited.
- He would not advertise, endorse or solicit investors.
- He would have no personal contact with prospective investors.
- Only officers and directors of the Senators would contact the potential investors.
- Compensation paid to the Senators' officers and directors would comply with 1934 Act Rule 3a4-1 (governing compensation to issuer's agents).
- He would not provide financing for any investors.
- He would not advise on valuation.
- He would not perform due diligence on the Senators' offering.
- He had never been a broker-dealer or registered representative of a broker-dealer.

Based on these facts, the SEC indicated that it would not recommend enforcement action if Anka engaged in the proposed activities without registering as a broker-dealer.

While the SEC did not comment specifically on the issue, it would appear that the staff was willing to tolerate the commission-like structure of Anka's fee arrangement because his role in finding prospective purchasers—which was limited to sending a list of names to the Senators—providing no opportunity or incentive to engage in abusive sales practices. See John Polanin, Jr., *The "Finder's" Exception from Federal Broker-Dealer Registration*, 40 Cath. U. L. Rev. 787, 814 (1991). The SEC staff may be reconsidering whether Mr. Anka's activities sufficiently removed him or others like him from having the opportunity to engage in abusive sales practices that registration is intended to regulate and prevent. Based on staff comments at a

recent Business Law Section meeting, the SEC staff may also be reconsidering its position in the Paul Anka letter situation and might not issue such a letter today. Although the SEC's position in the *Anka* letter was not premised on the 1985 *Dominion Resources* letter (discussed below and in Section IV), the revocation of *Dominion Resources* in 2000 seems to demonstrate that the staff is moving to a position where the existence of transaction-based compensation alone may be sufficient to trigger broker-dealer registration. From the SEC staff's perspective, transaction-based compensation creates the incentive for abusive sales practices that registration is intended to regulate and prevent. Many financial intermediaries would rather be sure of their status by being registered, but avoid the burdensome and generally inapplicable process that is found in the present regulatory scheme.

## 2. Negotiation or Advice.

If the financial intermediary is involved in negotiations or has provided detailed information or advice to a buyer or seller of securities, the staff is more likely to require the finder's registration as a broker-dealer. See, e.g., *Mike Bantuveris*, SEC No-Action Letter (Oct. 23, 1975) (requiring registration); *May-Pac Management Co.*, SEC No-Action Letter (Dec. 20, 1973) (requiring registration); *Fulham & Co.*, SEC No-Action Letter (Dec. 20, 1972) (requiring registration); cf. *Caplin & Drysdale, Chartered*, SEC No-Action Letter (Apr. 8, 1982) (not requiring registration where finders neither negotiated nor provided advice); *Leonard-Trapp & Assocs. Consultants*, SEC No-Action Letter (Aug. 25, 1972) (requiring registration). The staff has emphasized that "persons who play an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally are deemed to be either a broker or a dealer, depending upon their particular activities, and are required to register with the Commission." *May-Pac Management Co.*, *supra*. But if the intermediary's participation in negotiations is limited to performing the "ministerial function of facilitating the exchange of documents or information," the staff has indicated that no registration is required. *Samuel Black*, SEC No-action Letter (Dec. 20, 1976).

For example, no-action relief was denied to May-Pac, a company specializing in mergers and acquisitions, who proposed to seek out potential sellers of corporations, bring them together with potential buyers, and work toward closing the transaction. The company acknowledged that, in most cases, it would participate in whatever negotiations were necessary to close the deal and advise its client as to the quality of any offer received. On the basis of these activities, the SEC concluded that the company would be required to register as a broker-dealer. The staff found that the proposed activities were more than merely bringing together the parties to transactions involving the purchase or sale of securities. The firm proposed to negotiate agreements, engage in other activities to consummate the transactions, and to receive fees for its services that would be proportional to the money or property obtained by its clients and would be contingent upon such transactions in securities.

Alternatively, the SEC granted no-action relief to Victoria Bancroft, a licensed real estate broker, who established lists of clients who might be interested in acquiring financial institutions that are for sale. *Victoria Bancroft*, SEC No-action Letter (August 9, 1987). The *Bancroft* letter describes her activities as being "limited merely to the introduction of parties." She did not participate in the establishment of the purchase price or any other negotiations

between the parties. The parties created all materials related to either the sale or purchase of the financial institutions without Bancroft's involvement. She didn't even facilitate exchange of the information. At most she described to the potential purchaser the type of institution, the asking price, and the general location. If the potential person were interviewed, Bancroft would arrange a meeting with the seller or seller's representative. Either the buyer or seller would compensate Bancroft by a flat fee or a percentage of the purchase price. The compensation was considered to be a referral fee or finder's fee.

In granting no-action relief, the staff indicated that (1) Bancroft had a limited role in negotiations between the purchaser and seller; (2) the businesses represented by Bancroft were going concerns and not shell corporations; (3) transactions effected by means of securities would convey all of a business's equity securities to a single purchaser or group of purchasers formed without the assistance of Bancroft; (4) Bancroft did not advise the two parties whether to issue securities or assess the value of any securities sold; and (5) Bancroft did not assist purchasers to obtain financing. The staff further stated that Bancroft would be subject to the anti-fraud provisions of the federal securities law to transactions in which securities are used to transfer ownership of a business. *Bancroft* is an old no-action letter lacking the details found in more current no-action letters.

### **3. Solicitation.**

Solicitation of investors for securities is also a factor that weighs in favor of broker-dealer registration. In *Thomas R. Vorbeck*, SEC No-Action Letter (Mar. 24, 1974), the SEC required registration where the company proposed to offer a two-part securities service package to its employees in order to cure what it viewed as deficiencies in its employee stock purchase plan. Under the plan, employees could elect to reduce their commission expenses by assigning the stock to the employer, and/or to increase their profits by authorizing the employer to sell short designated shares of stock once each quarter. On the basis of these facts, the staff indicated that the company would be required to register as a broker-dealer under Section 15(a). As the staff explained, the proposed activities "would appear to bring [the company] within the definition of a broker since it is reasonable to presume that [among other things] . . . the plan would entail some form of solicitation of business on your behalf." See also *SEC v. Schmidt*, Fed. Sec. L. Rep. 93,202 (S.D.N.Y. 1971) (finder was determined to be a broker-dealer when he placed advertisements in a daily newspaper offering savings on commissions); *Joseph McCulley*, CCH Fed. Sec. L. Rep., 78,982 (Sept. 1, 1972) (requiring registration based on mere repeated advertising to buy and sell securities).

The SEC has not provided much guidance on what activities constitute solicitation or advertising sufficient to trigger broker-dealer registration under Section 15(a). However, the staff has accepted a finder's use of a cover letter and a press release to notify prospective purchasers of the proposed transaction. See *Ewing Capital, Inc.*, SEC No-Action Letter (Jan. 22, 1985). It is the content and extent of the solicitation, rather than the mode of communication, which will most likely determine the SEC's reaction to a finder's solicitation activities. See, e.g., *Victoria Bancroft*, SEC No-Action Letter (Aug. 9, 1987); *Mike Bantuveris*, SEC No-Action Letter (Oct. 23, 1975); *F. Willard Griffith, II*, SEC No-Action Letter (Oct. 7, 1974).

#### 4. Previous Securities Sales Experience or Disciplinary Action.

Another factor given weight by the staff is whether the finder has previously been involved in the sales of securities and/or disciplined for violations of the securities laws. The SEC wants to be certain that the finder exception is not a "back door" for past violators barred from the industry to remain involved and put investors at risk. Accordingly, previous involvement of in the securities industry increases the likelihood that the finder will be required to register as a broker-dealer. An interesting example of this is *Rodney B. Price and Sharod & Assocs.*, SEC No-Action Letter (Nov. 7, 1982). In *Price*, the usual indications of broker-dealer status seemed to be lacking. The finder was retained to locate brokers and dealers as potential underwriters or participants in private offerings. The finder was to have no involvement in actual selling efforts, and his fee was not based on commissions tied to sales.

While the staff did not directly attribute this opinion to the finder's prior securities activities and disciplinary history, the letter began by describing at length the fact that the finder had previously engaged in the sale of securities and that he had recently been disciplined for violations of the Act. Since nothing in the nature of the finder's proposed activities would otherwise seem to have necessitated registration as a broker-dealer, it is fair to conclude that the staff's decision was motivated by the finder's previous securities activities. Cf. *Carl L. Feinstock (John DiMeno)*, SEC No-Action Letter (April 1, 1979) (stating initially that the finder, who was to receive commissions tied to sales, had to register but then changed its opinion after being informed in a follow-up letter that the finder had "not previously been engaged in any private or public offerings of securities").

In 1998, the SEC brought an action against Michael Milken and MC Group for allegedly violating the broker-dealer registration provisions of the federal securities laws. In its complaint, the SEC alleged that MC Group, through Milken and others, acted as business consultants, introduced companies, suggested business arrangements between them, participated in negotiations regarding the structure of transactions, and received transaction-based compensation in the amount of \$42 million. The SEC further alleged that as a result of this conduct Milken violated the SEC's March 11, 1991 order prohibiting Milken from associating with a securities broker, and was liable for MC Group's violations of the Exchange Act because he directly and indirectly controlled MC Group.

Milken and MC Group consented to settle the action, without admitting or denying the allegations. They also agreed to disgorge the \$42 million earned from the transactions and prejudgment interest of \$5 million. The final judgment commands Milken to comply with the March 11, 1991 order and permanently enjoins him and MC Group from directly or indirectly violating §15(a) of the Exchange Act. The nature of Milken's and MC Group's alleged activities did seem to require registration as a broker-dealer. The alleged transactions included giving advice, participating in negotiations and receiving transaction-based compensation. It is also fair to conclude that the staff's decision was motivated in part by Milken's violation of the SEC's 1991 order that disciplined Milken for previous violations of the securities laws.

## **Financial Intermediaries for Issuers.**

The scope of activities permitted for financial intermediaries for issuers has been narrowing. On March 7, 2000, no-action assurance previously granted to Dominion Resources was revoked. *Dominion Resources, Inc.*, SEC No-Action Letter (March 7, 2000). Without discussion, the SEC's 1985 letter had allowed Dominion Resources, Inc., to recommend a bond lawyer to the issuer, recommend an underwriter or a broker-dealer for the distribution or the marketing of a security in the secondary market, and recommend a commercial bank or other financial institution to provide a letter of credit or other credit support for the securities. *Dominion Resources, Inc.*, SEC No-Action Letter (August 24, 1985). If the nature of the financing so required, Dominion Resources was allowed to introduce the issuer to a commercial bank (which may have a pre-existing customer relationship with the issuer) to act as the initial purchaser of the securities and as a standby purchaser if the securities cannot be readily marketed by the broker-dealer. Dominion Resources did not receive any commissions or other transaction-based compensation in connection with those activities. Dominion Resources did not purchase, sell or solicit purchasers for the securities. The only contact Dominion Resources had with any potential purchaser was the possible introduction of the issuer to a commercial bank standby purchaser.

In addition, Dominion Resources did not bid on any issues of securities nor did it underwrite, trade or hold funds or securities of the issuer. Representatives of Dominion Resources were available, as requested by the issuer, for consultation regarding the terms of the financing, preparation of official statements and other matters leading to the closing. In its capacity as consultant, Dominion participated in discussions and meetings prior to the closing among the issuer, issuer's counsel, bond counsel, the underwriter or broker-dealer, authority counsel, and any commercial bank standby purchasers. At any meetings prior to and including the closing, Dominion Resources provided financial advice consistent with its role as a consultant, but had no authority to represent any of the parties in the negotiations or to bind them to the terms of any agreement. While Dominion Resources might, upon occasion, as part of the consultative, advisory and negotiating process articulate, explain or defend negotiating proposals or positions that have been adopted by its client or that Dominion Resources had recommended for its client's adoption, under all circumstances, Dominion acted only on behalf of its client and subject to the direction of its client and did not act as an independent middleman between the parties.

Representatives of Dominion Resources reviewed the documentation associated with the financing, but the parties to the financing were responsible for the preparation of the documentation and other operational aspects of the financing, such as printing, mailings, delivery of securities or preparation of bond registration.

Dominion Resource charged fees for its consultative and coordinating services that were related to the overall size of the financing that the client wished to arrange, and generally were not payable unless the financing closed successfully. Dominion Resources' fees were not based on successful issuance of securities to the public or affected by secondary trades thereafter. After the closing, Dominion Resources had no further significant involvement with the financing, except that upon occasion, and at the request of the issuer, Dominion Resources

would, without compensation and as an accommodation to the issuer from time to time make recommendations about investment of temporarily idle proceeds of an issue or monitor the performance of the issue.

In revoking the 1985 no-action letter, the staff said it had frequently considered the distinction between activities of a broker which require registration and activities of a finder which is not subject to registration. The staff said that because of technological advances and other developments in the securities markets, more and different types of persons have become involved in the provision of securities-related services, requiring greater restrictions on the types of services finders may offer without registering as a broker under the Securities Exchange Act of 1934. Since that time, the staff has denied no-action requests in situations similar to the activities described in the *Dominion* August 22, 1985 letter. E.g. *John Wirthlin*, SEC No-Action Letter (Jan. 19, 1999) (no-action request denied where person would solicit investments in real estate limited partnership interests from investors through their accountants and commercial real estate brokers and would receive a fee if any referred investors purchased those securities); *Davenport Management, Inc.*, SEC No-Action Letter (Apr. 13, 1993) (broker-dealer registration required where, among other things, business broker receives transaction fees and participates in negotiations); *C&W Portfolio Management, Inc.*, SEC No-Action Letter (July 20, 1989) (broker-dealer registration required where company acts as intermediary in negotiations between Treasury dealers until they reach agreement as to the terms of the transaction, and receives a set fee contingent upon consummation of the transaction).

In light of those denials, the staff reconsidered the no-action position taken in the August 22, 1985 letter to *Dominion Resources*. The staff no longer believes that an entity conducting the activities described in that letter would be exempt from registration as a broker-dealer under §15 of the Exchange Act.

The 2000 *Dominion* letter is even less explicit in its reconsideration than the 1985 letter was in its grant of no-action relief, but we can assume that concern over any *Dominion* activities that were similar to the activities of *Wirthlin*, *Davenport*, and *C&W* were the basis for revoking the letter. Since *Dominion* received transaction-based compensation, provided advice, made recommendations, and was involved in negotiations, the staff felt compelled to revoke the letter for consistency. This letter reflects the staff's position that these activities are significant factors in determining whether the finder is engaged in the activities of a broker-dealer. It also suggests that other letters that came after the 1985 *Dominion Resources* letter may receive

### **Consulting Activities.**

Individuals can have a limited role in securities transactions without being deemed to be agents. They can consult on structure, provide valuation reports, render technical advice, provide industry expertise, assist as accountants in the development of forecasts, etc. However, the SEC views transaction-based compensation for such persons as problematic and is suspicious that they really are involved in the entire transaction, including playing a role in obtaining investors. The less involved a business consultant is in the negotiation and structuring of a transaction, the less likely it will be that the staff will require the business consultant to register as a broker-dealer despite the fact that the consultant receives transaction-based

compensation. For example, in *Russell R. Miller & Co., Inc.*, SEC No-Action Letter (Aug. 15, 1977), the finder was in the business of locating insurance agencies and evaluating them for acquisition. The finder was paid a fee that was contingent on a subsequent purchase or sale. However, the acquisition of a specific agency was not necessarily structured by the sale of securities and the finder played no role in organizing the actual acquisition. The staff considered the finder to be a consultant "retained to bring to bear its knowledge and expertise to the task of identifying an acquisition prospect" and not as a broker. See also *International Business Exchange Corp.*, *supra*.

Compensation for consulting services was also the subject of *Caplin & Drysdale, Chartered*, SEC No-Action Letter (April 8, 1982). Copeland, a registered broker-dealer wanted to sell annuity plans to public employers in various market areas. In each market, Copeland proposed to hire consultants as independent contractors to provide demographic information about the public employees and financial information about the insurance policies, pension plans, and other financial benefits provided by public employers for public employees. Copeland proposed to pay the consulting firms an annual flat fee and a bonus based on a percentage of the first year annuity's commissions earned from specific annuity plans. The consulting firms would not represent Copeland, provide investment advice, distribute sales material, or participate in negotiations involved in the sales of securities to public employers or their employees. The staff found the proposed actions would not trigger broker-dealer status under the Act.

### **Compensation Sharing Arrangements.**

Registered broker-dealers and their registered representatives are not permitted to share commissions or transaction-based compensation with unregistered persons. This was recently made clear in the context of CPAs and their CPA firms in *1st Global, Inc.*, SEC No-action Letter (May 7, 2001).

In *1st Global*, the company was requesting No-Action relief on behalf of its subsidiary 1st Global Capital Corp., a registered broker-dealer. 1st Global Capital Corp. engaged CPAs as registered representatives to sell financial instruments to clients, and paid them commissions. Many of these CPAs have entered into agreements with their CPA firms that require them to account to the firm all revenues generated from firm clients. After firm expenses are paid, the remaining profits are allocated to all the partners under an allocation formula. The other partners, shareholders, or members that will receive a share of the commissions from securities transactions may or may not be registered representatives. 1st Global raised four specific compensation scenarios under which it proposed to pay securities commissions to CPA registered representatives and asked the staff for guidance as to which scenario no-action assurance would be granted. The four scenarios were:

1. 1st Global Capital Corp. would pay commissions to a CPA registered representative without the presence of a partnership agreement mandating the CPA/registered representative to account to the CPA firm for the commissions earned.

2. 1st Global Capital Corp. would pay commissions to a CPA registered representative without the presence of a partnership agreement mandating the CPA to account to the CPA firm for the commissions earned, but the CPA registered representative would then "voluntarily" turn the commissions over to the CPA firm.
3. 1st Global Capital Corp. would pay commissions to a CPA registered representative subject to an agreement, formal or otherwise, mandating that the CPA account to the CPA firm for the commissions earned.
4. 1st Global Capital Corp. would pay commissions to another broker-dealer, with whom the CPA registered representative is dually registered, when the CPA firm or its partners own the other broker-dealer.

In its response, the staff stated that scenario (1) was the only scenario that would be granted no-action assurance. The staff stated that registration for individuals that receive transaction-based compensation is required not only for the individual that takes a customer's order, but also for any other person in the position to direct or influence the registered representative's securities activities. The staff stated that because the unregistered partners, shareholders, or members of the firm may direct or influence the broker-dealer or registered representative CPA's activities, it may engage in broker-dealer activities. Therefore, without the CPA firm being registered, no commissions may be shared.

The staff stated that this position was consistent with its *Freytag, LaForce, Teofan and Falik*, SEC No-action Letter (January 1988), where the staff stated it would not recommend an enforcement action if the broker-dealer paid securities commissions to a CPA registered representative. Its no-action position was conditioned on the fact that the CPA would not be subject to any agreement requiring the CPA to turn over the commission for distribution to the partnership. The staff further stated that the registered representative may not forward securities commissions to a CPA firm or other unregistered person under another title or label. Neither may the registered representative make payments for support or services unless they are proportionate to the market cost for those services and do not denote a form of compensation arising from securities transactions. The SEC wrote:

Under the arrangement described in your letter, an unregistered CPA firm would indirectly receive securities commissions earned by a CPA registered representative, thereby giving it a financial stake in the revenues generated by the registered representative's securities transactions, at the same time that the CPA firm is in a position to influence the registered representative's actions and to direct customers to the registered representative. As discussed above, in the *Birchtree* line of letters the receipt of transaction related compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer, and that, absent an exemption, a person or entity that receives transaction-related compensation in connection with securities activities generally is

required to register as a broker-dealer. (See, e.g., Letter re: *Birchtree Financial Services, Inc.* (Sept. 22, 1998)). The Division is not persuaded that your attempts to factually distinguish the circumstances that underlie the *Birchtree* letters assuage the core regulatory concerns raised by the receipt of transaction-based compensation.

*1st Global* is an important letter because it clearly states that if registration is required to sell the security, the sharing or splitting of transaction-based compensation between unregistered persons and either broker-dealers or registered representatives is strictly prohibited. This would include any payments for support or services related to the sale of the security that were not proportionate to the market cost for those services. Payments for support or services may not be used as a form of compensation from securities transactions. The SEC raised the possibility that ordinary distributions of earnings and profits from a registered broker-dealer to an unregistered entity (the CPA firm) could raise compensation-splitting issues depending upon the exercise of the unregistered entity's control over the broker-dealer. The SEC wrote:

Finally, the Division cannot assure you that, under any circumstances, it would not recommend enforcement action to the Commission under Section 15(a) should 1st Global pay securities commissions to a registered broker-dealer, with which a 1st Global registered representative is dually registered, when that other broker-dealer is owned by an unregistered CPA firm or its partners. This is due to the highly fact-specific nature of any such relationship. Clearly, a registered broker-dealer may receive commissions arising from securities transactions. Under some circumstances, however, the unregistered CPA firm or its partners may exercise such a degree of control over the activities of the broker-dealer or its registered representatives that they themselves engage in broker-dealer activity. In that case, the CPA firm or its partners would have to register as broker-dealers pursuant to Section 15(b), or else, in the case of natural persons, register as associated persons of a broker-dealer. Although you suggest that the unregistered CPA firm or its partners would passively own the registered entity, the question of whether the actions of the CPA firm or its partners constitute broker-dealer activity must turn upon the facts and circumstances of each particular situation.

## CONCLUSION

In order to break through the walls that keep out those who can legitimately assist small issuers, dramatic reform of the present system is necessary. That reform can be accomplished without legislation, but will take substantial coordination by the SEC, NASAA, the NASD and individual states, hopefully working with the bar and business people experienced in working with the problems of small business finance and finders.

The alternative to action is that the situation for small issuers will continue to get worse, as the brokerage community shrinks, and regulatory requirements and costs escalate. Common sense dictates that it is time for dramatic change. Will the regulatory authorities seize the initiative, or will this opportunity pass us all by?

1027387-September 13, 2004