

Buzz Article:

Mandatory Registration of Finders as Private Placement Brokers: SEC Action On The Way (Part 2)

by Joseph Bartlett, Of Counsel, Fish and Richardson, 1/16/2007

The next question, and this is critical question in my mind, has to do with what (if anything) legitimate so-called "finders" can do, short of registration, to go about their business pending the publication of, and their compliance with, Broker/Dealer Lite registration provisions. There are at least two issues involved:

First, as indicated in various publications,^[8] an unregistered finder takes the risk that, when the transaction closes, the obligor ... the party responsible for his, her or its commission ... will renege. That is a risk that counsel routinely exposes to the so-called finders when the question is asked; and the answer is reasonably clear, as the Report states (p. 39).

"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 [in my experience, it means] 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."^[9]

Assume, then, that the finder is what we might call a legitimate finder ... there is no fraud involved in the transaction and all the other `33 and `34 Acts rules are honored, including Rule 10b-5 and Regulation D. Does the issuer, and counsel for the issuer, have a problem on two levels:

First, if counsel to the issuer is required, as is frequently the case, to issue an opinion that the transaction is exempt under Federal and indeed State securities law, does the presence of an unregistered finder ... arguably illegal ... so contaminate the entire transaction that the opinion cannot issue? Assume, secondly, that an opinion is not called for, what then are the potential consequences to the issuer? The Report raises, although there is not enough precedent to resolve the question, the issue whether the presence of this type of illegality infects the entire process, to the extent the investors may enjoy a rescission right. Again, to quote the Report (p. 39.)

"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 in Section 29(b) is broad enough to permit such an interpretation."^[10]

Further. if the above did not involve enough confusion and uncertainty. consider the following scenario ...

again drawing from my personal experience: Some years ago, having written on this subject frequently, I was contacted by a major (then Big 5) accounting firm, to obtain advice on the question whether the firm's involvement in the issuance and sale of certain tax flavored securities was enough to implicate the firm in engaging in activities amounting to "the business of effecting transactions in securities," and thus, require broker/dealer registration. For better or worse, the counsel regularly employed by the accounting firm intervened and I can only guess that the result was that the law firm advised against registration. That said, let me again refer to the Report. On p. 36, it makes the point that:

"The SEC declined to make a decision on whether an accountant, that advises a client on how to structure the sale of its business, needs to be registered as a broker-dealer under Section 15(a). *Magnuson, McHugh & Company, P.A.*, SEC No-Action Letter (November 13, 1989). There, the SEC stated that if the accountant advised any other person on the value of the stock or the advisability of investing in the stock, then that person might have to be registered as a broker-dealer. The SEC enclosed the *IBEC* No-Action letter so the person could conduct its own analysis."^[11] (Emphasis added.)

Advice on "structuring?" Is that a red flag?

As I continue to think long and hard on this issue, of course, I am personally drawn to the question whether a law firm, any law firm which practices in the private equity arena representing issuers and investors, could be implicated as broker/dealer because, on occasion, the firm will point either the buy or the sell side in the direction of a counterparty. A law firm does not typically (at least in my experience) receive transaction based compensation nor does it solicit investors. In fact, a careful firm is usually very specific in advising all parties that it is not soliciting or recommending an investment; and, again, if it is prudent, the firm will not express any opinion whatsoever on the business or economic aspects of the transaction. Assume again, the firm has had no involvement in SEC or State law proceedings involving the sale of securities and/or been disciplined for violation of Securities laws. However, counsel routinely participates ... indeed is paid to participate ... in negotiations between the buyer and seller, whether the deal is an M&A transaction^[12] or a private placement; and participation in negotiations is an indicator of "broker" status. The Report, p. 30.^[13]

There is some comfort to be had in the so-called IBEC No-Action letter ("IBEC").^[14] It is conceivable that the law firm, and/or the accounting firm can fit, *mutatis mutandis*, inside the four corners of the IBEC letter. However, it is reasonably clear that, if the firm either advises on the value of the securities involved or the advisability of investing in the securities and/or obtains transaction-based compensation,^[15] the IBEC letter will not afford much protection. And, on the question of transaction-based compensation, it is relatively routine for a law firm to offer selected clients engaging in M&A and securities floatation/placement transactions so-called 'over and under' fee agreements. That is to say, if the transaction does not close for any reason (which could be *force majeure*), the client will be afforded a discount on the law firm's time charges ... balanced by an agreement that if the transaction does close, a modest premium will be charged. As I have continued to think on these issues, I am prepared, as we wait for clarification from the SEC, to suggest that such a provision ought to be scrapped.

Finally, again referring to the issue of what to do "until the doctor comes," assume a law firm is engaged by an issuer seeking capital; the issuer coincidentally has a well known and well respected finder ... which is not however, registered under the '34 Act or an NASD member. Need the law firm turn down the representation? Assuming the answer to that query is 'no,' what type of advice and/or cautions should the firm, under the applicable Code of Professional Responsibility provisions, extend to its client? Assume, as a

variation on that theme, that the law firm is representing the investors ... say, a professionally managed private equity fund. Herewith some suggestions for discussion ... not meant as pronouncements but as items which recipients of this memorandum are invited to peruse and respond to.

My view which is personal, and does not represent the position of this law firm, is as follows:

When counsel is representing the issuer, the engagement letter should contain a warning and caveat to the following effect (target language to be shaped by the lawyers at the firm sensitive to the requirements of the local version of the Code of Professional Responsibility), viz:

"We understand that Newco Inc. has employed a placement agent, Finder Inc. ("Finder") to assist in the placement referred to in the body of this letter and proposes to compensate Finder on a basis which includes a success fee. Moreover, it is anticipated by Newco that Finder will participate in the negotiating the placement ... amount and terms ... with potential investors.

"You are hereby cautioned that, as we understand it, Finder may be required to register, but currently is not registered, as a broker/dealer under Section 15 of the Securities & Exchange Act of 1934 and to join, but has not joined, the NASD as a member [plus any requirements under State law arguably applicable]. Although there is no controlling precedent of which we are aware, at least some authorities have suggested (and there are, to be sure, opposing views) that the participation of an unregistered broker/dealer in the placement might involve legal responsibilities and consequences imposed on Newco as the issuer of the securities in question by virtue of, e.g., Section 29(b) of the Exchange Act. We are also cognizant of the various proposals to the SEC that this issue be clarified by the promulgation of rules on the subject ... but such clarification has not yet been published. In view of the lack of authority on this issue, we express no opinion on the likely outcome of any controversy involving Newco and the provisions of the '33 and '34 Acts, and/or State securities law, including but not limited to a challenge to the status of the transaction as a private offering exempt from registration under Section 5 of the Securities Act of 1933. We call the issue to your attention and will be happy to discuss it further with you."

Is this enough? Will it adequately clue the client in that the firm may not issue an opinion on the exempt status of the offering ... which may scare off investors? Stay tuned ... particularly to the *Forums* portal on www.vcexperts.com. Let's have your views.

[8] See e.g., "Finder's Keepers," VC Experts *Buzz of the Week* (9/30/2000); www.vcexperts.com.

[9] 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).

[10] On this point, Sam Shafner of Burns & Levinson brought to our attention a 3d Circuit case, *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d. 189 (3rd Cir. 2001), cert. denied, 536 U.S. 923 (2002). I quote from Sam's memorandum:

"In it, [GFL] the court summed up many of the small number of cases which have addressed this issue and reconciled them as follows:

Although the court of appeals in *Regional Properties* rescinded the contracts therein and explicitly rejected

Dranser's narrow reading of Section 29(b), its opinion is nevertheless consistent with the outcomes in *Drasner, Slomiak, and Zerman* were "collateral or tangential to the contract between the parties," whereas the violation alleged in *Regional Properties* was "inseparable from the performance of the contract; the plaintiffs were attempting to avoid." ... The parties could - and did - perform the contracts at issue in *Drasner, Slomiak and Zerman* without committing any violations of the Exchange Act, but the broker in *Regional Properties* could not carry out his obligations under the agreements without violating the Exchange Act, for performance of the agreements entailed selling partnership interests, which the broker lawfully could not do due to his failure to register as a broker-dealer ...

272 F.3d at 202.

With respect to the case before it, the Third Circuit ruled:

In the end, *GFL's* alleged unlawful activity (*i.e.* the National Medical and EquiMed notes) or *GFL's* performance thereunder? Therefore, we conclude that the notes were neither made nor performed in violation of any federal securities laws as is required for rescission under Section 29(b).

Id. Sam indicates that an important Bankruptcy Court case in Massachusetts followed the reasoning of the 3rd Circuit that issues "collateral or tangential" to the agreement with the agent would not expose the issuer to liability.

[11] To quote at some length from the Report, p. 6, on this subject:

"The SEC recently addressed the unregistered broker-dealer issue in its revisions to the rules on accountant's independence under Section 201 of the Sarbanes Oxley Act of 2002. 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.

"More importantly for the purposes of the Report is the pronouncement, buried in FN 82 of Release 33-8183 which 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 purchasers 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" (Emphasis added.)

'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.'" (Emphasis added.)

[12] The Report, as indicated covers both placement agents and advisers in M&A transactions ... financial intermediaries. Report p. 29, citing No-Action Letters:

"Registration pursuant to Section 15 of the Act of persons engaged in merger and acquisition activity has in the past often been deemed necessary where these activities involve either a distribution or an exchange of securities. Individuals who do nothing more than bring merger or acquisition-minded persons or entities together and do not participate in negotiations or settlements probably do not fit the definition of a "broker" or a "dealer" and would not be required to register. On the other hand, persons who play an integral role in negotiating and effecting mergers or acquisitions, particularly those persons who receive a commission for their efforts based on the cost of the exchange of securities, are required to register with the Commission."

It is likely, in my view, the SEC will attempt further to define the dividing lines between placement agents and business adviser/brokers. See a September 12, 2005, letter from certain members of the Task Force, Ms. Colish and Messrs. Yadley and Niesar to the SEC's Advisory Committee on Smaller Public Companies. I quote from that letter:

"The Special Problem of Merger and Acquisition Transactions. We believe that it is not practical to advocate an exemption from the broker-dealer laws for PPBDs where the activity engaged in is funding. Indeed, we believe that very convincing arguments can be advanced that some level of registration and oversight is useful for any activity in the area of brokering securities on behalf of issuers, even if limited to accredited investors. On the other hand, the development of an exemption from the licensing requirements for persons or transactions involved in the "sale of a business" might very well be a more logical approach than an NASD membership allocation."

[13] Of interest is the legend the U.K. law firms include in their routine correspondence:

"Although not regulated by the Financial Services Authority [XYZ] LLP can provide services relating to investments which are limited to those incidental to its legal services or excluded from regulation under the Financial Services and Markets Act 2000."

[14] International Business Exchange Corporation, SEC No-Action Letter (Dec.12, 1986).

[15] The most recent indication of SEC Staff tightening is the denial, June 29, 2006, of the No-Action request forwarded by Attorney William Dellicato on behalf of John W. Loofbourrow Associates. Dellicato identified his client, a non NASD member, which had referred a client to an NASD member, for private placement of securities. He argued (unsuccessfully) that:

"Loofbourrow [the member] would like to pay Eagle [the non-member] a finders or referral fee in consideration of the introduction of Hometown as a client. The fee paid to Eagle by Loofbourrow would be a commission-like arrangement tied to the ultimate size of the amount of the securities offered, if and when Loofbourrow successfully places the securities ... Eagle would not be involved in the structuring or placement of these securities and its role would be limited to the introduction of the parties. Further, it would not be involved in any negotiations and would not discuss details regarding the transaction or make any investment recommendations. Eagle would not offer or sell any securities or solicit any offers to buy any securities and would not handle the funds or securities of any other party. ... Section 3(a)(4)(A) of the Exchange Act defines a "broker" as a

person : "engaging in the business of effecting transactions in securities for the account of others." Section 15(a) of the Exchange Act generally requires broker-dealers to register with the Commission. The NASD, in the past, has deferred to the Commission as to when an entity is required to be registered as a broker/dealer.

"The Staff has stated I a number of no-action letters that transaction-based compensation (commissions) represents one of the hallmarks of being a broker-dealer. The underlying concern has been that transaction-based compensation represents a potential incentive for abusive sales practices that registration is intended to regulate and prevent.

"However, in this instance it is respectfully submitted that the proposed payment of transaction-based compensation to Eagle lacks the traditional concerns. Eagle's proposed role is very limited and the potential for abusive sales practices is *de minimis*."