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SPECIAL FEATURE

Finding the law of finders proves to be SEC mystery

By Stephen M. Honig

I find it rare when an important legal issue remains unresolved after 30 years. Regulation of the so-called "finder" is such an issue. It now is refocused following an April meeting between an American Bar Association task force and the Securities and Exchange Commission.

Finders: the early years

Intermediaries in raising capital long have been a reality in our financial markets. When registration of broker/dealers became required under the Securities Exchange Act of '34, it is unlikely that such intermediaries were a target.

But the Exchange Act contained an inclusive definition of a broker: a person in the business of effecting securities transactions for the account of others. The definition contains only three moving parts: Is it a business? Does it effect securities transactions? Is it for the account of others?

For decades, no finder worried about broker/dealer registration. Numerous transactions involving finders closed in the 1960s. Everyone knew who they were. These individuals were "in the business" and regularly financed emerging businesses. They were compensated with a percentage of the proceeds and shares in the entity.

By the next decade, regulators began focusing on finders, although regulatory response was unclear. While the Blue Sky regulators automatically demanded that anyone serving as an intermediary for capital formation had to register, enforcement was nil. SEC regulation was inconsistent.

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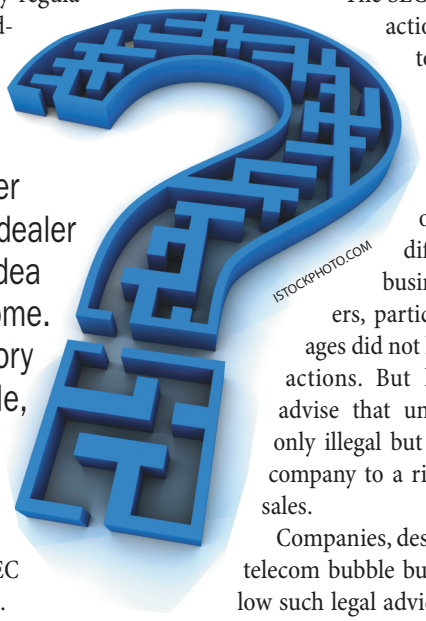

In 1985, the SEC granted no action relief to Dominion Resources even though it designed securities, provided financial advice, negotiated the transaction and produced investors.

In 1999, singer Paul Anka similarly received no action treatment even though he obtained a 10 percent finder's fee in introducing potential investors to a hockey team. Although his participation was limited (no part in negotiations, sole instance as finder), the finder community latched onto that decision (perhaps because of the famous name involved) and asserted that unregistered finders were permissible regardless of details.

Around that time, the standard "approach" was to engage the finder as a "consultant" to structure the investment, value the securities and prepare offering materials. Almost inevitably, finders then would introduce potential investors and seek a commission.

The SEC staff continued to receive no action requests, which caused it to focus more analytically, and in March 2000, the staff withdrew the Dominion Resources no action letter.

The year 2001 was a time of market turmoil, and it was difficult to finance deals. The business community needed finders, particularly because large brokerages did not have interest in smaller transactions. But lawyers were beginning to advise that unregistered finders were not only illegal but also would open the issuing company to a risk of recission of their stock sales.

Companies, desperate for financing after the telecom bubble burst, were not inclined to follow such legal advice. The fact that many transactions were being effected by unregistered finders, without regulatory intervention, did not make easier the task of corporate counsel in giving this advice to issuer companies.

Given pressures in the marketplace, an ABA task force in July 2002 proposed "Form 1010-EZ-Private Placement Broker/Dealer" for registering finders with less disclosure than regular broker/dealer registration, an approach that came to be known as "broker/dealer lite." The proposal was not enthusiastically embraced by regulators.

Undaunted, the ABA in June 2005 issued its "Report and Recommendations of the Taskforce on Private Placement Broker/Dealers." The report concluded that the expensive registration provisions and regulatory scheme required of regular

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broker/dealers were not necessary in regulating finders.

Recognizing the importance of finders in capital formation, the report recommended a simplified system of registration for private placement broker/dealers (defined as PPBDs) while recognizing that they "will be permitted to engage in only very limited activities."

Form 1010-EZ, in hindsight, wasn't all that easy. Filed with the NASD District Office (FINRA's predecessor), its exhibits were substantial: signed and notarized broker/dealer form, fingerprints, financial statement, P&L projection, supervisory procedures, anti-money laundering procedures, continuing education plan and business continuity plan.

PPBDs could not participate in public offerings; would offer only to accredited investors; could not handle funds or securities; could work only on best efforts; could participate only when an escrow agent held funds until closing; and could not engage in trading activities.

Principals and representatives would have to complete NASD examinations. Recordkeeping, capital and continuing education requirements would be reduced for PPBDs, but PPBDs would file annual statements with NASD and applicable states.

SEC position

At first the proposal gained traction. The SEC's Advisory Committee on Small Business Capital Formation "supported the concept" of a modified regulatory scheme, and in November 2005, the SEC staff indicated it was contemplating an interpretative release loosening finder regulation.

On SEC request, the ABA task force drafted amendments to net capital rules that would address finder registration.

The NASD did not embrace the idea, noting that the small size of finders and their lower membership fees would be insufficient to finance NASD regulatory requirements. State regulators suggested that PPBDs be regulated by the states. The initiative died.

In 2008, the SEC posted (and maintains to this day) on its website a restrictive "Guide to Broker/Dealer Registration." Noting the necessity for registration is not always clear, the guide states that "finders" and "business brokers" may well be securities brokers if they, inter alia, find investors for companies; make referrals to broker/dealers who find investors; find investors for issuers even "in a 'single consultant' capacity"; find venture capital or "angel" investors; find buyers or sellers for businesses.

How, according to the SEC, can you know whether you must register? You "may" need to register (how is that for definitive advice?) if you: participate in important parts of the transaction including solicitation, negotiation or execution; receive compensation that depends on or is "related to" the outcome or size of the transaction; receive any other transaction-related compensation; otherwise engage in the business of facilitating securities transactions; or handle securities or funds.

Sporadic litigation and SEC sanctions in finder cases have continued to this day and constitute a caution against complacency. SEC regulation of finders also was asserted in PIPE offerings; the SEC classified certain PIPE intermediaries as broker/dealers, even where investors were hedge funds quite able to protect themselves.

2012 ABA task force

Since markets continue to need intermediaries to unblock funds in light of a difficult capital formation environment, the ABA has again put its oar in the water.

In March, the ABA Taskforce on Private Placement Brokers again promulgated a "broker/dealer lite" solution. The current suggestion would exempt from federal registration any "securities intermediaries" (SIs) registered with the states.

The proposal is solely focused on capital formation, as the task force understands that there may be legislation that will address M&A brokers.

The exemption would apply to parties that introduce investors either to the issuer or to registered brokers, or conduct due diligence, or structure a transaction, or recommend or negotiate, even if they receive transaction-based compensation. The proposal anticipates registration both of the entity and of the operating individuals.

The task force punts on the types of transactions effected by SIs. It asks whether there should be an aggregate dollar limitation, relating this inquiry to the issue of what it means to be "engaged in the business of" brokerage. It also asks whether there should be a size limit per transaction, such as the threshold that triggers Hart-Scott Rodino review (presently $68.2 million).

Since SIs will hold neither money nor securities, the report finds no need for any net capital requirements. It leaves open the questions of a fidelity bond, submitting periodic reports to state regulators, and the need for uniform examinations.

The ABA is clear that "bad boys" cannot be SIs: people with criminal convictions, or parties to certain securities or fraud litigation or to certain court actions or regulatory orders. These disqualifications also are compelled by Section 926 of the Dodd-Frank Act, which charges the SEC with adopting rules to keep "bad actors" out of the securities markets.

There was a meeting between the task force and SEC staff on April 26; information is sparse, but (per the ABA) there is indication that the SEC "might be receptive to ... [the] proposal for a federal exemption for finders, conditioned on a state registration regime," even allowing state registered finders to be compensated by FINRA members.

The ABA report is couched in rhetoric from the JOBS Act, promoting securities deregulation to assist capital formation and job creation.

An April reiteration by the task force expands on the March report and concludes that there should be no limitation on the number of registered agents an SI may employ.

On the issue of maximum size of offering, the ABA goes for broke, suggesting that an "emerging growth company," as defined in the JOBS Act might be a proper criterion; under the JOBS Act, an emerging growth company has annual revenues below $1 billion, so in effect the ABA is recommending no limit on the size of SI transactions.

Conclusion

It may be that finder relief from broker/dealer compliance is an idea whose time has come. A reduced regulatory scheme is desirable, necessary and logical.

The degree to which registration burden is truly "reduced" and made available without undo expense or delay, will determine whether any new program will bring the finder community in from the cold. NEIH