BNA

Securities Regulation & Law Report™

BROKER-DEALERS

Still Room for Finders? Courts Question SEC View of Broker Activity

BY STEPHEN M. GOODMAN

Many small to mid-size businesses are approached by ''finders'' who offer to introduce them to potential investors in exchange for a fee based on a percentage of the amount raised if the investors invest. Many of these finders operate without registering as ''brokers'' with the Securities and Exchange Commission (''SEC'' or the ''Commission''), even though the SEC takes the position that the receipt of such ''transaction-based compensation'' brings the finder within the definition of a ''broker'' under the Securities Exchange Act of 1934 (the ''Exchange Act'').[1] If someone is acting as a broker and is not registered, a violation of Section 15(a) of the Exchange Act[2] has occurred.

As interpreted by the SEC (most recently in the *Brumberg, Mackey* no-action letter[3]), if transaction-based compensation is being paid, registration is required even if virtually no other indicia of broker activity are present. Only in the very narrow circumstances described in the Commission's 1991 *Paul Anka* no-action letter[4] has the SEC staff reluctantly agreed that a finder might make investor introductions and receive transaction-based compensation without registration. In that letter, the staff indicated that the finder could not approach the potential investors directly, but could only submit to the issuer the names of potential investors ''with whom he has a preexisting personal and/or business relationship and whom he thinks may be interested.'' Further, the finder would be exempt from registration only if he, she or it ''has not previously engaged in any private or public offering of securities (other than buying and selling securities for his own account through a broker-dealer) and has not acted as a broker or finder for other private placements of securities.''

The staff has even tried to discourage reliance on the *Paul Anka* letter. In a speech at the SEC's Government-Business Forum on Small Business Capital Formation

[1] Section 3(a)(4) of the Exchange Act defines ''broker'' to mean ''any person engaged in the business of effecting transactions in securities for the account of others.'' 15 U.S.C. § 78c(a)(4)(A).

[2] Section 15(a)(1) of the Exchange Act states: ''It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.'' 15 U.S.C. § 78o(a)(1).

[3] *See* Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf. For an extensive discussion of the issues raised by this no-action letter, see Stephen M. Goodman, *Vanishing Breed: The Narrowing Opportunities for Unregistered Finders*, 42 SEC. REG. & L. REP. 1911, Oct. 11, 2010.

[4] Paul Anka, SEC No-Action Letter, 1991 LEXIS 925 at *3, 4 (July 24,1991).

Stephen M. Goodman (sgoodman@pryorcashman.com) is co-head of the Mergers and Acquisitions Practice at Pryor Cashman LLP.

 ISSN 0037-0665

held on November 20, 2008, a staff member of the SEC Division of Trading and Markets observed that:

> Ever since *Paul Anka* has come out, a lot of people in the private bar, a lot of people in the business industry, have felt that that has given some sort of coverage to allow for what is thought of as the traditional providing an introduction between investors and an issuer, and being able to receive compensation for that. The truth is, from the staff point of view, there is no progeny of *Paul Anka*, in fact, and the ways that we look at broker-dealer regulation today, I'm not even sure that we would issue the *Paul Anka* letter again. And so, [I] really don't think it's something that people out there doing transactions should be relying on. A lot of other letters that have come out where persons have asked to earn some form of transaction-based compensation and when you're talking about capital raising, there is not a lot of relief that is given.[5]

Called Into Question

However, judges are apparently not quite ready to accept the SEC's approach to unregistered finders. At least two recent court cases have called into question the SEC's presumption that if the issuer pays transaction-based compensation in connection with a securities transaction, the recipient must be a ''broker'' subject to the Exchange Act's registration requirements.

In April 2011, a Florida federal District Court judge rejected the SEC's allegation that Kenneth Kramer acted as an unregistered broker, even though Mr. Kramer expressed enthusiasm about a particular stock to a limited number of investors and received shares as compensation tied to the number of shares purchased by these individuals.[6] Thereafter, in May 2011, a Massachusetts judge refused to throw out a claim by a plaintiff consultant for payment of transaction-based compensation, even though the consultant was not registered as a broker and was to receive such compensation for finding investors.[7] The defendant, Perseus Realty Partners, claimed that its agreement to pay the plaintiff, Maiden Lane Partners, was unenforceable because Maiden Lane was acting as an unregistered broker, but the court found that there were ''genuine issues of material fact as to whether Maiden Lane acted as a 'broker' . . . or only as a 'finder'. . . .''

The *Kramer* case has been appealed to the 11th Circuit by the SEC and the *Perseus* decision will go to trial if not settled, so either or both may eventually result in a finding that the alleged broker was in fact a ''broker'' within the meaning of Sections 3(a)(4) and 15(a) of the Exchange Act. Nevertheless, the cases are noteworthy because each of the alleged brokers clearly engaged in activities which went beyond the limits enunciated by the SEC in *Paul Anka*. Therefore, it seems useful to examine both cases more closely to understand how the courts' positions may differ from those enunciated by the SEC.

SEC v. Kramer

This case was one of several resulting from sales of securities in SkyWay Communications Holding Corp., a company which filed for bankruptcy in 2005. SkyWay had gone public through a reverse merger arranged by Affiliated Holdings, Inc., a company owned by Kenneth Bruce Baker. Sometime after the reverse merger, Kramer (doing business as LCP Consultants, Inc.) entered into a ''cooperative'' agreement with Affiliated under which the parties agreed to present each other transaction and financing opportunities and to share fees.

Kramer was introduced to the President of SkyWay in mid-2003 as someone who worked for Baker. Kramer subsequently introduced SkyWay to a registered broker named Kenneth Talib. Talib raised approximately $14 million for SkyWay from sales of SkyWay shares to investors. As a result of Talib's sales, Kramer received payments from SkyWay of between $189,000 and $200,000. Kramer also invested in SkyWay himself and ''encouraged'' his friends to visit the company's website and to read its press release. He also shared his opinion that it was a good investment. Some of these friends also got their friends to invest. Kramer was asked by Baker to provide reports of purchases of SkyWay shares by these individuals and Baker (not SkyWay, according to the court) ''paid'' Kramer with shares equal to 20% of the number of shares each person bought.[8] All of the friends purchased the shares through registered brokers. By the time SkyWay filed for bankruptcy in 2005, Kramer had earned approximately $700,000 from his SkyWay shares.

In March 2009, the Commission filed a civil injunctive action against SkyWay and its principals, alleging among other things that they had orchestrated a pump-and-dump scheme of SkyWay Communications stock, including engaging in numerous fraudulent and deceptive practices.[9] The Commission also charged Baker and Kramer. The complaint does not allege that they were responsible for the fraudulent practices but stressed that they had acted as unregistered broker-dealers who found investors for SkyWay and sold SkyWay stock.

Baker apparently failed to answer the SEC complaint and on July 29, 2010, the Court entered a default judgment against him and permanently enjoined him from violating Section 15(a)(1) of the Securities Exchange Act of 1934 by acting as a broker-dealer and promoting the purchase of a security without first registering with the Commission.[10] The claim against Kramer proceeded to trial. The SEC argued that Kramer was a broker because (1) he received transaction-based compensation, (2) he was paid in connection with ''effecting transactions in securities'' by bringing together the parties to a transaction, and (3) he had ''demonstrated a

---

[5] Quoted in Hugh Makens & Shane Hansen, Presentation on Regulation Of Third Party Finders: The Illusion, The Needs, And The Prospects at the North American Securities Administrators Association's 92nd Annual Conference, Panel Three: Monitoring The Middlemen: Enhancing The Regulation Of Third Party Finders (September 14, 2009), *available at* https://jmf-law.com/uploads/Regulation_ofThird_Party_Finders_by_Makens__9-14-09_.pdf.

[6] SEC v. Kramer, 778 F. Supp. 2d 1320 (M.D. Fla. 2011). The SEC has appealed this ruling.

[7] Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P., II, LLC, 28 Mass. L. Rep 380 (Mass. Super. Ct. 2011).

[8] According to the complaint, these shares were improperly issued to Baker under a Form S-8 registration statement.

[9] SEC v. SkyWay Global LLC, et al., No. 8:09-CV-455. (M.D. Fla. filed Mar. 13, 2009).

[10] SEC v. SkyWay Global LLC, et. al, Fed. Sec. L. Rep. (CCH) ¶ 95,818, 2010 U.S. Dist. LEXIS 88616 (M.D. Fla. July 29, 2010).

  SRLR ISSN 0037-0665

regularity of participation (through the money that [he] earned and the two-years over which the conduct occurred).'' However, based on the testimony, the court apparently accepted Kramer's argument that he had not had an active role in any negotiations between SkyWay and Talib nor had he promoted the stock of SkyWay to his friends and family other than to say that it was ''a good company'' and to encourage them to visit the website and read the company's press releases.

In rejecting the Commission's arguments, the court stated, ''The distinction between a finder and a broker . . . remains largely unexplored, and both the case law and the Commission's informal, ''no-action'' letter advice is highly dependent upon the facts of a particular arrangement.'' When the Commission attempted to use the *Brumberg, Mackey* letter to bolster its case, the court responded:

> . . . the Commission's proposed single-factor 'transaction-based compensation' test for broker activity (i.e., a person 'engaged in the business of effecting transactions in securities for the accounts of others') is an inaccurate statement of the law both in 2003 and in 2011. As this order exhaustively explains, an array of factors determine the presence of broker activity. In the absence of a statutory definition enunciating otherwise, the test for broker activity must remain cogent, multi-faceted, and controlled by the Exchange Act.

As noted above, the SEC has appealed. In the brief supporting its appeal, the Commission continues to assert that compensation standing alone is sufficient to show broker activity. For example, the brief points to three findings of fact as demonstrating that Kramer qualified as a ''broker'': solicitation of investors, receipt of transaction-based compensation based on sales to those investors and the amount received. However, the brief then states, ''[e]ach of these three findings corresponds to a factor that, *even viewed separately*, courts and the Commission have found to be *strongly indicative* of 'broker' conduct.''[11] To add to the confusion, while asserting that the Commission had not proposed a single-factor test, the brief refers to the *Brumberg, Mackey* letter for the proposition that 'any person receiving transaction-based compensation in connection with another person's purchase or sale of securities *typically* must register as a broker-dealer'',[12] asserting that this position has been ''universally accepted by courts''. Thus, the SEC continues to adhere to the view that where transaction based compensation is received, registration is required.

Maiden Lane Partners v. Perseus Realty Partners

This case (before the Supreme Judicial Court of Suffolk County, Massachusetts) involves a more typical dispute between a finder and an issuer, in which the finder claims to have successfully raised money for an issuer and the issuer has then refused to pay an agreed-upon fee. According to the court, Maiden Lane Partners executed an agreement in November 2007 ''to assist Perseus Realty Partners in identifying potential investors for the capital fundraising [sic] campaign of PRP II, L.P.'' In April 2008, two benefit plans for the Knights of Columbus invested a total of $20,000,000 in PRP II, L.P. The court found that Perseus had not had direct contact with the representatives of the investors, but that communications had been channeled through Maiden Lane and a consultant hired by them.

Nevertheless, Perseus eventually refused to pay any fee to Maiden Lane for the investment, in part on the grounds that the funding was the result of the efforts of Perseus's own personnel. Maiden Lane then filed suit for breach of the contract. Perseus counterclaimed, alleging among other things that Maiden Lane had acted as an unlicensed broker-dealer in violation of Section 15(b) of the Exchange Act and therefore the contract was unenforceable under Section 29(b) of the Exchange Act. Perseus then moved for summary judgment, claiming that rescission of the unenforceable contract would dispose of all of Maiden Lane's claims.

The Massachusetts court, like the court in *Kramer*, rejected the idea that the receipt of transaction-based compensation in connection with a securities transaction automatically rendered the recipient a ''broker''. Citing *Kramer*, the court stated that ''[a]lthough one of the hallmarks of being a broker is receiving transaction-based compensation, . . . this is by no means dispositive.'' It went on to quote from several other federal cases to the effect that, if there is no involvement in negotiating the price or any of the other terms, '' 'merely bringing together the parties to transactions, even those involving the purchase and sale of securities, is not enough' to warrant broker registration under Section 15(a).''[13] The court continued, ''. . . [t]he evidence must also show involvement at 'key points in the chain of distribution,' such as participating in the negotiation, analyzing the issuer's financial needs, discussing the details of the transaction, and recommending an investment.''[14]

According to the court,

> It is undisputed that Maiden Lane's commission was to be based on the successful completion of a transaction under the Consulting Agreement. It is unclear, however, whether Maiden Lane analyzed Perseus' needs (or that of other clients), ''recommended'' Perseus or any of its other clients to investors, was involved in ''key points in the chain of distribution,'' or was involved in negotiating any transactions. The court therefore cannot resolve the issue of whether Maiden Lane's activities amounted to those of a broker. That determination will involve assessments of credibility as well as the development of a full record.

The court thus refused to grant Perseus' summary judgment motion on the grounds that there were genuine issues of material fact as to whether Maiden Lane acted as a broker or only as a finder.

Conclusion

While neither of these decisions is definitive, each of them emphasizes that determining whether someone has acted as a broker is highly dependent on the nature of their overall activities, even when transaction-based

[11] SEC v. Kramer et al., No. 11-12510-DD (11th Cir. 2011), Opening Br. of the SEC, Appellant, 23. (Emphasis added.)

[12] Id. at 29. (Emphasis in original.)

[13] The court cited Apex Global Partners, Inc. v. Kaye/Bassman Intern. Corp., Fed. Sec. L. Rep. (CCH) ¶ 95,346, 2009 U.S. Dist. LEXIS 77679 (N.D. Tex. Aug. 31, 2009).

[14] The court cited Cornhusker Energy Lexington, LLC v. Prospect St. Ventures, Fed. Sec. L. Rep. (CCH) ¶ 93,974, 2006 U.S. Dist LEXIS 68959 at *19 (D. Neb. Sept. 12, 2006).

compensation was involved and even when the alleged broker may have been active in more than one transaction.[15] In short, the decisions reject the SEC's apparent view that one cannot accept transaction-based compensation in connection with a securities transaction without first registering as a broker under the Exchange Act.

In light of *Kramer* and *Maiden Lane*, it is possible to imagine that the outcome in *Brumberg*, *Mackey* might have been different if the SEC had sought to enforce its broker registration requirements against the finders in a civil action before a court. Not only do the cases seem to reinvigorate *Paul Anka*, but they render plausible the argument that a finder can be ''in the business'' of introducing investors to issuers without registering as a broker so long as the finder's contacts with investors are strictly limited to making introductions and the finder has no role in any communications with investors which might be interpreted as promoting a specific offering or security.[16]

Although finders must continue to beware that the SEC's attitudes toward enforcement have not softened, it does appear that courts may be more willing than the SEC to tolerate this pre-*Brumberg*, *Mackey* paradigm. As one blogger has put it, ''the definition of a ''broker'' is an important one, and further judicial explication would be welcome.''[17]

---

[15] The level of activity engaged in by both Kramer and Maiden Lane clearly exceeded one of the criteria cited by the SEC in the *Paul Anka* letter in finding that Mr. Anka was a finder, namely, that Mr. Anka ''has not previously engaged in any private or public offering of securities (other than buying and selling securities for his own account through a broker-dealer) and has not acted as a broker or finder for other private placements of securities.'' Yet neither court referred to this issue in its analysis.

[16] The foregoing analysis does not address whether state securities laws may require registration of a finder even if the finder is not deemed to be a broker. *See, e.g.*, Mich. Comp. Laws Sec. 451.502 (2006); 7 Tex. Admin. Code Secs. 115.1, 115.3, and 115.11. Also, a finder should probably counsel its issuer-clients to disclose to investors that fees may be payable from the proceeds to a finder who is not registered as a broker. This should help avoid the finder becoming embroiled in investor claims that the issuer failed to disclose a material fact regarding the use of proceeds.

[17] Securities Law Prof Blog, ''SEC Seeks Judicial Review of the Definition of a Broker'', August 30, 2011 at http://lawprofessors.typepad.com/securities/2011/08/sec-seeks-judicial-review-of-the-definition-of-a-broker.html.

  SRLR ISSN 0037-0665