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Client Alert

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"Finders" and the "Issuer's Exemption": The SEC Sheds New Light on an Old Subject

Recent enforcement actions by the Securities and Exchange Commission (SEC) and a speech by a senior SEC staff member have shed new light on the use of so-called "finders" who seek to assist companies and private fund managers in capital raising activities, as well as the use of the issuer's exemption by private fund managers.

On April 5, 2013, David Blass, Chief Counsel of the SEC's Division of Trading and Markets, addressed the potential application of the broker-dealer registration requirements under Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act) in the context of fund raising activities and other services for private funds.[1] Blass indicated that in connection with its examinations of newly-registered private fund advisers, the SEC staff has observed that (i) certain private fund advisers are paying transaction-based compensation to their personnel for selling interests in a fund and (ii) private fund advisers, their personnel and/or their affiliates are receiving transaction-based compensation "for purported investment banking or other broker activities relating to one or more of the fund's portfolio companies."[2] Reiterating that the SEC and the SEC staff have consistently viewed transaction-based compensation as the "hallmark" of broker-dealer activity, Blass cautioned that the receipt of transaction-based compensation coupled with the types of activities being performed may trigger the requirement to register with the SEC as broker-dealers under the Exchange Act.

> "…there are serious consequences for acting as an unregistered broker-dealer, even absent allegations of fraud or other misconduct."

Blass's remarks follow recent SEC enforcement actions against William M. Stephens (Stephens), Donald W. Phillips (Phillips) and Ranieri Partners LLC (Ranieri Partners).[3] In the settlement order related to the action against Stephens, the SEC claimed that Stephens violated Section 15(a) of the Exchange Act by actively soliciting investors for two private funds (the Funds) managed by Ranieri Partners in return for transaction-based compensation, despite not being registered as a broker-dealer or associated with a registered broker-dealer. The SEC also alleged that (i) Ranieri Partners caused Stephens' violations by failing to adequately oversee his activities, and (ii) Ranieri Partners' former managing partner, Phillips, aided and abetted Stephens' violations by failing to sufficiently limit Stephens' activities.

Neogenix Oncology Inc.'s (Neogenix) mid-2012 bankruptcy offers another recent, and drastic example. The bankruptcy followed an SEC inquiry into the use by Neogenix of finders in connection with its capital raising efforts.

As detailed below, these recent SEC actions have placed the contours and consequences of paying transaction-based compensation to finders that are not registered as brokers in stark relief. While Blass indicated a willingness to consider exemptive relief for certain limited broker activities at some point in the future, it is clear that private fund managers, early stage companies and others who may be involved in capital raising activities must carefully structure their arrangements to comply with applicable regulatory requirements as they exist today.

Regulatory Framework

Section 15(a) of the Exchange Act requires that persons engaged in broker or dealer activity must register with the SEC pursuant to Section 15(b) of the Exchange Act unless an applicable exemption is available.[4] In general, a "broker" is any person "engaged in the business of effecting transactions in securities for the account of others" and a "dealer" is any person "engaged in the business of buying and selling securities for such person's own account."[5] Although the Exchange Act and the rules promulgated thereunder do not specifically define "effecting transactions" or "engaged in the business," the SEC and the SEC staff have taken a very expansive view of the scope of those terms. Based on no-action guidance from the SEC staff, activities that may be deemed (alone or in combination) to confer "broker" status include, among other things:

- Soliciting investors to enter into securities transactions;
- Assisting issuers in structuring prospective securities transactions or helping issuers to identify potential purchasers of securities;
- Participating in the negotiating process or otherwise bringing buyers and sellers of securities together; and
- Receiving compensation contingent on the success of a securities transaction or based on the amount or value of a securities transaction.[6]

Activities that have been identified (alone or in combination) by the SEC staff as indicators of "dealer" status include, among other things:

- Participating in a selling group, underwriting securities or purchasing or selling securities as principal from or to customers rather than from or to only brokers or dealers;
- Carrying a dealer inventory (positions intended to be used directly or indirectly to trade with customers) or holding oneself out as a dealer or market-maker or as otherwise willing to buy or sell particular securities on a continuous basis;
- Obtaining a regular clientele of customers, issuing or originating securities or rendering incidental investment advice to others; and
- Engaging in trading transactions for the benefit of others (including for an affiliate or for an affiliate's customers), rather than consistently with one's own judgment and investment and liquidity objectives.[7]

In the early 1990s, the SEC staff granted no-action relief to an individual whose involvement in securities transactions was limited to one instance of providing a list of names and telephone numbers of potential investors and receiving a success fee for doing so.[8] This no-action position gave rise to the notion that a so-called "finder's exemption" exists in the law and lore under the Exchange Act. Nonetheless, despite this very limited fact pattern, the SEC staff has subsequently indicated its

disapproval of this no-action position, and has in fact stated that even one instance of transaction-based compensation may be enough for a finding that a person was "engaged in the business" of broker activity, and thus subject to registration.[9] Notably, while the SEC staff has taken an extremely expansive view of the concept of being "engaged in the business," some courts have been more lenient in this regard, finding that something more than just transaction-based compensation is necessary to require broker registration.[10] In any event, we believe that the SEC staff would view the role of an unregistered finder to be extremely limited, if not entirely untenable as a practical matter.

Recent Enforcement Actions

As mentioned above, the enforcement actions in Stephens, Ranieri Partners, and Phillips stemmed from Ranieri Partners' capital raising efforts for their Funds. Phillips was a senior managing partner of Ranieri Partners and caused an affiliate of Ranieri Partners to retain Stephens as an "independent consultant" to find potential investors for the Funds.[11] Ranieri Partners agreed to pay Stephens a fee equal to one percent of all capital commitments made to the Funds by investors introduced by Stephens.[12]

Phillips was a long-time friend of Stephens and was "generally aware" that Stephens had a prior disciplinary history with the SEC. In fact, Stephens had been previously barred from the securities industry.[13] According to Phillips, he specifically informed Stephens that Stephens' activities on behalf of Ranieri Partners would be limited to simply contacting potential investors to arrange meetings for the principals of Ranieri Partners and that Stephens was not permitted to provide private placement memoranda directly to potential investors or to contact investors directly to discuss the merits or strategies of the Funds.[14] Nevertheless, the SEC found that, in fact, Phillips did very little to limit Stephens' activities and that Stephens actively solicited investors on behalf of the Funds.[15]

As a result of these activities, the SEC concluded that Stephens violated Section 15(a) of the Exchange Act by failing to register as a broker or dealer or as an associated person of a broker or dealer.[16] The SEC also found that Ranieri Partners caused Stephens' violations of Section 15(a) of the Exchange Act because it failed to adequately oversee Stephens' activities.[17] Similarly, the SEC concluded that Phillips willfully aided and abetted Stephens' violations of Section 15(a) of the Exchange Act by failing to limit Stephens' activities, despite knowing that Stephens was to have a limited role in introducing potential investors.[18]

As part of the settlement, Stephens agreed to be permanently barred from the securities industry and to pay disgorgement and pre-judgment interest in excess of $2.8 million.[19] Ranieri Partners agreed to a civil money penalty of $375,000 and to cease and desist from causing any violations or future violations of Section 15(a) of the Exchange Act.[20] Phillips also submitted to a cease and desist order and agreed to a $75,000 civil penalty as well as a nine-month suspension from acting in a supervisory capacity in the securities industry.[21]

Consequences of Failing to Register as a Broker-Dealer

In discussing the SEC's settlements with Stephens, Ranieri Partners and Phillips, Blass emphasized that there are serious consequences for acting as an unregistered broker-dealer, even absent allegations of fraud or other misconduct.[22] Using unregistered broker-dealers to help raise capital may expose private fund managers, companies and their principals to enforcement actions, as demonstrated in these cases. In addition, there are other serious consequences of such actions. Section 29(b) of the Exchange Act provides that contracts made in violation of the Exchange Act shall be void in respect of the "rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract." Thus, if a sale of securities is effected through an unregistered broker-dealer, investors may have the right to rescind their purchases.

Providing a potential "put" right to investors can have dire consequences. For example, Neogenix, a biotechnology firm mentioned above, went public in 2010. In late 2011, Neogenix revealed that an inquiry by the SEC in connection with its periodic filings had uncovered that it had employed finders in its late stage capital raising efforts and that such persons were not registered under the Exchange Act as brokers.[23] As a result, Neogenix concluded that some of its investors may have the potential right to rescind their investments. These potential rescission rights, in turn, caused uncertainty regarding the accounting treatment of the company's liabilities and prevented Neogenix from obtaining an audit opinion on the company's financial statements. Ultimately, this uncertainty restricted Neogenix's ability to raise additional capital and the company declared bankruptcy in July 2012.

As Blass underscored in his remarks, the perils of falling within the definition of a broker or dealer under the Exchange Act are not limited to outside consultants, but can likewise apply to employees. Rule 3a4-1 under the Exchange Act (the so-called "issuer's exemption") provides that an associated person of an issuer (such as employees and directors of the issuer or its affiliates) may be exempt from the requirement to register as a broker or dealer under the Exchange Act to the extent he or she complies with the conditions outlined in the Rule. Among these conditions is the requirement that the individual not receive transaction-based compensation.[24] Accordingly, employees, such as investor relations personnel, may not qualify for the exemption to the extent they receive commissions or bonuses based on the amounts raised. It should also be noted that the exemption is only available to persons who participate in an offering of securities no more than once every 12 months, which further limits the exemption's utility for many private funds.

Conclusion

Although the relevant statutes and rules have been in place for many years, their application to private placement activities, such as for startup companies and private funds, has only recently captured the attention of the regulators. While enforcement actions may result in significant fines, they can have even greater reputational consequences. Moreover, unwittingly providing rescission rights to investors can quickly lead to the downfall of an enterprise. Accordingly, company executives and fund managers should be careful in their arrangements surrounding capital raising activities, and be particularly wary of compensation agreements that may be construed as providing transaction-based compensation to persons not properly registered as broker-dealers under the Exchange Act and applicable state securities laws.

Endnotes

[1] *See* David W. Blass, A Few Observations in the Private Fund Space (April 5, 2013), available at: http://www.sec.gov/news/speech/2013/spch040513dwg.htm (the Blass Speech).

[2] *See* the Blass Speech. Among the fees observed by the SEC staff were "fees the manager directs a portfolio company of the fund to pay directly or indirectly to the fund's adviser or one of its affiliates in connection with the acquisition or disposition (including an initial public offering) of a portfolio company or a recapitalization of the portfolio company." Such fees, according to Blass, were described as "compensating the private fund adviser or its affiliates or personnel for 'investment banking activity,' including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions."

[3] In re William M. Stephens, Order Instituting Administrative and Cease-and-Desist Proceedings, SEC Release No. 34-69090 (Mar. 8, 2013) (the Stephens Order). Stephens consented to the issuance of the order without admitting or denying the findings in the order; In re Ranieri Partners LLC and Donald W. Phillips, Order Instituting Administrative and Cease-and-Desist Proceedings, SEC Release No. 34-69091 (Mar. 8, 2013) (the Phillips Order). Phillips and Ranieri Partners consented to the issuance of the order without admitting or denying the findings in the order.

[4] *See* Section 15(a) of the Exchange Act. Although this Alert and the Blass Speech focus on the broker-dealer registration requirements of the Exchange Act, we note that broker-dealer registration is also required under the various state securities laws.

[5] *See* Sections 3(a)(4) and 3(a)(5) of the Exchange Act. A person that is a broker and/or dealer is commonly referred to as a "broker-dealer."

[6] *See, e.g.*, MuniAuction Inc., SEC No-Action Letter (available March 13, 2000); BondGlobe, Inc., SEC No-Action Letter (available February 6, 2001).

[7] *See, e.g.*, Continental Grain Company, SEC No-Action Letter (available November 6, 1987); Fairfield Trading Corp., SEC No-Action Letter (available January 10, 1988); Acqua Wellington North American Equities Fund, Ltd., SEC No-Action Letter (available July 11, 2001).

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

[9] *See* Record of Proceedings of 2008 Annual SEC Government-Business Forum on Small Business Capital Formation (Nov. 20, 2008); Brumberg, Mackey & Wall, SEC No-Action Letter (available May 17, 2010) (reiterating that the receipt of transaction-based compensation is the hallmark of broker-dealer activity).

[10] *See SEC v. Kramer*, 778 F. Supp. 2nd 1320 (M.D. Fla. 2011); *see also SEC v. Benger*, in the U.S. District Court for the Northern District of Illinois, No. 09 C 676, Memorandum Opinion and Order (Mar. 28, 2013) (rejecting the SEC's argument that anyone who facilitates any transaction in securities through conduct in the United States must register as a broker under Section 15(a) of the Exchange Act, even if the transaction did not involve the domestic sale of stock); *but cf.* In re Ambit Capital Pvt. Ltd., Order Instituting Administrative Proceedings, SEC Release No. 34-68295 (Nov. 27, 2012), In re Motilal Oswal Securities Limited, Order Instituting Administrative Proceedings, SEC Release No. 34-68296 (Nov. 27, 2012), In re JM Financial Institutional Securities Private Limited, Order Instituting Administrative Proceedings, SEC Release No. 34-68297 (Nov. 27, 2012), and In re Edelweiss Financial Services Limited, Order Instituting Administrative Proceedings, SEC Release No. 34-68298 (Nov. 27, 2012) (charging four financial services firms based in India for providing brokerage services to institutional investors in the United States without being registered with the SEC).

[11] *See* the Phillips Order at 3.

[12] *See* the Phillips Order at 3.

[13] *See* the Phillips Order at 3. In November 2002, the SEC had entered an order, based on an offer of settlement by Stephens, finding that Stephens violated certain provisions of the federal securities laws in connection with the investment of pension fund assets. At that time, Stephens agreed to a $25,000 civil penalty and to be barred from association with any investment adviser, with the right to reapply after two years (which Stephens did not do). Stephens' disciplinary history was clearly an aggravating factor in this action.

[14] *See* the Phillips Order at 3.

[15] *See* the Phillips Order at 6.

[16] *See* the Stephens Order at 6.

[17] *See* the Phillips Order at 6.

[18] *See* the Phillips Order at 6.

[19] The SEC waived those monetary penalties based on Stephens' sworn statement of his inability to pay disgorgement plus prejudgment interest or a civil penalty. *See* the Stephens Order at 6-7.

[20] *See* the Phillips Order at 7.

[21] *See* the Phillips Order at 7-8.

[22] *See* the Blass Speech.

[23] *See* Neogenix Letter to Shareholders (available Nov. 23, 2011).

[24] In addition, employees seeking to utilize the Rule 3a4-1 exemption must also generally perform substantial duties for or on behalf of the issuer otherwise than in connection with transactions in securities.

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