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Finders and Unregistered Broker-Dealers: Understanding the Risks and Recent Developments

Avoiding the Pitfalls of Broker-Dealer Registration Violations, Lessons From SEC Enforcement Actions and SEC Guidance

TUESDAY, JUNE 22, 2021

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Finders and Unregistered Broker-Dealers: Understanding the Risks and Recent Developments Avoiding the Pitfalls of Broker-Dealer Registration Violations, Lessons From Recent SEC Enforcement Actions and FINRA Guidance

Presented by:

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June 22, 2021 1 p.m. EDT

Federal Securities Laws Applicable To Registration Requirements for Broker-Dealers

THE SECURITIES EXCHANGE ACT OF 1934

Section 15(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") requires any broker or dealer that makes 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) to register with the U.S. Securities and Exchange Commission ("SEC").

WHAT IS A FINDER?

The federal securities laws have no formal definition of a finder

Generally understood to be a person (corporate entity or individual) who identifies investors for a capital raising transaction or potential targets for a business combination – and are understood not to require registration.

Also understood to be a category of intermediary who is not required to register as a broker or dealer.

WHAT IS A BROKER?

Section 3(a)(4) of the Exchange Act defines a “broker” broadly as “any person engaged in the business of effecting transactions in securities for the accounts of others.”

- The Exchange, however, does not define “engaged in the business of” or “effecting transactions.”
- The courts and SEC have often looked to whether the person participates on a regular basis in securities transactions at key points in the chain of distribution and have identified certain activities as indicators of broker status, including:
  - Actively soliciting or recruiting investors;
  - Participating in negotiations between the issuer and the investor;
  - Advising investors as to the merits of an investment or opining on its merits;
  - Handling customer funds and securities;
  - Having a history of selling securities of other issuers; and
  - Receiving commissions, transaction-based compensation or payment other than a salary for selling the investments.

WHAT IS A BROKER?

- FINRA has also determined that participating in the order-taking or order-routing process is also a broker activity.
- A person who identifies and “solicits” potential investors for an issuer or other party could be viewed as a broker.
- “Solicitation” viewed as any affirmative effort intended to induce a securities transaction, including, but not limited to:
  - Telephone calls;
  - Mailings;
  - Advertising (online or in print); and
  - Conducting investment seminars.

WHAT IS A DEALER?

Section 3(a)(5)(A) of the Exchange Act defines a “dealer ” generally as “any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise. ” The term “dealer ” expressly excludes “a person that buys or sells securities for such person’s own account, ... but not as part of a regular business.”

A dealer is a person who both buys and sells securities or is willing to both buy and sell contemporaneously. This is distinguished from a “broker” who participates in securities transactions for the accounts of others, which can be either a purchase or sale at key points in the chain of distribution.

WHAT IS A DEALER?

Factors that indicate a person is acting as a dealer include:

- issuing or originating securities;
- having a regular clientele;
- advertising or otherwise holding itself out as buying or selling securities on a continuous basis or at a regular place of business;
- actively soliciting clients;
- having a regular turnover of inventory (or participating in the sale or distribution of new issues, such as by acting as an underwriter);
- acting as a market maker or specialist on an organized exchange or trading system;
- generally transacting a substantial portion of its business with investors (or, in the case of a dealer who is a market maker, other professionals);
- generally providing liquidity services in transactions with investors (or, in the case of a dealer who is a market maker, for other professionals);
- buying and selling as principal directly from or to securities customers together with conducting any of an assortment of professional market activities such as providing investment advice extending credit and lending securities in connection with transactions in securities, and carrying a securities account;
- using an interdealer broker (other than a retail screen broker) to effect securities transactions; and
- running a matched book of repurchase and reverse repurchase agreements.

WHAT IS A FINDER?

According to the SEC staff (Guide to Broker-Dealer Registration), finders engaged in the following activities may need to register as a broker, depending on a number of factors:

- Finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers, investment companies or other securities intermediaries;
- Finding investment banking clients for registered broker-dealers;
- Finding investors for “issuers”, even in a “consultant” capacity;
- Engaging in, or finding investors for, venture capital or “angel” financings, including private placements; and
- Finding buyers and sellers of businesses (i.e., activities relating to mergers and acquisitions where securities are involved).

WHAT IS A FINDER?

Classic Finder Paul Anka SEC No-Action Letter (July 1991)

- One of the first SEC no-action letters on the subject.
- The Ottawa Senators Hockey Club, a Canadian hockey team retained the entertainer Paul Anka (*Having My Baby*) to act as a finder for purchasers of limited partnership units issued by the hockey club.
- Anka had agreed to purchase units and would receive a fee related to additional units he purchased.
- Anka had agreed to purchase units and would receive a fee related to additional units he purchased.
- Conditions included that Paul Anka:
  - Would provide a list of potential investors, who he reasonably believed were accredited investors, to the issuer;
  - Directors, officers or employees of the team would contact potential investors and could indicate that their names were provided by Mr. Anka;
  - Would not participate in any advertisement, endorsement or general solicitation, would not participate in the preparation of any materials (including financial data or sales literature), perform any independent analysis, engage in due diligence, assist in or provide any financing, provide advice regarding valuation or make any recommendation regarding the investment;
  - Would be paid a finder's fee equal to 10% of any sales traceable to the names he offered and which would be disclosed to investors; and
  - Would only participate in a single transaction.

SEC'S 2020 Proposed Conditional Exemption For Finders

CONTENT OF THE PROPOSAL

- On October 7, 2020, the U.S. Securities and Exchange Commission ("SEC") proposed a conditional exemption for Finders
- Would operate as a nonexclusive safe harbor from the broker registration requirements of Section 15(a) of the Securities Exchange Act
- Would permit natural persons to engage in certain limited activities on behalf of issuers in connection with private placement offerings ("Finders")
- Comment period expired November 12, 2020
- SEC received 96 comment letters overwhelmingly critical of the proposal, including from state regulators

THE SEC PROPOSAL – EXTENSIVE MATERIALS AND SHORT COMMENT PERIOD

- Open Meeting conducted by audio webcast
- **Proposing release: U.S. SEC. & EXCH. COMM'N, NOTICE OF PROPOSED EXEMPTIVE ORDER GRANTING CONDITIONAL EXEMPTION FROM THE BROKER REGISTRATION REQUIREMENTS OF SECTION 15(A) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR CERTAIN ACTIVITIES OF FINDERS, RELEASE NO. 34-90112; FILE NO. S7-13-20 (Oct. 7, 2020)**
- In support:
  - Statement of Chairman Jay Clayton
  - Public Statement of Commissioner Hester M. Peirce
  - Public Statement of Commissioner Elad L. Roisman
- Dissent:
  - Public Statement of Commissioner Allison Herren Lee, Regulating in the Dark: What We Don't Know About Finders Can Hurt Us
  - Public Statement of Commissioner Caroline A. Crenshaw
- Office of the Advocate for Small Business Capital Formation created two educational resources consisting of a video and a chart showing a comparison of some of the permissible activities, requirements and limitations for Tier I Finders, Tier II Finders, and registered brokers.

THE PROPOSED EXEMPTION

- Defines 2 categories of Finders: Tier I and Tier II
- Tier I essentially would codify the Paul Anka No-Action Letter
- The two Tiers are differentiated by the level, extent, and frequency of their activities on behalf of issuers
- Natural persons
- Finders can assist in capital raising activities on behalf of issuers in private placement transactions
- Permitted to accept transaction-based compensation;
- Must comply with conditions
- Heightened conditions for Tier II Finders

PERMITTED OFFERINGS

- Tier I and Tier II Finders may only participate in offerings that meet the following conditions:
  - The issuer is not required to file reports under Sections 13 or 15(d) of the Exchange Act;
  - The offering of securities is conducted in reliance on an applicable exemption from registration under the Securities Act such as Section 4(a)(2) or Regulation D;
  - The Finder does not engage in general solicitation;
  - Potential investors are “accredited investors” or the Finder has a reasonable belief that potential investors are “accredited investors”;
  - The Finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
  - The Finder is not an associated person of a broker-dealer; and
  - The Finder is not subject to statutory disqualification.

CONDITIONS FOR BOTH TIER I AND TIER II FINDERS

- Finders would **not** be permitted to:
  - Participate in structuring the transaction or negotiating the terms of the offering;
  - Handle customer funds or securities or bind the issuer or investor;
  - Participate in the preparation of any sales materials;
  - Perform any independent analysis of the sale;
  - Engage in any due-diligence activities;
  - Assist or provide financing for such purchases;
  - Provide advice as to the valuation or financial advisability of the investment; or
  - Participate in resales of securities.

TIER I FINDERS

- Provide only contact information of potential investors
- Single capital raising transaction by a single issuer in a 12-month period
- No contact with a potential investor about the issuer
- Essentially codifies Paul Anka, SEC Staff No-Action Letter (July 24, 1991)

TIER II FINDERS

- Could participate in multiple offerings and solicit potential investors
- Solicitation activities limited to:
  - Identifying, screening, and contacting potential investors;
  - Distributing issuer offering materials to investors;
  - Discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and
  - Arranging or participating in meetings with the issuer and investor.

CONDITIONS APPLICABLE TO TIER II FINDERS ONLY

- Must provide disclosure to a potential investor, prior to or at the time of the solicitation, which includes:
  - The name of the Tier II Finder;
  - The name of the issuer;
  - The description of the relationship between the Tier II Finder and the issuer, including any affiliation;
  - A statement that the Tier II Finder will be compensated for his or her solicitation activities by the issuer and a description of the terms of such compensation arrangement;
  - Any material conflicts of interest resulting from the arrangement or relationship between the Tier II Finder and the issuer; and
  - An affirmative statement that the Tier II Finder is acting as an agent of the issuer, is not acting as an associated person of a broker-dealer, and is not undertaking a role to act in the investor's best interest.
- The disclosure may be provided orally or in writing. If provided orally, the Finder must supplement with written disclosure; and
- Must obtain from the investor a dated written acknowledgment of receipt of the disclosures prior to or at the time of investment.

WHY THE PROPOSAL WAS GROUNDBREAKING/CONTROVERSIAL

- The SEC had not previously defined the term “Finder”
- The SEC had consistently refused to allow unregistered intermediaries to facilitate investments
- No notice or registration requirement
- No standard of care other than anti-fraud
- Inconsistent with issuers’ exemption – SEA Rule 3a4-1
- Proposal allows Finders to participate in private placements for OTC microcap issuers
- Similar but inconsistent with solicitor rule – IAA Rule 206(4)-3
- Proposed exemption rather than rulemaking
- Inconsistent with state rules.

Finders Registration Under Various State Laws

TEXAS FINDERS

- Texas Administrative Code §115.1(a)(9) defines a finder is “an individual who receives compensation for introducing an accredited investor to an issuer or an issuer to an accredited investor solely for the purpose of a potential investment in the securities of the issuer.”
- Finders are required to register.
- Not subject to examination, capital or bonding requirements.
- Required to make disclosures to investors:
  - that compensation will be paid to the finder
  - that the finder can neither recommend nor advise the accredited investor with respect to the offering; and
  - any potential conflict of interest in connection with the finder's activities (such as receipt of equity compensation)
- Activities limited to interactions with accredited investors and permitted to provide only some or all of the following information:
  - the name, address, and telephone number of the issuer of the securities;
  - the name, a brief description, and price (if known) of any security to be issued;
  - a brief description of the business of the issuer in 25 words or less;
  - the type, number, and aggregate amount of securities being offered; and/or
  - the name, address, and telephone number of the person to contact for additional information. A finder may also provide to an issuer basic contact information regarding an accredited investor.

TEXAS FINDERS

Texas Finders are prohibited from:

- participating in negotiating any of the terms of an investment;
- giving advice to an accredited investor or an issuer regarding the advantages or disadvantages of entering into an investment;
- conducting due diligence on behalf of a potential issuer or potential investor, providing valuation, or providing other analysis to an accredited investor or an issuer regarding an investment;
- advertising to seek accredited investors or issuers;
- having custody of an accredited investor's funds or securities;
- serving as an escrow agent for the parties; or
- disclosing information to an accredited investor or to an issuer other than information that is categorized as a required or permitted disclosure

CALIFORNIA FINDERS

- Section 25206.1 of the California Securities Law, a “finder” is defined as “a natural person who, for direct or indirect compensation, introduces or refers one or more accredited investors to an issuer or an issuer to one or more accredited investors, solely for the purpose of a potential offer or sale of securities of the issuer in an issuer transaction” conducted entirely within the state of California.
- The finder may not “provide services to an issuer for a transaction or a series of related transactions for the offer or sale of securities of the issuer that exceeds a securities purchase price of fifteen million dollars ($15,000,000) in the aggregate.”
- The finder is **not** permitted to negotiate, advise, conduct due diligence, sell its own securities, or handle funds or securities.
- The finder is permitted to make limited disclosures to potential purchasers by providing only the name, address and contact information of the issuer; name, type, price and aggregate amount of any securities being offered in the issuer transaction; and the issuer’s industry, location, and years in business.
- “Bad Actors” are not eligible.

CALIFORNIA FINDERS

- Finders are required to obtain at the time of introduction, informed written consent in the form of an agreement signed by the finder, issuer and person(s) introduced disclosing:
  - the type and amount of compensation,
  - that the finder is not proving advice as to the transaction,
  - whether the finder is an owner of securities being sold,
  - any actual and potential conflicts of interest and
  - that the parties to the agreement have the right to pursue any available remedies for breach of the agreement.
- The agreement must contain representations by the person introduced to the issuer that the person is an accredited investor and knowingly consents to the payment of compensation described therein.
- A notice filing is required **prior** to engaging in any services under the exemption.
- Finders are also subject to certain recordkeeping requirements.

MICHIGAN FINDERS

- Section 102(i) of the Michigan Uniform Securities Act (Act) defines 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.”
- The Act defines a broker-dealer as “a person engaged in the business of effecting transactions in securities for the account of others or for the person’s own account.”
- Michigan Securities Rule 1.2 excludes from the definition of “broker-dealer” a “finder” as defined in the Act.

MICHIGAN FINDERS

- The Michigan Securities Rule 1.2 also excludes a person whose participation in an offer or sale of securities, for direct or indirect compensation, is limited to introducing accredited investors who are residents of Michigan to a Michigan issuer, or introduces a Michigan issuer to accredited investors who are residents of this state, solely for the purpose of a potential offer or sale of the issuer's securities in an issuer transaction in Michigan. Such person must not:
  - Engage in introductions for a transaction or series of related transactions relating to an issuer's securities that exceeds $15 million in the aggregate;
  - Participate in the negotiation of the terms of the offering or participate in the preparation, delivery or execution of the issuer's offering documents;
  - Conduct any due diligence of behalf of either the issuer or the purchaser or advise any party as to the value of the securities or the advisability of engaging in the securities transaction;
  - Sell or offer to sell securities of the issuer that are owned by the person;
  - Have custody of any funds or securities in connection with the transaction;
  - Receive compensation unless the person reasonably believes the offer or sale of securities complies with the registration requirements; or
  - Receive transaction-based compensation.
- The person and the issuer must enter into a written agreement that sets forth the compensation, that the person is not providing advice to the issuer or any person introduced by the person to the issuer, whether the person, a related person, or a member of the person's immediate family, has any beneficial interest in the securities being offered or sold by the issuer, and any actual or potential conflict of interest in connection with the person's participation in the potential securities transaction.
- The person must provide the written agreement to any potential purchaser and receive a written acknowledgment of receipt and must maintain records for 5 years.

SOUTH DAKOTA FINDERS

- Article 20:08:03:17 of the South Dakota Administrative Rules excludes “finders” from the definition of “agent” and “broker-dealer.”
- “Finder” is defined to mean “a person who directly or indirectly locates, introduces, or refers any person to an issuer.”
- A finder may not:
  - Render any investment advice as to the advantages or disadvantages of entering into an investment;
  - Participate in any presentations or negotiations regarding any material term of an investment;
  - Receive compensation based on the amount of any investment made but may otherwise receive compensation, and the compensation may be contingent on a potential investor actually investing;
  - Receive any compensation unless the amount of compensation is disclosed by the issuer to the investor prior to the sale of any security; or
  - Engage in general solicitation to find investors for any private offering other than an entity as described in § 20:08:07:38(1)(a) (economic development entity).

NEW YORK FINDERS PROPOSAL

- On April 6, 2020, the New York State Investor Protection Bureau of the Department of Law ("IPB") announced a series of proposed rules for broker-dealers and investment advisers including a new category of registration for "Finders."
- Finder is defined as "…a person, firm, association, or corporation who as part of a regular business, ***engages in the business of effecting transactions in securities for the account of others within or from this state*** [New York], to the limited extent that such person, firm, association, or corporation, receives compensation for introducing a prospective investor or investors to any broker, dealer or salesperson."
- Limited to persons who introduce investors with other securities industry professionals. Would not apply to a finder who wished to introduce an investor directly to an issuer.
- Subject to registration and examination requirements.
- In December 2020 the IPB adopted other rules related to Form D and investment advisers. However, based on the comment letters received and the SEC's proposal declined to adopt the finder category. The IPB indicated that it intended to issue guidance on the types of finder activity that constitutes broker activity under NY law and any registration requirements for finders.

Exemptions From Broker-Dealer Registration

ISSUERS AND THEIR ASSOCIATED PERSONS

- Issuers
- Associated Persons of the Issuers: safe harbor Rule 3a4-1 of the Exchange Act
  - Each of three general conditions must be met:
    - Not subject to statutory disqualification;
    - No commissions or other transaction-based compensation; and
    - Are not associated persons of a broker-dealer
  - One of three alternative sets of restrictions on sales activities must be met:
    - Restrict participation to transactions with a limited class of financial institutions;
    - Perform substantial duties on behalf of the issuer other than marketing securities, not registered with a B-D, and does not participate in more than one offering for any issuer in any 12 month period; or
    - Restrict activities to preparing written materials and responding to investor-initiated inquiries

TITLE II ANGEL INVESTOR PLATFORMS

- Section 201(c) of Title II of the JOBS Act / Section 4(c) of the Securities Act
- An online investment portal is not required to register as a broker-dealer so long as:
  - It does not receive compensation in connection with the purchase and sale of securities;
  - It does not have possession of customer funds or securities; and
  - It is not subject to statutory disqualifications.
- Exemption applies only to Rule 506 offerings
- Permitted to co-invest in securities
- Permitted to provide ancillary services (but not advice)

TITLE II ANGEL INVESTOR PLATFORMS

Relevant SEC No-Action Letters and FAQ

- *FundersClub Inc. and FundersClub Management LLC* SEC No-Action Letter (March 2013)
- *AngelList LLC and AngelList Advisors LLC* SEC No-Action Letter (March 2013)
- February 5, 2013 SEC FAQs

TITLE II ANGEL INVESTOR PLATFORMS

No broker-dealer registration is required for an online investment portal if the following conditions are met:

- There is no transaction-based compensation (i.e., fees are not contingent upon the outcome or success of the offerings), but carried interest is permitted;
- The portal does not participate in any negotiations between the companies and the investors or structuring of the deals;
- The portal does not handle funds or securities involved in the transactions;
- The portal does not hold itself out as providing any securities-related service other than a listing or a matching service, but ancillary services are permitted; and
- The portal does not provide advice about the merits of a particular opportunity or investment.

M&A BROKERS

- The sale of all or a controlling interest in a business can be a securities transaction.
- SEC Trading and Markets Division, M&A Brokers No-Action Letter (Jan. 31, 2014, amended February 4, 2014).
- North American Securities Administrators Association (NASAA) adopted a model rule.

M&A BROKERS

SEC No-Action Letter, Key Conditions:

- Cannot bind a party to the M&A transaction;
- Will not provide financing;
- Will not have custody, control or possession of securities or funds;
- No shell companies;
- No public offering;
- Written disclosure and consent in joint representation;
- Will not form a group of buyers;
- Buyer will control and actively operate the business;
- Restricted securities; and
- Not barred or suspended from association with a broker-dealer.

M&A BROKERS

The following states have some form of relief for M&A Brokers:

- Alaska
- Colorado
- Florida
- Georgia
- Illinois
- Iowa
- Maryland
- Michigan
- Mississippi
- Oklahoma
- Pennsylvania
- South Carolina
- South Dakota
- Tennessee
- Texas Rules
- Utah
- Vermont

COMMUNICATION SYSTEMS

- Charles Schwab & Co., Inc., SEC No-Action Letter (Nov. 27, 1996). The Staff granted no-action relief to online service providers to permit Schwab to make its brokerage services available to the subscribers of the online services without the online services registering as broker-dealers. The online services providers would place a Schwab icon on their platform that could be accessed by subscribers. Schwab would compensate an online service by paying it a nominal flat fee for each order transmitted to Schwab. The amount of this fee would not vary depending on the number of shares or the value of the underlying securities comprising a customer order transmitted to Schwab, nor would the amount of this fee vary depending upon whether the order results in an executed trade.
- Loffa Interactive Corp., Inc., SEC No-Action Letter (Sept. 17, 2003). The Staff granted no-action relief for an electronic communications tool that broker-dealers could use as part of their transaction execution and compliance efforts. In particular, the Loffa system supported compliance with margin requirements with respect to "letter of free funds" requests. The sole function of the Loffa system was to convey information between transaction participants. Loffa charged a flat fee per transmission that was not based on the size or value of any transaction that was completed due to information communicated through the System.

COMMUNICATION SYSTEMS

- GlobalTec Solutions. LLP, SEC No-Action Letter (Dec. 28, 2005). The Staff granted no-action relief with respect to a desktop application that allowed users to develop personalized trading strategies for publicly traded securities, and to submit orders to participating broker-dealers. The application did not discriminate between participating broker-dealers. Users of the GlobalTec system could only send orders to a participating broker-dealer after opening an account with that broker-dealer. Other than the transmission of order information, the GlobalTec system did not effect securities transactions between users and participating broker-dealers. GlobalTec charged fees to access its system rather than based on the size, value or occurrence of securities transactions conducted through the system.
- IS3 Matching Technologies LP, SEC No-Action Letter (Jul. 19, 2012). The Staff granted no-action relief to a financial services software company that offered a computerized system that electronically linked registered broker-dealers to one another. The S3 system contained analytical tools relating to order routing and order execution as well as an order message communication tool, but the owner and operator of the system was not involved in the execution; settlement or clearance of transaction. The S3 system charged members a fee that was not calibrated to the size, value, or occurrence of securities transactions.

COMMUNICATION SYSTEMS

- NeptuneFI Fixed Income System, SEC No-Action Letter (Mar. 4, 2020). The Staff granted no-action relief to the operator of a passive fixed-income electronic data connectivity and communication system without registering as a broker-dealer. The system was a passive electronic data connectivity and communication system for institutional participants in the fixed-income market. The system did not have the capability to perform post-execution processes. Among the factors that the staff considered in granting no-action relief, were representations that NeptuneFI will not:
  - structure prospective securities transactions;
  - assist participants on the System in identifying potential purchasers of securities;
  - screen potential participants in a transaction for creditworthiness;
  - solicit securities transactions;
  - receive transaction-based compensation;
  - participate in negotiations between potential transaction participants;
  - provide valuation or other advice as to the merits of a potential investment;
  - handle customer securities or funds in connection with securities transactions; or
  - prepare or send confirmations for any transactions that may be entered into by buy-side and sell-side participants utilizing the System.

Risks and Penalties

RISKS AND PENALTIES

- SEC Enforcement
- State Enforcement
- Controlling Person and Aider and Abettor Liability
- Right of Rescission – Section 29(b) of the Exchange Act
- Bad Actor Disqualification under Rule 506(d)
- FINRA Considerations (Rule 2040)

RISKS AND PENALTIES

- SEC Enforcement
  - Investigative authority and subpoena power
  - Administrative cease-and-desist proceedings
    - Accounting and disgorgement
    - Civil money penalties
  - Federal court action
    - Injunction
    - Civil money penalties
  - Criminal prosecution for willful violations

RISKS AND PENALTIES

- State Enforcement
- Secondary Liability
  - Controlling Persons
    - Person who controls person liable is jointly and severally liable unless controlling person acted in good faith and did not induce the violation
  - Aider and Abettor
    - Person who knowingly or recklessly provides substantial assistance to violator is deemed a violator

RISKS AND PENALTIES

- Right of Rescission
  - Contracts in violation of broker-dealer registration requirements are void as to violator (Section 29(b) of the Exchange Act)
  - Investor can rescind purchase of security from issuer, unregistered broker cannot collect fee
  - Can create contingent liability accounting issues

RISKS AND PENALTIES

How can the SEC or a state regulator find out about an unregistered broker?

- Form D disclosure – Items 12 and 15 of Form D require disclosure of sales commissions and "finders' fees";
- Tips from disgruntled investors or competitors of issuer or finder; or
- Routine examinations of broker-dealers or investment advisers.

ENFORCEMENT ACTIONS

- Enforcement actions against unregistered brokers historically arose in connection with other securities law violations:
  - Fraud, violation of securities registration requirements, etc.
- Recent enforcement actions show SEC will pursue failure to register as B-D in situations not involving fraud; and
- Still not a high priority enforcement area in the absence of investor harm.

WOODBRIDGE GROUP OF COMPANIES ENFORCEMENT ACTIONS (2018-2020)

- $1.3B Ponzi scheme affecting 8,400 retail investors.
- Woodbridge filed for bankruptcy in December 2017.
- Interests were often sold through the use of unregistered intermediaries.
- In December 2018, the SEC charged 13 individuals and 10 companies.
- In January 2019, Woodbridge and its affiliates ordered to pay $892M in disgorgement and former CEO Robert Shapiro ordered to pay $100M civil penalty, disgorge $18.5M and pay $2.1M pre-judgment interest.
- In April 2019 U.S. federal prosecutors charged Shapiro and two former executives with orchestrating a $1.3-billion Ponzi scheme.
- In August 2019, Shapiro pled guilty and was sentenced to 25 years in prison.
- Numerous unregistered brokers charged in federal court with violations of Section 15(a)(1) in wake of SEC investigation.
- Numerous state enforcement actions.
- Woodbridge Liquidation Trustee brought numerous litigations including against 9 law firms who prepared offering documents and legal opinions that helped Woodbridge conceal the scheme.

IN THE MATTER OF RANIERI PARTNERS LLC, ET AL., EXCHANGE ACT RELEASE NO. 69091 (MARCH 8, 2013)

- Administrative proceeding against private fund adviser and senior managing partner for violation of broker-dealer registration requirements.
- Fund paid transaction-based compensation (1% of capital commitments) to unregistered consultant for soliciting investors.
- Consultant:
  - Had a prior disciplinary history with the SEC;
  - Sent offering materials to prospective investors;
  - Urged investor to adjust portfolio allocation to accommodate investment;
  - Provided investors with analysis of firm's funds' strategy and track record; and
  - Provided investors with confidential information about identity and capital commitments of other investors.
- Did not involve any allegations of fraud.
- Firm fined $375,000 and senior managing partner $75,000.
- Separate enforcement action against consultant.
- Disgorgement of $2.4 million in compensation plus interest and barred from association with any securities firm.

SEC V. KENNETH R. KRAMER, ET AL., 778 F. SUPP. 2D 1320 (M.D. FLA. 2011)

- Receipt of transaction-based compensation alone is not enough to conclude broker-dealer activity.
- "Kramer's conduct consisted of nothing more than bringing together the parties to a transaction."
- No evidence that Kramer either participated in the negotiation, discussed the detail of the transaction, analyzed the financial status of the issuer, or promoted an investment in the issuer.
- No evidence that Kramer possessed authority over the accounts of others or sought to influence a registered broker's authority over the accounts of others.
- Sharing of information regarding the issuer to close friends and business associates not enough to support broker activity.
- At most, Kramer acted as an associated person of an unregistered broker-dealer (citing SEC v. Corporate Relations Group, Inc.).

SEC V. WILLIAM E. MAPP, III, WARREN K. PAXTON, JR., CALEB J. WHITE, AND SERVERGY, INC. (MARCH 2, 2017)

- The SEC alleged that Paxton, the Texas Attorney General, raised $840,000 for Servergy in July 2011 through his efforts to promote the company and recruit investors in exchange for an undisclosed payment of 100,000 shares of Servergy common stock.
- The SEC complaint charged that Paxton, by promoting Servergy to prospective investors while receiving payment of Servergy common stock, acted as an unregistered broker-dealer.
- The court, in dismissing the case against Paxton, found that Paxton acted merely as facilitator and did not engage in transactions in securities for the account of others. Specifically, the court found that Paxton did not:
  - exercise control over the account of others (investor assets were not entrusted to him);
  - engage in negotiating the terms of the transactions; or
  - discuss the details of the investments with potential investors (merely offering to do so was not sufficient).
- Paxton's prior involvement as a registered broker-dealer was not enough to classify him as a broker rather than a finder under the circumstances.

IN THE MATTER OF ALEXANDRE S. CLUG, AURUM MINING, LLC, PANAM TERRA, INC., AND THE CORSAIR GROUP, INC., EXCHANGE ACT REL. NO. 90385 (NOV. 9, 2020)

- The SEC heard appeal from an ALJ's initial decision and subsequent orders concerning alleged violations of the antifraud, reporting, and registration provisions of the federal securities laws by Clug, Crow, and three companies that they founded in 2011 and controlled—Aurum Mining, LLC ("Aurum"), PanAm Terra, Inc. ("PanAm"), and The Corsair Group ("Corsair").
- The SEC found that Corsair acted as an unregistered broker-dealer by entering into a referral agreement with ABS Manager, LLC, an investment adviser that managed three investment funds. Under the agreement, Corsair would "introduce potential investors" to ABS and, "if an investment [wa]s made in" an ABS fund, ABS would pay Corsair a "fee equal to 3%" of the investment.
- In its decision, the SEC stated that:
  - A company is liable for the actions of its responsible officers, and its scienter is imputed from that of the individuals controlling the company.
  - The Commission has never recognized a "finder's exception" to the definition of a broker.
    - Cited SEC v. Collyard, 861 F.3d 760, 767-68 (8th Cir. 2017) (rejecting argument that "there is a 'finder exception' or 'finder defense' to unregistered-broker liability"). Pointed to Eighth Circuit's statement that the "so-called 'finder's exception'" referenced in SEC v. Kramer, 778 F. Supp. 2d 1320 (M.D. Fla. 2011), "just means that individuals can engage in 'a narrow scope of activities without triggering the broker/dealer registration requirements'—not that there is a 'finder defense' available to those who are otherwise 'brokers.'"
- SEC found that Corsair violated, and that Clug was a cause of its violation of, Exchange Act Section 15(a)(1).
- Imposed bars from the industry and penny stock offerings; a cease-and-desist order; and disgorgement (nearly $4 million in the aggregate) plus prejudgment interest (about $1.2 million in the aggregate) and a third-tier civil money penalty against Clug ($150,000).

IN THE MATTER OF JOSHUA D. MOSSHART, EXCHANGE ACT REL. NO. 82998 (FEB. 12, 2021) (ALJ INITIAL DECISION)

- Follow-on proceeding based on SEC v. Enviro Board Corp., No. 2:16-cv-6427 (C.D. Cal.), in which Mosshart was enjoined from violating the registration provisions of the federal securities laws.
- Mosshart, who was employed as president of Enviro Board as of January 1, 2012, for an annual salary of $120,000, also engaged in other activities on behalf of the company, such as public relations, lobbying, and sales. Enviro Board paid a total of $553,355 for Mosshart's services between May 2011 and May 2013.
- The ALJ's conclusions of law:
  - Scienter not required to find a violation of Section 15(a)(1) of the Exchange Act.
  - Activities of a broker are characterized by "a certain regularity of participation in securities transactions at key points in the chain of distribution." Other relevant factors include whether the alleged broker: 1) is an employee of the issuer; 2) received commissions as opposed to salary; 3) is selling, or previously sold, the securities of other issuers; 4) is involved in negotiations between the issuer and the investor; 5) makes valuations as to the merits of the investment or gives advice; and 6) is an active rather than passive finder of investors.
  - "Transaction-based compensation" is "one of the hallmarks of being a broker-dealer."
  - "Activities that are indicative of being a broker include holding oneself out as a broker-dealer, recruiting or soliciting potential investors, handling client funds and securities, negotiating with issuers, and receiving transaction-based compensation."
- The ALJ found that Mosshart was acting as a broker in his activities "referring" investors to Enviro Board. He received transaction-based compensation.
- In imposing a 12-month suspension from the securities industry, the ALJ considered that Mosshart did not handle client funds and was only tangentially involved in negotiations between the issuer and the investor when he referred potential investors to the founders of Enviro Board.
- While Mosshart was registered with a broker-dealer, he was acting outside the scope of his association during the time he was associated and acting as an unregistered broker when he was no longer associated with the broker-dealer.

IN THE MATTER OF TOKENLOT, LLC, LENNY KUGEL, AND ELI L. LEWITT (SEPTEMBER 11, 2018)

- Advertised and sold digital tokens to retail investors using TokenLot's website platform.
- Received payment from issuers to promote their tokens.
- Handled more than 200 different tokens and received more than 5,800 investor purchase orders in connection with both initial coin offerings conducted by other entities and TokenLot's secondary market activities.
- By effecting unregistered securities transactions as unregistered broker-dealers, respondents violated Section 15(a) of the Exchange Act and Sections 5(a) and (c) of the Securities Act.
- Individual respondents barred from securities industry and ordered to pay civil money penalties.
- Respondents ordered to disgorge total compensation received.

IN THE MATTER OF LEI (LILY) LEI, EXCHANGE ACT REL. NO. 87429 (OCT. 31, 2019)

- Settled administrative proceeding against Lei, a former Vice President of Business Development of Luca International Group LLC.
- Lei's role was to solicit investors for which she received approximately $144,000 in salary and $464,190 in commissions from Luca. She has never been registered or associated with a registered broker-dealer.
- A permanent injunction already entered against Lei for sale of unregistered securities, antifraud violations and for acting as unregistered broker-dealer.
  - The final judgment also enjoined Lei from participating in the issuance, offer, or sale of any security of any entity controlled by, or under joint control with, the president of Luca International; and (2) soliciting any person or entity to purchase or sell any security.
- The administrative order barred Lei from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, and barred Lei from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

SEC V. DEANDRE P. SEARS, AND MASEARS LLC D/B/A PICASSO GROUP

- SEC filed complaint for injunctive and other relief in December 2020 alleging that defendants acted as unregistered brokers on behalf of EquiAlt Funds, managed by EquiAlt, LLC. The SEC alleged that:
  - Defendants raised at least $25 million from the unregistered offer and sale of securities in EquiAlt Funds to more than 145 retail investors in 25 states.
  - Defendants received approximately $3.5 million in transaction-based sales commissions, netting approximately $2.15 million after payments to other sales agents.
  - Defendants engaged in sales activity indicative of a broker including (1) soliciting new investors; (2) communicating directly with investors by phone, by e-mail, or in person; (3) espousing the merits of the EquiAlt Funds' securities; (4) reassuring investors about the "risk" of the investment or about the EquiAlt business model; and (5) receiving transaction-based compensation.
  - Picasso communicated directly with investors while facilitating the unregistered sales transactions and serving as the intermediary between EquiAlt and the investors.
  - Defendants charged with violations of Section 5(a) and 5(c) of the Securities Act and Section 15(a)(1) of the Securities Exchange Act.
  - SEC seeks permanent injunction, disgorgement, and civil penalties.

Q&A