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Sent via e-mail to rule-comments@sec.gov

Advisory Committee on Smaller Public Companies
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-3628
Attn: James C. Thyen, Co-Chair
Herbert S. Wander, Co-Chair

Re: File No. 265-23
Recommendations for Reducing Unnecessary Regulatory Burdens on Smaller Companies

Ladies and Gentlemen:

With this letter we are submitting to the United States Securities and Exchange Commission Advisory Committee on Smaller Public Companies (the "Committee") the full *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, recently published at 60 The Business Lawyer 959 (May 2005) (the "Report"). The undersigned has been actively involved for the past seven years as a member of the Task Force which authored the Report. Greg Yadley and Faith Colish, who also have been active members of the Task Force during such time, join me as co-authors of this letter. While we do not purport to speak on behalf of the Task Force, nor on behalf of The American Bar Association or any Committee or Section of that organization, as members of the Task Force since its inception we believe our summary in this letter will accurately reflect the salient issues and recommendations contained in the full Report, a copy of which is attached to this letter with permission from The Business Lawyer.

Applicability of The Report to the Committee's Charter. While the Report includes recommendations for legitimizing the activities of, and simplifying compliance procedures applicable to, persons exclusively involved in private placements of securities, the Report has important relevance to the Committee's charter. First, smaller public companies often seek to raise capital through private placement of their securities. In addition, a typical growth pattern for smaller public companies is to acquire privately held complementary companies. These merger and acquisition transactions are often facilitated by persons who are the focus of the Report and whose involvement under the current state of the law might create regulatory issues for both the acquiring small public company as well as the equity holders of the acquired company. Finally, we are mindful of the fact that this letter and the Report, being submitted in connection with the testimony of Gerald Niesar at the Committee's hearings on September 19, 2005, is highly relevant and of extreme interest to the SEC Government-Business Forum on

Small Business Capital Formation (the "Forum") which is meeting in conjunction with the Committee during such hearings. In each of the most recent two sessions of the Forum, the number one recommendation of the Forum has been to have the SEC, NASD and State Securities Regulators enact regulations that would be consistent with the recommendations contained in the Report (see attached Report at Pages1014-15).

The Nature and Scope of the Problem. Most private companies and many smaller public companies are unable to attract the attention of broker-dealers that are members of the National Association of Securities Dealers ("NASD").[1] Over the years the requirements for persons becoming NASD members or registered as representatives or principals of NASD members, and the oversight and audit requirements to maintain such regulatory status, have become increasingly complex and, therefore, expensive. This may account for the reason why the licensed brokers have little interest in raising capital for smaller companies, and it certainly accounts for the reason why many of those persons who operate as "finders" or "consultants", but who are actually unlicensed brokers, do not become licensed. Nevertheless, it is well known that hundreds of persons, probably thousands, regularly engage in capital formation, merger and acquisition activities that, under current laws and interpretations of such laws, require a securities broker's license. They fill a void that is created by the lack of interest on the part of licensed brokerage firms and venture capital funds in smaller equity transactions. Yet we know, from our own experience, as reinforced by countless anecdotal reports from other members of the Task Force, and other persons submitting comments to us, that this class of individuals is of fundamental importance to the capital formation needs of small public and private companies. Further, it is also our firm belief, based upon personal experience and such reports and comments, that a large percentage of the unlicensed broker-dealers are honest, ethical, knowledgeable and trustworthy business persons whose activities should be legitimized and encouraged. A corollary to such legitimization would be to screen out those persons engaged in these activities who are not honest, ethical, knowledgeable and trustworthy, providing real protection for both issuers and investors where today there is only the illusion of such protection because the unworkable overregulation encourages a massive "gray market" of unlicensed activity.

The Recommendations. The recommendations in the Report essentially boil down to providing a simplified registration process, and on-going regulatory oversight better adapted to the limited nature of the business of what are referred to as Private Placement Broker-Dealers ("PPBDs"). We, of course, agree with these recommendations which we believe will more practically balance the amount of regulatory activity necessary and useful with the activities that would be allowed by the licensed PPBDs. Perhaps the fundamental recommendation of the Report, which appears to have been the recommendation of the 2004 Forum as well, is that the SEC, NASD and State Regulators should form a collaborative committee, perhaps a Regulatory Task Force, to build upon the work already done by the Task Force, to the end that in short order regulations, laws if necessary, and procedures can be adopted to encourage the honest PPBDs to become licensed. To those of us dealing with the capital formation and merger and acquisition

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[1] Brokers and dealers registered with the SEC are generally required to be NASD members (Securities Exchange Act Section 15(b)(8) and Securities Exchange Act Rule 15b-9-1).

transactions practice on a daily basis, the need for such action, and the logic behind the simplified approach seem irrefutable. What is proposed, in brief, is:

+ A greatly simplified registration procedure.
+ Lower application fees.
+ Qualifying examinations to be relevant to activities to be licensed.
+ Activities to be limited to non-public offerings of securities in exempt transactions (i.e., no Regulation A offerings).
+ No custody of investor's funds or securities to be allowed.
+ Business conducted only on a broker (agency) basis with no investment or trading for the account of the PPBD or any other dealer (principal) transactions in securities.
+ No minimum capital requirement—hence no FOCUS Reports, FINOPs, or annual financial audits required, with the possible substitution of a bonding requirement to provide more meaningful protection for investors.
+ Appropriate record keeping requirements to be established.
+ No licensing of persons with "bad boy" disqualifications, or firms employing or controlled by them.

Perhaps The Most Significant Practical Problem. If these recommendations are to accomplish their major goal, it will be necessary to address the issue of those honest brokers who have been in technical violation of the registration laws, particularly at the state level. We believe this can be accomplished by allowing a short period, perhaps one year, during which persons who would qualify as PPBDs but for their past technical violations of the licensing laws would be allowed to register as PPBDs without prejudice based on their past private placement activities. Of course, since the recommendations include denying a license to persons with "bad boy" disqualifications, that limited inquiry would be allowed. We do not suggest by this that civil remedies available to individuals based upon prior violations of licensing laws should be eliminated or affected, or that civil and/or criminal sanctions for prior frauds and other violations above and beyond the mere performance of unlicensed activity should be foreclosed. While this may at first appear to be condoning previous illegal, even criminal activity, there is a significant precedent for such an approach. Certainly, we would not today think it was improper of the United States to ignore the social drinking that occurred during prohibition, even though it was illegal. Moreover, it did not seem to be a significant problem for law enforcement after 1933 to distinguish between the Al Capones and the John and Mary Smiths, all of whom were violating federal and state laws by consuming alcohol prior to repeal. The fact that people may be violating a law or regulation that constitutes overregulation, should not be raised as a reason not to eliminate the overregulation.

The Special Problem of Merger and Acquisition Transactions. We believe that it is not practical to advocate an exemption from the broker-dealer laws for PPBDs where the activity engaged in is funding. Indeed, we believe that very convincing arguments can be advanced that some level of registration and oversight is useful for any activity in the area of brokering securities on behalf of issuers, even if limited to accredited investors. On the other hand, the development of an exemption from the licensing requirements for persons or transactions involved in the "sale of a business" might very well be a more logical approach than an NASD membership application. Many persons who are referred to as "business brokers" are already licensed in one form or another. In California, for example, such persons may hold a real estate license. In any case, the sale of a business, merely because it entails the sale of common stock of the two or three equity owners of the business, does not present a compelling case for requiring registration as a securities broker-dealer. Once again, one observes the problems that such overregulation presents even for smaller public companies. As the issuer of securities in an acquisition transaction brokered by an unlicensed person, the smaller public company enters into the unstable marshland of potential rescission rights, or joint and several liability for the illegal activity of the unlicensed person, whose only "securities related activities" are those that are technically present as a result of the transaction being structured as a sale of stock instead of a sale of assets. We believe that an exemption from the applicability of the broker-dealer licensing laws and regulations might very well be considered a better alternative for persons whose activities are more logically described as effecting transactions involving the purchase and sale of businesses.

Conclusion. For the reasons stated above, we enthusiastically support and endorse the Report, commend it to the Committees' attention, and urge the Committee to include in its report to the SEC the immediate formation of a Regulatory Task Force whose mission would be to reduce the Report to a practical set of regulations and procedures to effect a PPBD regime that will eliminate barriers to smaller public and private companies' capital formation activities, and rationalize the applicability of the laws and regulations to persons assisting such companies in merger and acquisition activities. By informal poll of the member of the Task Force, we feel confident that the proposed Regulatory Task Force could count upon the continued support and contributions of all of the Task Force members to such an effort.

Respectfully submitted,

Gerald V. Niesar

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Attachment:
Report and Recommendations of the Task Force on Private Placement Broker-Dealers,
Reprinted with permission from The Business Lawyer, May 2005, Volume 60, No.3.

Report and Recommendations of the Task Force on Private Placement Broker-Dealers

By the Task Force on Private Placement Broker-Dealers, ABA Section of Business Law[*]

PART ONE

I. INTRODUCTION AND OBJECTIVES

This Report and Recommendations ("Report") has been prepared by a Task Force of representatives from the Business Law Section of the American Bar Association, consisting of representatives from the Committees on Small Business, Federal Regulation of Securities, Negotiated Acquisitions, and State Regulation of Securities Committees. The impetus for this Report is a widely held perception by many members of the Committees mentioned that there exists a major disconnect between the various laws and regulations applicable to securities brokerage activities and the methods and practices actually in daily use by which the vast majority of capital is raised to fund early stage businesses in the United States. This vast and pervasive "gray market" of brokerage activity creates continuing problems for the unlicensed brokers, the businesses which rely upon them for funding, attorneys and other professionals advising both the brokers and businesses, and, last but not least, the federal and state regulators who are charged with the obligation to enforce laws and regulations that are out of step with current business practices.

Briefly stated, the federal law and the law of every state prohibit a person from being engaged in the business of effecting transactions in securities, unless such person is licensed as provided by the applicable laws. At present, this means the person who wishes to engage in such business, i.e., a securities broker or dealer, must be a member of the National Association of Securities Dealers ("NASD"), or hold one or more appropriate licenses that allow him or her to be a representative of a NASD member. Essentially, this means that any person who accepts "transaction based compensation," i.e., commissions, for bringing capital to a third party securities issuer, must be somehow registered to sell those securities through a member of the NASD. As will be explained in more detail later in this Report, there is an exception for a person who merely introduces a potential purchaser to an issuer and accepts a "finders fee" for that introduction when a sale of securities results. However, it is the position of the Securities and Exchange Commission ("SEC"), and most state securities law administrators ("State Administrators"), that a person who accepts a fee for introduction of capital more than once is probably "engaged in the business of selling securities for compensation" and is therefore required to be registered. Certainly, accepting fees for more than a very small number of

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[*] Task Force members: Mary M. Sjoquist, Chair; JosephW. Bartlett, Jean L. Batman, Robert Boresta, Faith Colish, Brian James Craig, Barry M. Dicker, Alexander Drapatsky, Nancy Fallon-Houle, Philip Alan Feigin, Richard M. Leisner, Mike Liles Jr., Hugh H. Makens, Jeffery Keith Mitchell, Marlee Mitchell, Gerald V. Niesar, Louis J. Rogers, John Raymond Short, Todd Taylor, Raymond K. Walheim, John P. Walsh, Gregory C. Yadley.

transactions will require registration, and we need not debate whether that number is two, three, six or ten, because the great majority of the persons with whom this Report is concerned are involved in numerous transactions that far exceed those numbers.

It is also very important to note that the same laws and regulations govern the activities of those persons whose business is introduction and assistance in consummation of what are regularly referred to as "mergers and acquisitions" transactions ("M&A transactions"). Often the persons with whom we are concerned will engage in both the straight placement of securities as well as advice in mergers and acquisitions. There are many extremely large M&A transactions in which commissions are paid to advisors who specialize in this activity, and who are critical to the success of the transaction. Nevertheless, those advisors are, by the nature of their respective activities, unlicensed securities brokers operating in violation of the federal and applicable state securities laws.

Unregistered securities brokers who raise funds for small businesses or engage in mergers and acquisition activities on a commission basis are most often referred to as "finders." Other labels include "merchant bankers," "investment bankers," "financial public relations advisors," and simply "business consultants." The one common thread which ties all of these persons together is that they are compensated, in substantial part, on the basis of a percentage of the amount of securities their clients sell with the assistance of the unlicensed broker. Notwithstanding the various labels, and despite the fact that a great number of the brokers, funded businesses, and even sometimes their attorneys, do not realize that they are operating in violation of securities laws; simply put, they are unlicensed securities brokers whose fee contracts are unenforceable and whose activities are, in fact, illegal. For ease of reference, throughout this Report we refer to these unlicensed persons as Private Placement Broker-Dealers ("PPBDs").

The activities of PPBDs is of critical importance to the efforts of a vast number of small businesses, and without their assistance it is unlikely that a great percentage of such businesses would ever be successful in raising early stage funding. In this regard, we are referring to capital in amounts of less than $5,000,000. Below this level the issuer is almost never interesting to professional capital such as Venture Capital Funds, and certainly will seldom if ever be able to attract attention from fully licensed members of the NASD. Small business capital formation is key to creating jobs in America. Small businesses create many more new jobs than large public companies who have no need for PPBDs.

It is also the experience and, therefore, belief of most members of the Task Force that a great number of the unlicensed brokers currently operating in the gray market are ethical and honest individuals. These persons are in a situation similar to that of our parents and grandparents who were social drinkers during prohibition; they did not suddenly become "good people" when the twenty-first amendment to the Constitution was ratified. They were, and a large majority of the unlicensed PPBDs are, violating laws which are over-broad and largely ignored because of the need of the community to act in disregard of those laws.

The objectives of this report are to present a comprehensive survey of the relevant issues relating to this vast gray market of securities brokerage, and second, to propose a solution that the Task Force believes will provide a reduced, but appropriate, level of regulation in the M&A and Private Placement arenas. The proposed solution should, if effected, achieve a number of critical goals. First, it should modify the amount and scope of the regulations that will apply such that they would be in proper balance with the scope of activities to be pursued by those who will be subject to the regulations. Second, it should make possible and encourage the effective licensing of those PPBDs who do adhere to honest and ethical business practices. Third, it should diminish the number of unlawful securities brokers to a level that will make feasible effective enforcement actions against continuing unlawful activity. And finally, it should provide the business consumers of the services of PPBDs, and their professional advisors, a means of distinguishing the good (the honest, ethical and licensed) from the bad (the charlatans and dishonest, unethical brokers who cannot be licensed, or refuse to become licensed even though the regulations are redesigned to fit the activities). The Task force respectfully suggests that the recommendations set forth below should be implemented as the most likely course of action to achieve those four goals.

II. RECOMMENDATIONS

The following recommendations are intended to bridge the gap between the current regulatory system and a system better targeted at the unregistered financial intermediaries.

A. PRIVATE PLACEMENT BROKER-DEALER

We believe that the SEC, NASD and State Administrators ("Regulators") should work to establish a simplified system for registration for PPBDs. This system should recognize that PPBDs will be permitted to engage in only very limited activities.
Firms and principals of those firms eligible to participate in this limited category should meet certain minimum criteria including:

- No participation in public offerings registered pursuant to the Securities Act of 1933, but with the ability to receive referral fees for introducing such offerings to full service broker-dealers.
- No statutory disqualifications of the firm or its principals.
- Offerings by PPBDs could be made only to accredited investors and qualified purchasers when the SEC defines the term. Issuers, however, could separately offer to any investor qualified by the type of exemption.
- The firm may not handle or take possession of funds or securities.
- All offerings would be done on a best efforts basis.
- All funds from offerings will be placed in escrow in an unaffiliated financial institution and in accordance with escrow requirements in SEC Rule 15c2-4.
- The firm must not engage in secondary market or trading activity, including assisting with maintenance of "desk drawer" markets at the issuer or the broker-dealer.
- Principals and representatives shall have successfully completed NASD examinations appropriate to the scope of activities of the PPBD.

The rules and procedures relating to membership in the NASD, record keeping and reporting, net capital, testing and continuing education should be modified to address only requirements which are logically applicable to the activities of the PPBD.

We recommend that the PPBD be required to file an annual Statement of Activity with the NASD and applicable states which summarizes the transactions in which it has participated during the past calendar year and provides sufficient statistical information for regulators to analyze the effectiveness of the PPBD program or to conduct appropriate inspections.

We propose for consideration the following Attachments for regulatory consideration:

- Attachment A—[Proposed] Form 1010-EZ.
- Attachment B—NASD Membership Application Checklist with Commentary.

Persons who cannot meet the requirements listed above should be required to register under existing registration categories, except as noted below.

B. EXAMINATION REQUIREMENTS

Traditional examination requirements are not appropriate for PPBDs, since the scope of their coverage vastly exceeds the knowledge required to perform obligations which we anticipate they must meet. Accordingly, we recommend that the Regulators develop new targeted examinations for registered representatives and principals, testing only relevant topics.

The skills needed for principals are dramatically different for private offerings or merger and acquisition transactions than the skills needed in a full service firm. Development of written supervisory procedures should be keyed to what is needed to do the job; not to a laundry list of inapplicable topics. The Task Force would be pleased to work with the Regulators to develop a more relevant examination structure.

C. ADOPTION OF RULES OR ISSUANCE OF A CLARIFYING RELEASE RELATING TO BUSINESS BROKERS

The need for full broker-dealer registration of entities or individuals involved solely in the match-making to permit merger and acquisition brokerage activities is not apparent to us. We believe that the vast preponderance of this activity occurs by non-registered persons, and that there is little history to warrant a requirement for full broker-dealer registration. Accordingly we recommend consideration of two alternatives:

1. Expansion of the International Business Exchange Corporation[1] ("IBEC Letter") to permit stock as well as asset transactions. This would not include authorization to participate in securities offering activities to fund the transaction. Such an activity would require PPBD registration.
2. Creation of a simplified M&A Broker Dealer registration procedure for PPBDs involved in M&A transactions involving the transfer of ownership through the sale of securities from one entity to another. This procedure would recognize that those engaged in this activity will meet all other requirements of the IBEC letter. Hence, there should be no need for net capital; examination requirements would not appear to be appropriate though again some distribution of information relative to the standard for engaging in this activity is appropriate; and books and records requirements should be modified to appropriate requirements for this kind of business. Again, an annual report of activity may be appropriate. We do not believe that membership in the NASD is appropriate for PPBDs involved solely in M&A transactions.

D. ISSUANCE OF AN SEC/NASAA EXPLANATORY RELEASE CLARIFYING THE REQUIREMENTS FOR CIRCUMSTANCES UNDER WHICH TRANSACTION-BASED COMPENSATION IS APPROPRIATE

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[1] International Business Exchange Corp., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 3065 (Dec. 12, 1986) [hereinafter "*IBEC Letter*"].

If the registration and exemption procedures that we recommend were adopted, it should be possible for the Commission to issue a far stronger release or rule about the ability of persons to receive transaction-based compensation. If our Recommendations are accepted, viable alternatives would then exist which would permit registration without substantial cost or delay for most transactions.

It is in the interest of the public, issuers, the brokerage community, the bar, the accounting profession and government to create a workable system and to have clear, unequivocal direction on these issues. Our common objective should be compliance with a realistic system.

E. MERGERS AND ACQUISITIONS

The present “form over substance” approach is not in the public interest. While the IBEC letter has provided a partial solution, it is often honored in the breach rather than with compliance.[2]

If the concept of IBEC is valid, then an exemption should be created for M&A transactions with a single entity buyer.[3] If not, a simplified broker-dealer category should be created. We also urge that such firms be permitted to receive a fee for true venture capital firm referrals without broker-dealer registration.

F. CREATE AN ENVIRONMENT WHERE APPLICANTS WANT TO REGISTER

An obvious concern for those financial intermediaries who have engaged in transactions without registration in the past is that the Regulators, particularly the State Administrators, will require disclosure of past activities in their states. We believe that about half of the states presently require such disclosures.

We strongly recommend that the states establish a period or procedure under which prior activities would not require disclosure. If an applicant faces virtual certainty of a state regulatory proceeding and a demand for rescission, there is little incentive to come into compliance. We urge the North American Securities Administrators Association (“NASAA”) to promote among its members a system to encourage, rather than discourage, appropriate registration.

Many states require letters from an applicant for broker-dealer registration stating that the entity has not engaged in securities transactions in the state in the past (often without a time limit). These letters have the effect of terrorizing the applicant who wants to come forward and become compliant. We recommend a one-year hiatus in the use of such letters to permit firms to come into compliance. We also recommend that consideration be given by the states to the value of such letters in light of their compliance deterrent effect.

We do not suggest that those who have violated the law should not remain civilly liable or non-accountable for any past wrongdoing from a regulatory perspective.

G. NATIONAL ASSOCIATION OF SECURITIES DEALERS

The NASD obviously plays a crucial role in implementation of this process. These proposals require a substantial rethinking of the manner of regulation for firms that are impacted by this Report. Our challenge has been to provide to the NASD the basis for reconsideration of some of

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[2] *Id.*

[3] *Id.*

their procedures relative to this class of broker-dealers. We are prepared to work with the NASD to assist in identifying specific areas which require revision. We believe that the Task Force offers a wide range of experience in its members in dealing with the problems raised by the Report. We recommend that the NASD reexamine its internal procedures and requirements in light of the Report, and determine whether accommodation can be achieved which would address the many problems which the Report identifies.

The NASD should also permit a one year window to achieve registration without inquiry into past activities. We believe that is the policy in most NASD Districts today.

H. NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

We have received encouragement from several individual State Administrators and NASAA leaders on this project. We are prepared to work with NASAA to assist in its implementation, and to address the development of uniform procedures which can be recommended to the states for adoption. Our fear is that the states may unilaterally develop a multiplicity of requirements once NASAA has made its recommendations. Such a result would be counter-productive in attempting to ease the burden on small business financing. We recommend the formation of a group or task force within NASAA to work to implement our Recommendations which are applicable to the states.

We also urge states to consider the existing states' exemptions and exclusions from broker-dealer registration and work toward uniformity.

PART TWO

I. PUTTING THE PROBLEM INTO PERSPECTIVE

Often in both acquisitions and business financings lawyers learn that financial intermediaries are present. They can be both a blessing and a curse. As a source of funds otherwise unavailable to a client, or as the catalyst that leads to a successful acquisition, they are a boon to finance. As a purveyor of bad deals, bad relationships, securities law violations and the potential for rescission, they represent a major threat not only to the client but also to the professionals working with the client. Any system developed in reaction to this Report must screen out the undesirable individuals and entities while encouraging the legitimate ones.

At their worst, unregistered financial intermediaries are the bane of the financing business. They appear at the beginning of an offering (but sometimes aren't discovered until later in the offering) and may have engaged in general advertising or solicitation before the attorneys arrive. They can be making offerings that violate the antifraud provisions of the federal and state securities laws. They can be the purveyors of that most worthless product in the securities industry—the "clean public shell."[4] They can bring to the transaction the market manipulators and profiteers whose only interest is the fast buck regardless of the consequences to the company or its investors. They can cause offers or sales to occur without regard to compliance with the very requirements of the securities offering exemptions they purport to rely on when advising an issuer.

The definition of an unregistered financial intermediary characterized as a "finder" is elusive and, indeed, it varies under the circumstances. In *Use and Compensation of 'Finders' To Locate*

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[4] Richard H. Rowe, *Clean-up of a Legitimate Business Caught in the "Shell Game,"* 6 INSIGHTS 20, 20–25 (1991). *See also*, Proposed Rule: Use of Form S-8 and Form 8-K by Shell Companies, 69 Fed. Reg. 21, 650 (Apr. 21, 2004).

Purchasers in Private Placements,[5] the term is defined as "a person, be it a company, service or individual, who brings together buyers and sellers for a fee, but who has no active role in negotiations and may not bind either party to the transaction." In our view, the definition should be expanded to state "that the person should neither offer nor sell the security, nor solicit an offer to buy, but rather act strictly as an intermediary for the purpose of introducing the parties," to underscore this all too common problem of "finders" who are in reality nothing more than salespersons for an issuer. The SEC's Division of Market Regulation views even this limited activity with skepticism when coupled with transaction-based compensation.

The State of Michigan is the only state to register a finder, defining 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."[6] Michigan presently requires a finder to register as an investment adviser and imposes minimum requirements on the finder's method of operations.[7] Michigan generally expects the finder to perform the introduction, possibly deliver the offering materials, and then step away from the transaction. This may be an acceptable model for many states, though logically a short-form state broker-dealer registration is more appropriate than the investment adviser model presently used in Michigan. Legislation was introduced last year to move the "finder" registration in Michigan to a broker-dealer status. Some view the "introduce" then "step-away" as problematic, and no study has been done to determine actual involvement of such finders.

The principal risk to the finder and the issuer is that the finder is in reality acting as an unlicensed broker-dealer. The SEC has issued several no-action letters outlining the parameters of a financial intermediaries' acceptable conduct, or declining to find conduct acceptable, in conjunction with the offer or sale of a security. Alan Berkeley[8] lists the factors which move one to the status of a broker-dealer as involvement in negotiations, discussing details regarding the transaction or making a recommendation, receiving transaction-based compensation, and previous involvement in the sale of securities.

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[5] ALAN J. BERKELEY & ALISSA J ALTONGY, REGULATION D OFFERINGS AND PRIVATE PLACEMENTS, SF71, ALI-ABA (2001), at 51 (available at Westlaw SG022 ALI-ABA 415 (2001) [hereinafter "Berkeley"].

[6] Michigan Uniform Securities Act § 401(i) (codified at MICH. COMP. LAW. ANN. § 451.801 (2004)). Some states will permit agents to become registered with an issuer to sell private placements. Customarily the state will review the private placement memorandum prior to permitting registration. *See, e.g.*, MASS. REG. tit. 950, § 12.202(3) (2005).

[7] Michigan Uniform Securities Act § 102(c) (codified at MICH. COMP. LAW. ANN. § 451.502 (2004)) (setting forth seven requirements applicable to finders, including a prohibition on taking possession of funds or securities; failing to disclose the finder relationship and compensation as well as any beneficial interest in the offering or issuer; knowing participation in an offering in violation of the registration requirements for securities, after reasonable inquiry; participation without obtaining information relative to the risks of the offering, compensation, financial condition and use of proceeds, and failure to review offering materials provided by the issuer prior to recommendation; failure to disclose material information which the finder knows or should have known is based on material information available to the finder; and making an introduction of a person who is not suitable for the investment. The finder is not required to independently generate information.).

[8] Berkeley, *supra* note 5.

On March 7, 2000, the staff of the Division of Market Regulation withdrew its 1985 no-action letter in *Dominion Resources*,[9] which had permitted Dominion to engage in a bundle of activities. The activities previously acceptable to the SEC in that letter included analyzing the financial needs of an issuer, recommending or designing financing methods and securities to fit the issuer's needs, recommending the lawyers to prepare documentation and broker-dealers to distribute the securities, participating in negotiations, and introducing the issuer to a commercial bank to act as the initial purchaser and as a stand-by purchaser if the securities could not be readily marketed. In return for these services, *Dominion* received a transaction-based fee. The withdrawal letter did not fully articulate what factors in the 1985 letter are now considered sufficient to result in a finding of unregistered broker-dealer status. The SEC recently addressed the unregistered broker-dealer issue in its revisions to the rules on accountant's independence under Section 201 of the Sarbanes- Oxley Act of 2002.[10] Rule 10A-2[11] under the Exchange Act now states generally that a certified public accounting firm is prohibited from acting as a promoter or underwriter, or making investment decisions on behalf of an audit client, among other things. The amendment expanded the scope of the prohibition to address situations where a CPA firm acts as an unregistered broker-dealer. In the commentary the SEC notes that selling—directly or indirectly—an audit client's securities presents a threat to independence, regardless of whether the broker-dealer affiliated with the CPA firm was registered as such or not.

More importantly for the purposes of the Report is the pronouncement, buried in footnote 82 of Release 33-8183 which states that:

> Accountants and the companies that retain them should recognize that the key determination required here is a functional one (i.e., is the Accounting firm or its employee acting as a broker-dealer?). The failure to register as a broker-dealer does not necessarily mean that the accounting firm is not a broker-dealer. In relevant part, the statutory definition of 'broker' captures persons 'engaged in the business of effecting transactions in securities for the account of others.' Unregistered persons who provide services related to mergers and acquisitions or other securities-related transactions by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions, should limit their activities so they remain outside of that statutory definition. A person may 'effect transactions,' among other ways, by assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions. A person may be 'engaged in the business,' among other ways, by receiving transaction-related compensation or by holding itself out as a broker-dealer. . . .[12]

The Commission will undoubtedly apply this same standard whether dealing with a Certified Public Accounting firm or not. Further, in footnote 86,[13] the Commission notes that broker-

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[9] Dominion Resources, Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000) (withdrawing Dominion Resources, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2511 (Aug. 22, 1985)).

[10] Sarbanes-Oxley Act of 2002, P.L. 107-204 § 201, 116 Stat. 745, 770 (2002) (codified at 15 U.S.C. § 78j-1).

[11] 17 C.F.R. § 240.10A-2 (2003).

[12] Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, 68 Fed. Reg. 6006, 6014 (Feb. 5, 2003).

[13] *Id*. at n.86.

dealers provide an array of services that may include certain analyst activities, suggesting that when one provides analytical services to an issuer or investor, the question of broker-dealer registration is raised even beyond the concerns in expressed in footnote 82. While these footnote pronouncements further focus the concern, they do so only in a release which is likely to be read, or even found, by those concerned with permissible activities of auditors. It illustrates the problem of the need for clearer communication on the financial intermediary question generally, but it also leaves the interpretive door open for those who want to avoid its consequences outside of the public company auditing area. No-action letters have not proven to be an adequate method of dealing with this issue. Improved procedures for registration, revised rules that provide firm guidance, a comprehensive release which clearly lays out the limitations on financial intermediaries and delegation to the State Administrators, where appropriate would go a long way toward solving the problem.

A. A NEED FOR ACTION

A variety of factors drive the need for action. The broker-dealer universe for equity financing has been dramatically shrinking both in terms of the number of firms and the scope of services that they render. With bank acquisitions of brokerage firms, consolidations of regional firms, and loss of firms in the current economic downturn, the scarcity of investment banking services, particularly for mid to small size issuers, has dramatically worsened. Many smaller brokerage firms are focusing on mutual funds and variable products, especially after the economic bath that many took if they promoted technology, communications and .com stocks. The self-imposed thresholds for doing private deals are rising for economic reasons. The result is that too few brokerage firms are willing to do offerings, public or private, under $25 million. There are several rationale for this position. The risk of doing a small deal is often similar to a large one. The legal costs are often comparable to a larger transaction because of the lack of sophistication and systems of smaller issuers and the amount of work that must be done to prepare a private placement memorandum competently. The issuer’s financial and other information may not be as complete or accurate. Smaller issuers often lack the expertise and experience to adequately deal with 1934 Act financial and other reporting issues. Finally, the smaller the company, the less diversification it can provide to an investor in terms of product range and depth of personnel and markets.

Venture capital is not able to fill this void. Venture firms are trending to investment in profitable businesses and there has been a drop in available funds. They are looking more at mezzanine financing, and less at pure equity investment. Many venture capitalists got burned in tech and related stocks and their investors are more risk-adverse. This past year some venture capital funds have been returning their investors’ monies due to inability to find enough satisfactory investments under their criteria. Further, the high yield requirements for venture capitalists are frequently incompatible with the growth potential of the preponderance of smaller issuers. Finally, there are too few venture capital funds to have even a remotely significant impact on fulfilling the need for funds. This problem has recently been exacerbated by the Small Business Administration’s determination to close down its Small Business Investment Company (“SBIC”) participating securities program. Participating securities SBICs are equity venture funds that have provided funding for many start up and growth companies throughout the United States. No new participating securities funds may be licensed with the SBA and existing funds may not receive further SBA funding.

The traditional financing sources for smaller issuers remain limited. Most issuers engage in "cup of gas" financing, seeking enough funds to move their project down the road, but not getting the funds to really develop their business. These issuers run through the chain of friends and family, to customers, to suppliers, to extended contacts, and then often run out of alternatives for growth. Lying in wait for these small issuers, amidst the dark side of the securities business, are the purveyors of fraudulent shell corporations; the front-end fee con artists; the purported Regulation S specialists who send the stock off-shore and wait to dump it back into the U.S. through unscrupulous brokerage firms or representatives who are receiving under-the-table payments for promoting stocks; the micro-cap manipulators; and the representatives who have been barred from the securities business. All of these options are likely to cost the issuer dearly, even if promised funding is received from them. Often these individuals and entities hold themselves out as finders, investment bankers, or merchant bankers and aren't registered as broker-dealers. The cost to the issuer and insiders of the company of what these finders bring to the table often far exceeds any funds they produce.

We have been asked by Regulators to quantify the number of persons who engage in this activity. We believe that is an impossibility, since there is no effective measuring device. For several years the SEC Government-Business Forum on Small Business Capital Formation ("Forum") has recommended action on creating a better method to get these financial intermediaries registered or to develop an appropriate exemption for such persons in order to provide fund raising services for small business.[14] Traditionally the Form Ds filed by issuers under Regulation D have been used for statistical purposes at the SEC. We believe that an analysis of those Form Ds will reveal the existence of a significant number of unregistered persons who receive compensation. This issue appears not to be considered a matter of concern by the SEC presently. An informal survey of the states suggests that about 1/3 of state securities agencies have identified this issue and now routinely examine the Form Ds to detect and initiate inquiries as the result of the disclosures on the Form D. The number of states engaged in screening has been trending upwards. Disclosures in 1934 Act filings also disclose payments to unregistered persons in M&A transactions for reporting companies.

The primary source of the knowledge of the Task Force has been individual observations by its members, as well as innumerable conversations with members of the Section and state bars who have shared their observations that we have a significant problem which needs to be addressed. Most surprising has been the large number of attorneys who have expressed interest in our project and concern over the frequency with which they encounter unregistered finders in their practices in private offering transactions. They strongly echo the need to take effective action to create a system that will "really work" and lament the failure of the present regulatory procedures to competently address the financial intermediary problem. In addition to concern for their clients, attorneys often expressed frustration over the ability of promoters to obtain advice that finder activity involving negotiation and transaction-based compensation was lawfully rendered by attorneys who were either unaware of the SEC's interpretations or chose to ignore them.

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[14] See *infra* Part VIII (Recommendations of the 2005 Forum and preliminary recommendations of the 2004 Forum).

B. WHO ARE THE UNREGISTERED FINANCIAL INTERMEDIARIES?

Financial intermediaries come from a variety of sources. They include CPAs and to a lesser extent lawyers, M&A specialists, business brokers, local “monied people” (the country club set), consultants (who take a variety of forms), insurance agents and real estate brokers, registered representatives illegally selling away from their firms, individuals who have substantial investor networks or the people that work for such individuals, individuals hired by entities seeking capital, angel networks, retired executives and community leaders. They also include unregistered individuals or entities who hold themselves out as finders or investment bankers and do this for a living by providing business plans, private placement memoranda, and who may remain thereafter as paid consultants.

Members of the Section have observed a significant number of attorneys who provide opinions on transactions for their clients giving comfort to these unregistered financial intermediaries, while ignoring SEC no-action letters and federal and state enforcement actions leading to a different conclusion. Generally these individuals are solo or small firm practitioners with very limited securities experience and either no appreciation for the complexity of the analysis or a willingness to render opinions to accommodate a client.

C. WHAT PROBLEMS DOES ONE CONFRONT WHEN USING AN UNREGISTERED FINANCIAL INTERMEDIARY?

Unregistered financial intermediaries can cause major problems for an issuer. They can taint an offering by creating the basis for rescission rights, raise enforcement concerns, make fraudulent representations and engage in general solicitation. These issues are discussed in the section on Litigation Issues below. They can be individuals who have been suspended or barred from the securities business or fired by firms for misconduct. There are those who act in collusion with market manipulators and those who bribe registered representatives to act as touts. Use of these individuals often leads to litigation when the stock prices drop, as they frequently do.

These financial intermediaries can provide encouragement to cut legal corners. They often under-price legitimate firms or deter issuers from going to legitimate firms. For an attorney, they are a major concern, since their actions adversely affect our ability to render customary legal opinions in transactions and, therefore, harm our clients.

These individuals often lead the issuer down a primrose path with false promises. They may add to the issuer’s existing problems, create significant litigation or raise an enforcement action risk. The unregistered financial intermediaries’ contracts can be incredibly over-bearing, significantly hampering future financing for the issuer. After funding, issuers may find themselves faced with very unhappy investors who are angry over misrepresentations by the finders or drop in an artificially inflated price, and who demand rescission or the buy-out of their shares. Those investors may also apply pressure to the issuer to make a corporation “go public” or qualify its shares for trading on the NASDAQ Bulletin Board or Small Cap market before the company is prepared to take that step from a financial, compliance, risk management, management sophistication, or regulatory filing capability perspective.

Issuers who later desire to go public don't appreciate the difficulties which can be attached to prior offerings that violate securities laws.[15] The issuer must describe prior securities offerings as part of the registration process. The staff of the SEC's Division of Corporation Finance may well ask for a rescission, or at a minimum disclosure of contingent liability. Under such circumstances, the firm's auditors will also request disclosure, or perhaps a reserve which would have the effect of destroying the credibility of the balance sheet of the issuer. Further, the matter may be referred to the Enforcement Division at the SEC and states that review of the offering will likewise pick up on the disclosure and may commence investigations.

A consistent theme in the SEC proceedings against unregistered broker-dealers has been the lack of disclosure of compensation paid to such individuals or entities. While an issuer may have a belief that their offering complies with Regulation D, Rule 506,[16] the failure to disclose that compensation in the presence of even a single non-accredited investors destroys the exemption for failure to meet the Rule 502[17] disclosure requirements. Further, almost all state laws contain a prohibition against payment of compensation to unregistered broker-dealers as a condition of their private offering exemption. Some states have gone further and expressly deny compensation to finders. If the finder is acting as an unregistered broker-dealer, that addition is surplusage, but to the extent that a role for finders remains, the prohibition reaches that compensation as well. The consequence of failure of improper payment is loss of the exemption, and the issuer may face a demand from the state securities agency for rescission, or any investors may be able to take advantage of the "put" that is provided by an illegal sale, and require rescission under Section 410 of the Uniform Securities Act,[18] together with interest at the rate prescribed by the state. Finally, most such state acts provide for attorney's fees to the person seeking rescission. The persons liable under state law include not only the issuer, but its officers and directors, as well as those involved in selling the securities.

The entity with these problems is also less likely to be looked on favorably as an acquisition candidate, or the price offered for an acquisition may dramatically decrease.

Regulators have a substantial concern over the "finders" who flout the securities laws. We estimate that the various states bring well over 100 enforcement cases against unregistered finders on an annual basis (and probably a great deal more because statistics are not available from NASAA or the states to identify the full extent of state action). The NASD brings a large number of cases against individuals who are engaged in selling away from their brokerage firms for acting as unregistered financial intermediaries, often barring them from the business or imposing long suspensions. This is the second most frequently cited grounds for sanctioning registered representatives and has been for the past several years. The NASD asserts that Code of Conduct Rule 3040[19] includes situations where the associated person's role in a transaction is limited to a client introduction and to eventual receipt of a finder's or referral fee.[20] The NASD monthly Notice To Members, which lists enforcement actions, contains "selling away" allegations in virtually every issue. These actions represent only the tip of the iceberg of that

[15] Virginia K. Kapner, *When Finders Bring Trouble*, 47 BOSTON B.J. 14 (2003).

[16] 17 C.F.R. § 230.506 (2004).

[17] 17 C.F.R. § 230.502 (2004).

[18] Uniform Securities Act § 410 (2002).

[19] NASD Conduct Rules are part of the NASD manual available in the rules and regulations section at the NASD website, http://www.nasd.com.

[20] *See In the matter of* Gilbert M. Hair, 51 SEC 374, 378 (1993); *In the Application of* John P. Goldsworthy, 2002 SEC LEXIS 1279 (May 15, 2002).

problem. The SEC brings dozens of these cases annually, but the manner of description of the cases circulated to the public focuses almost exclusively on the fraudulent conduct that occurs, and mentions only in passing the unregistered broker or broker-dealer issue without details or explanation of the basis for the charge. These cases provide a great opportunity for better guidance, but the message is lost in the present descriptions of cases published in Exchange Act Releases.[21] However, it is worth noting that among the allegations of fraud in such cases are the failure to disclose compensation paid to the unregistered broker-dealer, misrepresenting the cost of the offering and lying about the amount of commissions paid.[22] The SEC has also barred persons from acting as finders.[23] In one of its better publicized cases, the SEC alleged that a former Tyco Lead Director and Chairman of the Compensation Committee collected a secret $20 million finder's fee in conjunction with Tyco's 2001 acquisition of the CITI Group, Inc.[24]

The illegitimate financial intermediaries, who are really unlicensed broker-dealers, were a direct cause of the SEC action in restricting the scope of Regulation S and Rule 504 in 1999. Regulators are also unhappy to find that the people that they have expelled from the business have resurfaced in a new guise.[25] Today, so-called "finders" are active in soliciting investors for a range of products which have been held to involve securities, including pay phone leases, viatical or life settlement contracts, promissory notes, foreign CDs, and "prime bank" scams. These areas of concern appear regularly in NASAA's Top Ten Investment Frauds which is published annually.

A concern expressed to the Task Force is that the unregistered financial intermediary makes it very difficult for smaller registered, reputable broker-dealers to become involved in raising funds. Unscrupulous entities and individuals can make exorbitant promises, enter into exclusionary contracts with unconscionable terms, and abuse the unsophisticated small businessman without much difficulty. Another concern frequently expressed to the Task Force addressed the problem that competent attorneys face when an issuer comes seeking guidance, is told that the financial intermediary who proposes to raise their funds is operating illegally, and recommends not doing business with that financial intermediary. A common lament from these attorneys is that too often the client walks down the street and easily finds attorneys who are willing to advise the issuer that there is no problem in hiring the financial intermediary to actively sell their deal to the public, and pay transaction-based compensation afterwards.

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[21] *In re* Charles K. Seavey, 2002 SEC LEXIS 398 (Feb 20, 2002) (The SEC expressed a strange ambivalence on the subject when the Administrative Law Judge on several occasions discussed the role of "finders" who helped fund a hedge fund, but did so without any discussion of the impropriety of the use of finders.). *But see*, SEC v. Terry L. Dowdell, 2003 SEC LEXIS 1180 (May 19, 2003) (The SEC obtained an order of disgorgement for over $1.6 million from a marketer for a Ponzi scheme).

[22] *See, e.g.*, SEC v. North American Medical Products, Inc, 2003 SEC LEXIS 572 (March 11, 2003); SEC v. Von Christopher Cummings, 2002 SEC LEXIS 2907 (November 15, 2002).

[23] *See, e.g.*, *In re* Vadim "Steven" Shapiro, 203 SEC LEXIS 1160 (May 14, 2003); *In re* Michael Danilovich, 2003 SEC LEXIS 1163 (May 14, 2003); and *In re* Justin Marvul, 2003 SEC LEXIS 1164 (May 14, 2003) (there is no pattern that emerges from the regulatory orders widely adopting this practice).

[24] SEC v. Frank E. Walsh, Jr., 2002 SEC LEXIS 3193 (December 17, 2002) (he was ordered to repay the $20 million subject to certain rights of set-off from other litigation).

[25] *See, e.g.*, SEC v. Gratz, 2003 SEC LEXIS 912 (April 18, 2003) (Gratz was subject to a criminal contempt action for disobeying the permanent injunction against him in *SEC v. Delta Rental Systems*, 2003 SEC LEXIS 693 (March 25, 2003)).

D. M&A CONCERNS

Unregistered financial intermediaries play an important role in M&A transactions, often bringing parties together when other conventional sources have been unable to do so. Even those who bring this benefit to the table can also bring problems, as they edge closer to the role of the broker-dealer in getting transaction-based compensation, in negotiating transactions or for bringing in venture capital, angels, institutional investors, or loans from non-commercial sources to assist in a management buy-out.

The SEC has carved out some guidance in this area, as discussed in Merger and Acquisition Transactions below. Our Recommendations suggest an expanded distribution of this guidance and a more-meaningful carve-out for permissible activities which do not raise material enforcement concerns.

E. THE SEARCH FOR CERTAINTY

For the lawyer asked to render opinions in conjunction with financing transactions or acquisitions involving fees for obtaining financing, we seek reasonable certainty. Tainted transactions are harmful to all parties involved, including investors.

The problem with certainty is that the present system really does not work well for regulating many financial intermediaries. Often intermediaries play a very limited role in transactions, but in order to engage in securities transactions, broker-dealer registration is required in a manner that may be more appropriate to a full-service firm. Consequently, financial intermediaries often state that they refuse to register under a system that has no real applicability to what they do.

The response of the Task Force is to work with the SEC, NASD and the states, through NASAA, to develop a regulatory system that works more effectively. This entails modifying existing procedures, forms, rules and systems to adapt them to what finders really do and to encourage registration as broker-dealers when they fall outside of safe harbors. At the same time, the Task Force encourages systems to identify those individuals or entities who are “bad boys” or statutorily disqualified persons. We believe that it is likely that the SEC will be more aggressive in the future in policing unregistered broker-dealers. Under the most logical sequence, when the new form of broker-dealer is established, the SEC and NASAA would issue clarifying releases on the role of PPBDs and the new broker-dealer registration procedures.

II. EXCEPTIONS TO REQUIRED BROKER-DEALER REGISTRATION

Within a very narrow scope of activities primarily described in SEC no-action letters, a person may perform certain limited activities without triggering broker-dealer registration requirements. In interpreting their own securities laws, states generally, but not always, follow a similar analysis. These limited exceptions to broker-dealer registration are entirely constructions of regulatory interpretation and are not explicitly recognized in federal or state securities laws (Michigan being the only exception).[26] The SEC and state securities regulators are free to modify the scope of these limited exceptions at any time. In fact, in recent years the SEC has been narrowing the permitted scope of finder activities. Indeed, in the last two years the SEC staff has not only expressly limited the scope of one well-established exception, but has withdrawn another significant no-action letter relied upon by many finders in structuring their arrangements

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[26] *See supra* notes 5 and 6.

with securities issuers citing, among other things, advances in technology that have permitted other types of persons to become involved in securities-related activities.

A. FINANCIAL INTERMEDIARIES

The SEC has by no-action letter defined the contours of financial intermediaries' exceptions, though as discussed below those contours are currently in flux. It is in this context of finders the SEC has articulated many of its guiding policy concerns.

Although no single factor is dispositive of the question of whether a finder is engaged in the activities of a broker-dealer, SEC no-action letters reveal a variety of factors that are typically given some weight by the staff including: (1) whether the finder was involved in negotiations; (2) whether the finder engaged in solicitation of investors; (3) whether the finder discussed details of the nature of the securities or made recommendations to the prospective buyer or seller; (4) whether the finder was compensated on a transaction-related basis; and (5) whether the finder was previously involved in the sale of securities and/or was disciplined for prior securities activities.[27] A review of these individual criteria provides some guidance as to the range of permissible conduct.

1. Transaction-Based Compensation

Transaction-based compensation has come under intense scrutiny by the SEC.
The SEC's Division of Market Regulation has repeatedly noted that:

> . . . [T]he receipt of compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer. Absent an exemption, an entity that receives securities commissions or other transaction- based copensation in connection with securities-based activities that fall within the definition of "broker" or "dealer" generally is itself required to register as a broker-dealer. Registration helps to ensure that persons who have a "salesman's stake" in a securities transaction operate in a manner that is consistent with customer protection standards governing broker-dealers and their associated persons. That principle not only encompasses the individual who directly takes a customer's order for a securities transaction, but also any other person who acts as a broker with respect to that order, such as the employer of the registered representative or any other person in a position to direct or influence the registered representative's securities activities.[28]

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[27] See Alan J. Berkeley and Alissa A. Parisi, *Frequently Asked Questions About the Resale of Restricted Securities* (ALI-ABA 2002) (available on Westlaw at SH001 ALI-ABA 517); David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899, 914, 927 (1987). A review of these individual criteria provides some guidance as to the range of permissible conduct. There is no indication that a transaction's status as a public offering, as opposed to a private placement, has any impact on the Staff's interpretation of the broker-dealer registration requirements. *Compare* NFC Petroleum, SEC No-Action Letter, 1978 SEC No-Act. LEXIS 1601 (July 17, 1978) (applying standards discussed herein to finder engaged in public offering) *with* Dana Investment Advisors, Inc., SEC No-Action Letter, 1994 SEC No-Act. LEXIS 871 (Oct. 12, 1994) (applying same standards in context of private transaction).

[28] Herbruck, Alder & Co., SEC No-Action Letter, 2002 SEC No-Act. LEXIS 598 (June 4, 2002); *see also*, Birchtree Financial Services, Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 875 (Sept. 22, 1998) (registered representative's personal service corporations); 1st Global, Inc., SEC No-Action Letter, [2001 Tranfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,119, at 77,790 (May 7, 2001) (unregistered CPA firms); John Wirthlin, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 83 (Jan. 19, 1999); Richard S. Appel, SEC No-Action Letter, 1983

Transaction-based compensation triggered a broker-dealer registration obligation in *Mike Bantuveris*,[29] where the company wished to offer a consulting service in which it would identify companies as possible acquisition candidates and assist its clients in negotiating toward a final agreement. The company proposed to base its fees, in part, on the total value of consideration received by the sellers or paid by the buyers. On these facts, the staff indicated that the company would be required to register as a broker-dealer. The staff noted that its opinion was "based primarily on the fact that the consulting firm would . . . receive fees for its services that would be proportional to the money or property obtained by its clients and would be contingent upon such transactions in securities."[30]

The SEC has left open whether a commission-like fee arrangement, standing alone, will always constitute grounds for registration as a broker-dealer. It is this letter which appears to create the greatest uncertainty for counsel and intermediaries. *Paul Anka*,[31] SEC No-Action Letter (July 24, 1991), provides the unusual case where a commission-like fee has been allowed to stand. The staff's favorable position would appear to be attributable to the uniquely limited duties of the finder involved in the case and to the one-time occurrence of the event. In *Anka*, the Ottawa Senators Hockey Club retained entertainer Paul Anka to act as a finder for purchasers of limited partnership units issued by the Senators. Anka agreed to furnish the Senators with the names and telephone numbers of persons in the United States and Canada whom he believed might be interested in purchasing the limited partnership units. Anka would neither personally contact these persons nor make any recommendations to them regarding investments in the Senators. It is noteworthy that in Mr. Anka's original proposal letter to the SEC he would have made the initial contact with prospective investors, but the SEC would not issue a no-action letter under those facts. In exchange for his services, Anka would be paid a finder's fee equal to 10 percent of any sales traceable to his efforts. Important factors identified in the *Anka* letter include:

- Mr. Anka had a bona fide, pre-existing business or personal relationship with these prospective investors.
- He reasonably believed those investors to be accredited.
- He would not advertise, endorse or solicit investors.
- He would have no personal contact with prospective investors.
- Only officers and directors of the Senators would contact the potential investors.
- Compensation paid to the Senators' officers and directors would comply with 1934 Act Rule 3a4-1 (governing compensation to issuer's agents).
- He would not provide financing for any investors.
- He would not advise on valuation.
- He would not perform due diligence on the Senators' offering.
- He had never been a broker-dealer or registered representative of a broker-dealer.

SEC No-Act. LEXIS 2035 (Feb. 14, 1983) (1031 exchange transactions; requiring registration because finder would receive commission-based compensation on sales).

[29] Mike Bantuveris, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2158 (Oct. 23, 1975).

[30] *See also* John M. McGivney Securities Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2159 (May 20, 1985).

[31] Paul Anka, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,797, at 78,577 (July 24, 1991).

Based on these facts, the SEC indicated that it would not recommend enforcement action if Anka engaged in the proposed activities without registering as a broker-dealer.

While the SEC did not comment specifically on the issue, it would appear that the staff was willing to tolerate the commission-like structure of Anka's fee arrangement because his role in finding prospective purchasers?which was limited to sending a list of names to the Senators—providing no opportunity or incentive to engage in abusive sales practices.[32] The SEC staff may be reconsidering whether Mr. Anka's activities sufficiently removed him or others like him from having the opportunity to engage in abusive sales practices that registration is intended to regulate and prevent. Based on staff comments at a recent Business Law Section meeting, the SEC staff may also be reconsidering its position in the Paul Anka letter situation and might not issue such a letter today. Although the SEC's position in the *Anka* letter was not premised on the 1985 *Dominion Resources* letter[33] (discussed below and in Section IV), the revocation of *Dominion Resources* in 2000[34] seems to demonstrate that the staff is moving to a position where the existence of transaction-based compensation alone may be sufficient to trigger broker-dealer registration. From the SEC staff's perspective, transaction-based compensation creates the incentive for abusive sales practices that registration is intended to regulate and prevent. Many financial intermediaries would rather be sure of their status by being registered, but avoid the burdensome and generally inapplicable process that is found in the present regulatory scheme.

2. Negotiation or Advice

If the financial intermediary is involved in negotiations or has provided detailed information or advice to a buyer or seller of securities, the staff is more likely to require the finder's registration as a broker-dealer.[35] The staff has emphasized that "persons who play an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally are deemed to be either a broker or a dealer, depending upon their particular activities, and are required to register with the Commission."[36] But if the intermediary's participation in negotiations is limited to performing the "ministerial function of facilitating the exchange of documents or information," the staff has indicated that no registration is required.[37]

For example, no-action relief was denied to May-Pac, a company specializing in mergers and acquisitions, who proposed to seek out potential sellers of corporations, bring them together with potential buyers, and work toward closing the transaction. The company acknowledged that, in most cases, it would participate in whatever negotiations were necessary to close the deal and advise its client as to the quality of any offer received. On the basis of these activities, the SEC concluded that the company would be required to register as a broker-dealer. The staff found that

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[32] See John Polanin, Jr., The "Finder's" Exception from Federal Broker-Dealer Registration, 40 CATH. U. L. REV. 787, 814 (1991).

[33] *Dominion Resources*, 2000 SEC No-Act. LEXIS 2511.

[34] *Dominion Resources*, 2000 SEC No-Act. LEXIS 304.

[35] *See, e.g.*, Mike Bantuveris, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2158 (Oct. 23, 1975) (requiring registration); May-Pac Management Co., SEC No-Action Letter, [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,679, at 83,834 (Dec. 20, 1973) (requiring registration); Fulham & Co., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4488 (Dec. 20, 1972) (requiring registration); cf. Caplin & Drysdale, Chartered, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2291 (Apr. 8, 1982) (not requiring registration where finders neither negotiated nor provided advice); Leonard-Trapp & Assocs. Consultants, SEC No-Action Letter, [1972–1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,971, at 82,093 (Aug. 25, 1972) (requiring registration).

[36] *May-Pac Management Co., supra* note 35.

[37] Samuel Black, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 104 (Dec. 20, 1976).

the proposed activities were more than merely bringing together the parties to transactions involving the purchase or sale of securities.[38] The firm proposed to negotiate agreements, engage in other activities to consummate the transactions, and to receive fees for its services that would be proportional to the money or property obtained by its clients and would be contingent upon such transactions in securities.

Alternatively, the SEC granted no-action relief to Victoria Bancroft, a licensed real estate broker, who established lists of clients who might be interested in acquiring financial institutions that are for sale.[39] The *Bancroft* letter describes her activities as being "limited merely to the introduction of parties."[40] She did not participate in the establishment of the purchase price or any other negotiations between the parties. The parties created all materials related to either the sale or purchase of the financial institutions without Bancroft's involvement. She didn't even facilitate exchange of the information. At most she described to the potential purchaser the type of institution, the asking price, and the general location. If the potential person were interviewed, Bancroft would arrange a meeting with the seller or seller's representative. Either the buyer or seller would compensate Bancroft by a flat fee or a percentage of the purchase price. The compensation was considered to be a referral fee or finder's fee.

In granting no-action relief, the staff indicated that (1) Bancroft had a limited role in negotiations between the purchaser and seller; (2) the businesses represented by Bancroft were going concerns and not shell corporations; (3) transactions effected by means of securities would convey all of a business's equity securities to a single purchaser or group of purchasers formed without the assistance of Bancroft; (4) Bancroft did not advise the two parties whether to issue securities or assess the value of any securities sold; and (5) Bancroft did not assist purchasers to obtain financing. The staff further stated that Bancroft would be subject to the anti-fraud provisions of the federal securities law to transactions in which securities are used to transfer ownership of a business.[41] *Bancroft* is an old no-action letter lacking the details found in more current no-action letters.

3. Solicitation

Solicitation of investors for securities is also a factor that weighs in favor of broker-dealer registration. In *Thomas R. Vorbeck*,[42] the SEC required registration where the company proposed to offer a two-part securities service package to its employees in order to cure what it viewed as deficiencies in its employee stock purchase plan. Under the plan, employees could elect to reduce their commission expenses by assigning the stock to the employer, and/or to increase their profits by authorizing the employer to sell short designated shares of stock once each quarter. On the basis of these facts, the staff indicated that the company would be required to register as a broker-dealer under Section 15(a). As the staff explained, the proposed activities "would appear to bring [the company] within the definition of a broker since it is reasonable to presume that [among other things] . . . the plan would entail some form of solicitation of business

[38] May-Pac Management Co., SEC No-Action Letter, [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,679, at 83,834 (Dec. 20, 1973).
[39] Victoria Bancroft, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2517 (Aug. 9, 1987).
[40] *Id.*
[41] *Id.*
[42] Thomas R. Vorbeck, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 1823 (Mar. 24, 1974).

on your behalf."[43] The SEC has not provided much guidance on what activities constitute solicitation or advertising sufficient to trigger broker-dealer registration under Section 15(a). However, the staff has accepted a finder's use of a cover letter and a press release to notify prospective purchasers of the proposed transaction.[44] It is the content and extent of the solicitation, rather than the mode of communication, which will most likely determine the SEC's reaction to a finder's solicitation activities.[45]

4. Previous Securities Sales Experience or Disciplinary Action

Another factor given weight by the staff is whether the finder has previously been involved in the sales of securities and/or disciplined for violations of the securities laws. The SEC wants to be certain that the finder exception is not a "back door" for past violators barred from the industry to remain involved and put investors at risk. Accordingly, previous involvement in the securities industry increases the likelihood that the finder will be required to register as a broker-dealer. An interesting example of this is *Rodney B. Price and Sharod & Assocs*.[46] In Price, the usual indications of broker-dealer status seemed to be lacking. The finder was retained to locate brokers and dealers as potential underwriters or participants in private offerings. The finder was to have no involvement in actual selling efforts, and his fee was not based on commissions tied to sales.

While the staff did not directly attribute this opinion to the finder's prior securities activities and disciplinary history, the letter began by describing at length the fact that the finder had previously engaged in the sale of securities and that he had recently been disciplined for violations of the Act. Since nothing in the nature of the finder's proposed activities would otherwise seem to have necessitated registration as a broker-dealer, it is fair to conclude that the staff's decision was motivated by the finder's previous securities activities.[47]

In 1998, the SEC brought an action against Michael Milken and MC Group[48] for allegedly violating the broker-dealer registration provisions of the federal securities laws. In its complaint, the SEC alleged that MC Group, through Milken and others, acted as business consultants, introduced companies, suggested business arrangements between them, participated in negotiations regarding the structure of transactions, and received transaction-based compensation in the amount of $42 million. The SEC further alleged that as a result of this conduct Milken

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[43] *See also* SEC v. Schmidt, 1971 Fed. Sec. L. Rep. (CCH) ¶ 93,202 (S.D.N.Y. Aug. 26, 1971) (finder was determined to be a broker-dealer when he placed advertisements in a daily newspaper offering savings on commissions); Joseph McCulley, SEC No-Action Letter, [1972–1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,982, at 82,110 (Sept. 1, 1972) (requiring registration based on mere repeated advertising to buy and sell securities).

[44] Ewing Capital, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 1597 (Jan. 22, 1985).

[45] *See, e.g.*, Victoria Bancroft, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2517 (Aug. 9, 1987); Mike Bantuveris, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2158 (Oct. 23, 1975); F. Willard Griffith, II, SEC No-Action Letter, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,994, at 84,561 (Oct. 7, 1974).

[46] Rodney B. Price and Sharod & Assocs., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2978 (Nov. 7, 1982).

[47] Cf. Carl L. Feinstock, SEC No-Action Letter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,067, at 81,749 (Apr. 1, 1979) (stating initially that the finder, who was to receive commissions tied to sales, had to register but then changed its opinion after being informed in a follow-up letter that the finder had "not previously been engaged in any private or public offerings of securities").

[48] SEC v. Milkin and MC Group, 1998 SEC LEXIS 323 (Feb. 26, 1998).

violated the SEC's March 11, 1991 order prohibiting Milken from associating with a securities broker, and was liable for MC Group's violations of the Exchange Act because he directly and indirectly controlled MC Group.

Milken and MC Group consented to settle the action, without admitting or denying the allegations. They also agreed to disgorge the $42 million earned from the transactions and prejudgment interest of $5 million. The final judgment commands Milken to comply with the March 11, 1991 order and permanently enjoins him and MC Group from directly or indirectly violating §15(a) of the Exchange Act. The nature of Milken's and MC Group's alleged activities did seem to require registration as a broker-dealer. The alleged transactions included giving advice, participating in negotiations and receiving transaction-based compensation. It is also fair to conclude that the staff's decision was motivated in part by Milken's violation of the SEC's 1991 order that disciplined Milken for previous violations of the securities laws.

B. ELECTRONIC COMMUNICATION SERVICES/LISTING SERVICES

Some financial intermediaries that use electronic communication services or listing services have been granted no-action assurance. In the IBEC Letter,[49] the SEC granted No-Action assurance. IBEC was a business broker in Texas, registered as a real estate broker in the states where it operated. It sold assets of businesses that were going concerns through advertising in national publications. Sometimes the only way to effect the sale was through a business entity, such as a closely held corporation, partnership, etc. This meant that stock or other securities might be involved in the transaction. For its services IBEC would get a commission based on the sales price, computed on the gross asset value. For purposes of computing the commission, all sales are treated as asset sales free and clear of all indebtedness. This letter is described in detail in Section IV.

Listing services can vary in nature extensively, from the routine listing of real estate to specific listings of unique kinds of business. It is not possible to describe the variety of such services, but the essence of the regulatory requirements starts with the *IBEC* letter. The evolution of the internet as a means of communication and negotiation suggests that we just scratched the surface of the development of such services.

C. FINANCIAL INTERMEDIARIES FOR ISSUERS

The scope of activities permitted for financial intermediaries for issuers has been narrowing. On March 7, 2000, no-action assurance previously granted to Dominion Resources was revoked.[50] Without discussion, the SEC's 1985 letter had allowed Dominion Resources, Inc., to recommend a bond lawyer to the issuer, recommend an underwriter or a broker-dealer for the distribution or the marketing of a security in the secondary market, and recommend a commercial bank or other financial institution to provide a letter of credit or other credit support for the securities.[51] If the nature of the financing so required, Dominion Resources was allowed to introduce the issuer to a commercial bank (which may have a preexisting customer relationship with the issuer) to act as the initial purchaser of the securities and as a standby purchaser if the securities cannot be readily marketed by the broker-dealer. Dominion Resources did not receive any commissions or other transaction-based compensation in connection with

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[49] *IBEC Letter*, 1986 SEC No-Act. LEXIS 3065.
[50] *Dominion Resources, Inc.*, 2000 SEC No-Act. LEXIS 304.
[51] *Dominion Resources, Inc.*, 1985 SEC No-Act. LEXIS 2511.

those activities. Dominion Resources did not purchase, sell or solicit purchasers for the securities. The only contact Dominion Resources had with any potential purchaser was the possible introduction of the issuer to a commercial bank standby purchaser.

In addition, Dominion Resources did not bid on any issues of securities nor did it underwrite, trade or hold funds or securities of the issuer. Representatives of Dominion Resources were available, as requested by the issuer, for consultation regarding the terms of the financing, preparation of official statements and other matters leading to the closing. In its capacity as consultant, Dominion participated in discussions and meetings prior to the closing among the issuer, issuer's counsel, bond counsel, the underwriter or broker-dealer, authority counsel, and any commercial bank standby purchasers. At any meetings prior to and including the closing, Dominion Resources provided financial advice consistent with its role as a consultant, but had no authority to represent any of the parties in the negotiations or to bind them to the terms of any agreement. While Dominion Resources might, upon occasion, as part of the consultative, advisory and negotiating process articulate, explain or defend negotiating proposals or positions that have been adopted by its client or that Dominion Resources had recommended for its client's adoption, under all circumstances, Dominion acted only on behalf of its client and subject to the direction of its client and did not act as an independent middleman between the parties.

Representatives of Dominion Resources reviewed the documentation associated with the financing, but the parties to the financing were responsible for the preparation of the documentation and other operational aspects of the financing, such as printing, mailings, delivery of securities or preparation of bond registration.

Dominion Resource charged fees for its consultative and coordinating services that were related to the overall size of the financing that the client wished to arrange, and generally were not payable unless the financing closed successfully. Dominion Resources' fees were not based on successful issuance of securities to the public or affected by secondary trades thereafter. After the closing, Dominion Resources had no further significant involvement with the financing, except that upon occasion, and at the request of the issuer, Dominion Resources would, without compensation and as an accommodation to the issuer from time to time make recommendations about investment of temporarily idle proceeds of an issue or monitor the performance of the issue.

In revoking the 1985 no-action letter, the staff said it had frequently considered the distinction between activities of a broker which require registration and activities of a finder which is not subject to registration. The staff said that because of technological advances and other developments in the securities markets, more and different types of persons have become involved in the provision of securities-related services, requiring greater restrictions on the types of services finders may offer without registering as a broker under the Securities Exchange Act of 1934. Since that time, the staff has denied no-action requests in situations similar to the activities described in the *Dominion* August 22, 1985 letter.[52]

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[52] *Id. E.g.* John Wirthlin, SEC No-Action Letter, 1999 SEC No. Act. LEXIS 83 (Jan. 19, 1999) (no-action request denied where person would solicit investments in real estate limited partnership interests from investors through their accountants and commercial real estate brokers and would receive a fee if any referred investors purchased those securities); Davenport Management, Inc., SEC No-Action Letter [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,643, at 77,729 (Apr. 13, 1993) (broker-dealer registration required where, among other things, business broker receives transaction fees and participates in negotiations); C&W Portfolio Management, Inc., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 1286 (July 20, 1989) (broker-dealer registration required

In light of those denials, the staff reconsidered the no-action position taken in the August 22, 1985 letter to Dominion Resources. The staff no longer believes that an entity conducting the activities described in that letter would be exempt from registration as a broker-dealer under §15 of the Exchange Act.

The 2000 *Dominion* letter[53] is even less explicit in its reconsideration than the 1985 letter was in its grant of no-action relief, but we can assume that concern over any Dominion activities that were similar to the activities of *Wirthlin, Davenport*, and C&W[54] were the basis revoking the letter. Since Dominion received transaction-based compensation, provided advice, made recommendations, and was involved in negotiations, the staff felt compelled to revoke the letter for consistency. This letter reflects the staff's position that these activities are significant factors in determining whether the finder is engaged in the activities of a broker-dealer. It also suggests that other letters that came after the 1985 *Dominion Resources* letter[55] may receive additional scrutiny.

D. FINDERS FOR BROKER-DEALERS

Finder's activities on behalf of a broker-dealer are not permitted without either broker-dealer registration or registration as a person associated with a broker-dealer. From its perspective, the NASD says it has long been policy to prohibit a member firm from paying finders or referral fees. In Notice to Member 97-11[56] where the NASDR was requesting public comment on a proposed Code of Conduct Rule 2460 (adopted later after very substantial modifications),[57] the NASDR wrote:

> The NASD believes that it is important to be able to regulate the flow of securities-related compensation from its members to unregistered persons in connection with the solicitation of securities transactions. Therefore, the NASD consistently has taken the position in published interpretations that it is improper for a member or a person associated with a member to make payments of "finders" or referral fees to third parties who introduce or refer prospective brokerage customers to the firm, unless the recipient is registered as a representative of an NASD member firm (See NASD Notice to Members 89-3; NASD Guide to Rule Interpretations (May 1994), p. 108.) This position is based on the definition of "representative" in the NASD rules and the definition of "associated person" in the NASD By-Laws. The NASD interprets these provisions to mean that persons who introduce or refer prospective customers and receive compensation for such activities are engaged in the securities business for the member in the form of solicitation. NASD disciplinary decisions have stated that solicitation is the first step in the consummation of a securities transaction and must be regarded as part of the conduct of business in securities. The NASD . . . believes that persons who receive compensation from a member for soliciting securities transactions are engaged in the securities business

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where company acts as intermediary in negotiations between Treasury dealers until they reach agreement as to the terms of the transaction, and receives a set fee contingent upon consummation of the transaction).

[53] *Dominion Resources, Inc.*, 2000 SEC No-Act. LEXIS 304.

[54] *Wirthlin*, 1999 SEC No-Act. LEXIS 83; *Davenport*, Fed. Sec. L. Rep. ¶ 76,643, at 77,729, C&W, 1989 SEC No-Act. LEXIS 1286.

[55] *Dominion Resources, Inc.*, 1985 SEC No-Act. LEXIS 2511.

[56] Notice to Members 97-11, 101, 103–104 (Mar. 1987) (*available at* http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004870.pdf).

[57] NASD Conduct Rule 2460 (adopted July 3, 1997).

> under the control of a member firm and should be subject to NASD qualification and registration requirements.[58]

The NASD's proposed Conduct Rule 2460[59] raised many other issues in the industry and was never adopted as proposed. However, that has not changed the NASD's view of these limitations.

From the SEC's perspective, a similar view is illustrated in *John R. Wirthlin*,[60] In *Wirthlin*, the finder proposed to find tax accountants, commercial real estate brokers, and other professionals ("Professionals") whose clients may be interested in a real estate limited partnership investment structured to achieve tax deferral benefits under Code § 1031.[61] The finder would introduce the Professionals to the registered representatives of a broker-dealer. The finder's involvement would end after setting up and attending a meeting of introduction between the Professionals and the registered representatives. The finder would not have any involvement in the transaction or even contact the potential investor. The finder's compensation would be based on a percentage of the investment and would be paid by the limited partnership. As support for his request, Wirthlin cited the *Paul Anka* letter[62] along with other letters where the SEC did not require registration. Common to those letters was the fact that the finder was not directly involved in the securities transaction and received transaction-based compensation.

In its analysis, the staff distinguished the activities described by Wirthlin from the activities permitted in the *Anka* letter because those involved finders for issuers not broker-dealers. The staff said that Wirthlin's proposed activities would be, in effect, soliciting investments in real estate limited partnership interests from investors through their advisors. In addition, Wirthlin would receive transaction-based compensation. Since both activities are characteristic of broker-dealer activities, they require registration. In essence, the finder's proposed activities would be a subset of the normal activities of the broker-dealer's own representatives and both the form and calculation of their compensation would be the same-only paid by different persons. In this case there was no basis for the SEC to draw any meaningful distinction between the finder and the representatives both required registration.[63]

E. CONSULTING ACTIVITIES

Individuals can have a limited role in securities transactions without being deemed to be agents. They can consult on structure, provide valuation reports, render technical advice, provide industry expertise, assist as accountants in the development of forecasts, etc. However, the SEC views transaction-based compensation for such persons as problematic and is suspicious that they really are involved in the entire transaction, including playing a role in obtaining investors. The less involved a business consultant is in the negotiation and structuring of a transaction, the less likely it will be that the staff will require the business consultant to register as a broker-dealer despite the fact that the consultant receives transaction-based compensation. For example,

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[58] The converse is also true, in that a registered broker-dealer cannot participate in an offering with an unregistered broker-dealer. NASD Conduct Rule 2420(b)(2).
[59] *Id.*
[60] *Wirthlin*, 1999 SEC No-Act. LEXIS 83.
[61] 26 U.S.C. § 1031 (2000).
[62] Paul Anka, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,797, at 78,577 (July 24, 1991).
[63] *Wirthlin*, 1999 SEC No-Act. LEXIS 83.

in *Russell R. Miller & Co., Inc.*,[64] the finder was in the business of locating insurance agencies and evaluating them for acquisition. The finder was paid a fee that was contingent on a subsequent purchase or sale. However, the acquisition of a specific agency was not necessarily structured by the sale of securities and the finder played no role in organizing the actual acquisition. The staff considered the finder to be a consultant "retained to bring to bear its knowledge and expertise to the task of identifying an acquisition prospect" and not as a broker.[65]

Compensation for consulting services was also the subject of *Caplin & Drysdale, Chartered*.[66] Copeland, a registered broker-dealer wanted to sell annuity plans to public employers in various market areas. In each market, Copeland proposed to hire consultants as independent contractors to provide demographic information about the public employees and financial information about the insurance policies, pension plans, and other financial benefits provided by public employers for public employees. Copeland proposed to pay the consulting firms an annual flat fee and a bonus based on a percentage of the first year annuity's commissions earned from specific annuity plans. The consulting firms would not represent Copeland, provide investment advice, distribute sales material, or participate in negotiations involved in the sales of securities to public employers or their employees. The staff found the proposed actions would not trigger broker-dealer status under the Act.[67]

F. NETWORKING ARRANGEMENTS

Networking arrangements, first started to be used between a broker-dealer and a financial institution (e.g., certain federal and state chartered banks, savings and loan associations, savings banks, and credit unions) or its service corporation subsidiary, have allowed a broker-dealer to provide securities brokerage services on the financial institutions' premises, often using dual financial institution/broker-dealer employees, compensating the financial institution on a percentage lease-revenue basis, and permitting a nominal referral fee to be paid to non-registered financial institution employees. Without no-action relief, it has been the SEC's view that registration would be required of the financial institutions and their employees involved in these arrangements. Registration by financial institutions is extremely difficult given the comprehensive regulatory scheme for financial institutions.[68]

Under the networking arrangement, the unregistered employees of the financial institutions must be restricted from recommending any security or giving any investment advice and must not be involved in any security transaction. The unregistered employees may receive a one-time, nominal fixed fee for referring financial institution customers to the broker-dealer. Current regulators' thinking is that this nominal fee would amount to no more than one hour of compensation at the employee's current rate. The broker-dealer and the financial institution may share employees that are registered representatives of the broker-dealer, but all compensation related to the sale of securities must come from the broker-dealer only.

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[64] Russell R. Miller & Co., Inc., SEC No-Action Letter, [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,324, at 88,550 (Aug. 15, 1977).
[65] *See also IBEC Letter*, 1986 SEC No-Act. LEXIS 3065.
[66] Caplin & Drysdale, Chartered, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2291 (Apr. 8, 1982).
[67] *Id.*
[68] Chubb Securities Corp., SEC No-Action Letter, [1993–1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,829, at 78,387 (Nov. 24, 1993).

The SEC has expanded the arrangements permitted under the *Chubb* letter to include other types of financial institutions.[69] The staff has also granted no-action requests for arrangements between broker-dealers and insurance companies that were limited in scope to insurance securities and were designed to respond to the difficulties posed by state and federal regulation of those securities.[70]

The SEC has only recently made clear its intent that networking arrangements such as these may only involve banks, insurance companies, and similarly regulated financial institutions. Networking and related compensation arrangements are not allowed between broker-dealers and CPA firms without broker-dealer registration.[71] The staff reasoned that, unlike financial institutions and insurance companies, there are no similar regulatory protections afforded investors and no regulatory barriers to prevent accounting firms from registering as broker-dealers.

The networking exception to broker-dealer registration was first crafted by a series of SEC no-action letters, but has since been codified into federal securities laws by GLB. GLB repeals the blanket exemption banks have enjoyed from the definition of "broker" and replaced it with a set of limited exemptions that allow the continuation of some traditional activities performed by banks. Thus, a bank will be considered a "broker" under the Exchange Act and subject to the full panoply of SEC regulation if it engages in the business of effecting transactions in securities for the accounts of others. GLB reflects a broader political sentiment to more uniformly and closely regulate activities performed by broker-dealers.

G. COMPENSATION SHARING ARRANGEMENTS

Registered broker-dealers and their registered representatives are not permitted to share commissions or transaction-based compensation with unregistered persons. This was recently made clear in the context of CPAs and their CPA firms in *1st Global, Inc*.[72]

In *1st Global*, the company was requesting No-Action relief on behalf of its subsidiary 1st Global Capital Corp., a registered broker-dealer. 1st Global Capital Corp. engaged CPAs as registered representatives to sell financial instruments to clients, and paid them commissions. Many of these CPAs have entered into agreements with their CPA firms that require them to account to the firm all revenues generated from firm clients. After firm expenses are paid, the remaining profits are allocated to all the partners under an allocation formula. The other partners, shareholders, or members that will receive a share of the commissions from securities transactions may or may not be registered representatives. 1st Global raised four specific compensation scenarios under which it proposed to pay securities commissions to CPA registered representatives and asked the staff for guidance as to which scenario no-action assurance would be granted. The four scenarios were:

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[69] *See, e.g.*, The Somerset Group, Inc., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 973 (Dec. 20, 1996); Mid-Hudson Savings Bank F.S.B., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 762 (May 28, 1993).

[70] First of America Brokerage Service, Inc., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 1050 (Sept. 28, 1995).

[71] 1st Global, Inc., SEC No-Action Letter, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,119, at 77,790 (May 7, 2001).

[72] *Id.*

1. 1st Global Capital Corp. would pay commissions to a CPA registered representative without the presence of a partnership agreement mandating the CPA/registered representative to account to the CPA firm for the commissions earned.
2. 1st Global Capital Corp. would pay commissions to a CPA registered representative without the presence of a partnership agreement mandating the CPA to account to the CPA firm for the commissions earned, but the CPA registered representative would then "voluntarily" turn the commissions over to the CPA firm.
3. 1st Global Capital Corp. would pay commissions to a CPA registered representative subject to an agreement, formal or otherwise, mandating that the CPA account to the CPA firm for the commissions earned.
4. 1st Global Capital Corp. would pay commissions to another broker-dealer, with whom the CPA registered representative is dually registered, when the CPA firm or its partners own the other broker-dealer.

In its response, the staff stated that scenario (1) was the only scenario that would be granted no-action assurance. The staff stated that registration for individuals that receive transaction-based compensation is required not only for the individual that takes a customers order, but also for any other person in the position to direct or influence the registered representative's securities activities. The staff stated that because the unregistered partners, shareholders, or members of the firm may direct or influence the broker-dealers or registered representative CPAs activities, it may engage in broker-dealer activities. Therefore, without the CPA firm being registered, no commissions may be shared.[73]

The staff stated that this position was consistent with its *Freytag, LaForce, Teofan and Falik*,[74] where the staff stated it would not recommend an enforcement action if the broker-dealer paid securities commissions to a CPA registered representative. Its no-action position was conditioned on the fact that the CPA would not be subject to any agreement requiring the CPA to turn over the commission for distribution to the partnership. The staff further stated that the registered representative may not forward securities commissions to a CPA firm or other unregistered person under another title or label. Neither may the registered representative make payments for support or services unless they are proportionate to the market cost for those services and do not denote a form of compensation arising from securities transactions. The SEC wrote:

> Under the arrangement described in your letter, an unregistered CPA firm would indirectly receive securities commissions earned by a CPA registered representative, thereby giving it a financial stake in the revenues generated by the registered representative's securities transactions, at the same time that the CPA firm is in a position to influence the registered representative's actions and to direct customers to the registered representative. As discussed above, in the *Birchtree* line of letters the receipt of transaction related compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer, and that, absent an exemption, a person or entity that receives transaction-related compensation in connection with securities activities generally is required to register as a broker-dealer. (See, e.g., Letter re: *Birchtree Financial Services, Inc.* (Sept. 22, 1998)). The Division is not persuaded that your attempts to factually distinguish the

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[73] *Id*.
[74] Freytag, LaForce, Teofan and Falik, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 1346 (Jan. 4, 1988).

> circumstances that underlie the *Birchtree* letters assuage the core regulatory concerns raised by the receipt of transaction-based compensation.[75]

1st Global is an important letter because it clearly states that if registration is required to sell the security, the sharing or splitting of transaction-based compensation between unregistered persons and either broker-dealers or registered representatives is strictly prohibited. This would include any payments for support or services related to the sale of the security that were not proportionate to the market cost for those services. Payments for support or services may not be used as a form of compensation from securities transactions. The SEC raised the possibility that ordinary distributions of earnings and profits from a registered broker-dealer to an unregistered entity (the CPA firm) could raise compensation-splitting issues depending upon the exercise of the unregistered entity's control over the broker-dealer. The SEC wrote:

> Finally, the Division cannot assure you that, under any circumstances, it would not recommend enforcement action to the Commission under Section 15(a) should 1st Global pay securities commissions to a registered broker-dealer, with which a 1st Global registered representative is dually registered, when that other broker-dealer is owned by an unregistered CPA firm or its partners. This is due to the highly fact-specific nature of any such relationship. Clearly, a registered broker-dealer may receive commissions arising from securities transactions. Under some circumstances, however, the unregistered CPA firm or its partners may exercise such a degree of control over the activities of the broker-dealer or its registered representatives that they themselves engage in broker-dealer activity. In that case, the CPA firm or its partners would have to register as broker-dealers pursuant to Section 15(b), or else, in the case of natural persons, register as associated persons of a broker-dealer. Although you suggest that the unregistered CPA firm or its partners would passively own the registered entity, the question of whether the actions of the CPA firm or its partners constitute broker-dealer activity must turn upon the facts and circumstances of each particular situation.[76]

III. MERGER & ACQUISITION TRANSACTIONS

A. INTRODUCTION

There have been very few SEC No-Action letters regarding intermediaries in mergers and acquisitions.[77] Many of the SEC No-Action letters consist only of general statements of law and expressly refrain from taking No-Action positions. The key ruling to date can be found in the IBEC Letter.[78]

In the 1970s and early 1980s, the SEC was active in denying relief to individuals or entities seeking blessing on their finder's activities which would require them to register as broker-dealers under Section 15(a) of the Securities Exchange Act of 1934 (the "Act"). The SEC frequently stated:

> Registration pursuant to Section 15 of the Act of persons engaged in merger and acquisition activity has in the past often been deemed necessary where these activities

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[75] 1st Global Inc., SEC No-Action Letter, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,119 at 77,800 (May 7, 2001).

[76] *Id.* at 77,800–77,801.

[77] John Polanin, Jr., *The "Finder's" Exception from Federal Broker-Dealer Registration*, 40 CATH. U. L. REV. 787, 816 (1991) [hereinafter "*Polanin* article"].

[78] *IBEC Letter*, 1986 SEC No-Act. LEXIS 3065.

> involve either a distribution or an exchange of securities. Individuals who do nothing more than bring merger or acquisition-minded persons or entities together and do not participate in negotiations or settlements probably do not fit the definition of a "broker" or a "dealer" and would not be required to register. On the other hand, persons who play an integral role in negotiating and effecting mergers or acquisitions, particularly those persons who receive a commission for their efforts based on the cost of the exchange of securities, are required to register with the Commission.[79]

In the context of the M&A transaction, let us review the considerations:

1. Transaction-Based Compensation

Transaction-based compensation triggered the requirement for broker-dealer registration in *Mike Bantuveris*,[80] where the company wished to offer a consulting service in which it would identify companies as possible acquisition candidates and assist its clients in negotiating toward a final agreement. The company proposed to base its fees, in part, on the total value of consideration received by the sellers or paid by the buyers. On these facts, the staff of the Division of Market Regulation indicated that the company would be required to register as a broker-dealer. The staff noted that its opinion was "based primarily on the fact that the consulting firm would . . . receive fees for its services that would be proportional to the money or property obtained by its clients and would be contingent upon such transactions in securities."[81]

In *Biscotti and Company*,[82] Biscotti and Company sought No-Action for an entity it wished to establish for the purpose of providing financial planning and related services. These services would include the compilation of financial data for clients, the analysis of clients' current and projected requirements in various areas (including cash flow, insurance needs, and prospective tax liability), and the preparation of a written financial plan making various recommendations. In many cases, the financial plan would include recommendations for the purchase of various investments, such as common stocks, bonds, mutual funds and limited partnerships. The entity planned to register as an investment advisor. Biscotti and Company expected that many of the clients would seek assistance in implementing their recommendations, including acquiring investments. The entity would then receive a finder's fee for putting the clients in touch with others that could help them. The SEC letter stated that it would recommend No-Action based on the stated facts, in particular the fact that neither the financial planning entity nor its principals directly, or indirectly, retain any portion of the implementation fees generated.[83]

There is a long series of SEC proceedings against individuals and entities for receiving transaction-based compensation in the sale of securities for Ponzi schemes, prime bank investments, promissory notes, and a variety of investment contracts. While these individuals or entities are not characterized as finders in the proceedings, they are engaged in finding investors, pitching the products or getting the investor into the hands of a pitchman, and receiving a percentage of the investment as compensation. The cases are too numerous to cite.

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[79] Gary L. Pleger, Esq., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 2491 (Oct. 11, 1977); Ruth Quigley, SEC No-Action Letter, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,474, at 83,321 (July 14, 1973); IMF Corp., SEC No-Action Letter, 1978 SEC No-Act. LEXIS 1246 (May 15, 1978).

[80] Mike Bantuveris, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2158 (Oct. 23, 1975).

[81] *See also* John M. McGivney Securities, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2159 (May 20, 1985).

[82] Biscotti and Company, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2924 (Nov. 29, 1985).

[83] *Id.* at *4–5.

2. Negotiation or Advice

Generally, if an entity acts as a finder and participates in negotiations between the buyer and seller, the SEC will require registration as a broker-dealer. In *Fulham & Co., Inc.*,[84] the private investment banking firm consulted on mergers and assets sales, reviewed financial reports, and advised management on financial decisions. The firm participated in negotiations and received a commission based on the sale. Broker-dealer registration was required based on the participation in negotiations. The other side of this spectrum was reflected in the *Corporate Forum, Inc.*,[85] where the staff granted relief to a financial consultant who would locate merger and acquisition candidates for its clients, but it would not participate in negotiations.

In *Russell R. Miller & Co.*, Inc.,[86] the finder was in the business of locating insurance agencies and evaluating them for acquisition. The finder was paid a fee that was contingent on a subsequent purchase or sale. However, the acquisition of a specific agency was not necessarily structured by the sale of securities and the finder played no role in organizing the actual acquisition. The staff considered the finder to be a consultant "retained to bring to bear its knowledge and expertise to the task of identifying an acquisition prospect" and not as a broker.

No-Action relief was denied in *May-Pac Management Co.*[87] There the company specialized in mergers and acquisitions, and proposed to seek out potential sellers of corporations, bring them together with potential buyers, and work toward closing the transaction. The company acknowledged that, in most cases, it would participate in whatever negotiations were necessary to close the deal and advise its client as to the quality of any offer received. On the basis of these activities, the SEC concluded that the company would be required to register as a broker-dealer.
The staff found that the proposed activities were more than merely bringing together the parties to transactions involving the purchase or sale of securities. The firm proposed to negotiate agreements, engage in other activities to consummate the transactions, and to receive fees for its services that would be proportional to the money or property obtained by its clients and would be contingent upon such transactions in securities. The SEC emphasized that "persons who play an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally are deemed to be either a broker or a dealer, depending upon their particular activities, and are required to register with the Commission."[88]

In the realm of real estate transactions, as noted earlier, the SEC granted No-Action relief to Victoria Bancroft, a licensed real estate broker, who established lists of clients who might be interested in acquiring financial institutions that are for sale. The *Bancroft* letter[89] describes her activities as being "limited merely to the introduction of parties." She did not participate in the establishment of the purchase price or any other negotiations between the parties. The parties created all materials related to either the sale or purchase of the financial institutions without Bancroft's involvement. She didn't even facilitate exchange of the information. At most, she

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[84] Fulham & Co., Inc. SEC No-Action Letter, [1972–1973 Transfer Binder], ¶ 79,186, at 82,604, 82,605 (Dec. 20, 1972).

[85] Corporate Forum, Inc. SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4320 (Dec. 10, 1972).

[86] Russell R. Miller & Co., Inc., SEC No-Action Letter, [1977–1978 Transfer Binder], ¶ 81,324, at 88,550 (Aug. 15, 1977).

[87] May-Pac Management Co., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 1117 (Dec. 20, 1973).

[88] Id. at *3. *See also* Samuel Black, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 104 (Jan. 20, 1977) (stating that no registration is required where a finder's participation in negotiations is limited to performing the "ministerial function of facilitating the exchange of documents or information").

[89] Victoria Bancroft, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2517 (Aug. 9, 1987).

described to the potential purchaser the type of institution, the asking price, and the general location. If the potential person were interviewed, Bancroft would arrange a meeting with the seller or seller's representative. Either the buyer or seller would compensate Bancroft by a flat fee or a percentage of the purchase price. The compensation was considered to be a referral fee or finder's fee.

In granting No-Action relief, the staff indicated that (1) Bancroft had a limited role in negotiations between the purchaser and seller; (2) the businesses represented by Bancroft were going concerns and not shell corporations; (3) transactions affected by means of securities will convey all of a business's equity securities to a single purchaser or group of purchasers formed without the assistance of Bancroft; (4) Bancroft did not advise the two parties whether to issue securities or assess the value of any securities sold; and (5) Bancroft did not assist purchasers to obtain financing. The staff further stated that Bancroft *would* be subject to the anti-fraud provisions of the federal securities law to transactions in which securities are used to transfer ownership of a business.[90]

3. Solicitations

In *Thomas R. Vorbeck*,[91] the company proposed to offer a two-part securities service package to its employees in order to cure what it viewed as deficiencies in its employee stock purchase plan. Under the plan, employees could elect to reduce their commission expenses by assigning the stock to the employer, and/ or to increase their profits by authorizing the employer to sell short designated shares of stock once each quarter. On the basis of these facts, the SEC indicated that the company would be required to register as a broker-dealer under Section 15(a). As the SEC explained, the proposed activities "would appear to bring [the company] within the definition of a broker since it is reasonable to presume that [among other things] . . . the plan would entail some form of solicitation of business on your behalf." Somehow in the submission the potential for loss was also overlooked.

In *Club Panorama*,[92] an individual acted as a finder in seeking out broker-dealer firms. The broker-dealer firms would then find buyers for limited partnership interests in Club Panorama, for whom the finder worked. He would not solicit to purchase or offer for purchase any limited partnership interest himself. Also, the selling agreements would be between the broker-dealers and the general partners of the limited partnership and the finder would not receive any commission-based funds. Under those facts, the SEC did not see the need for the finder to be registered as a broker-dealer.

4. Prior Experience and Violations

One other factor that has been given weight by the SEC in its broker-dealer analysis is whether the finder has previously been involved in sales of securities and/or disciplined for violations of the securities laws. As a general matter, previous involvement of this nature seems to increase the likelihood that the finder will be required to register as a broker-dealer. In *Price*,[93] the finder was retained to locate brokers-dealers as potential underwriters or participants in private offerings. The finder was to have no involvement in actual selling efforts, and his fee was

[90] *Id*. at *3.
[91] Thomas R. Vorbeck, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 1823 (Mar. 24, 1974).
[92] Club Panorama, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 440 (Feb. 27, 1975).
[93] Rodney B. Price and Sharod & Assocs., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2978 (Nov. 7, 1982).

not based on commission tied to sales. Although the usual indications of broker-dealer status seemed to be lacking from this case, the SEC indicated that the finder would be required to register as a broker-dealer. While the SEC did not directly attribute this opinion to the finder's prior securities activities and disciplinary history, the letter began by describing at length the fact that the finder had previously engaged in the sale of securities and that he had recently been disciplined for violations of the Act. Since nothing in the nature of the finder's proposed activities would otherwise seem to have necessitated registration as a broker-dealer, it is fair to conclude that the SEC's decision was motivated by the finder's previous securities activities and problems.

5. Advising

The SEC's interpretative letter of *Jack Northrup Associates*[94] presented a situation where a firm in the consulting business proposed to act as a finder for mergers, acquisitions and other venture capital situations. As a finder, the firm proposed through personal contact, referrals, direct mail and the like, to transmit data to likely prospects concerning companies which had an interest in being acquired, or in acquiring other interests. The firm's role in a transaction would normally stop short of becoming involved in negotiations. However, the firm proposed to continue to be involved in the communications between the parties, and would continue to advise one or the other parties in circumstances in which it had previously advised them on their general financial plans. On those facts, the SEC declined to provide a No-Action letter.

In *F. Willard Griffith, II*,[95] the finder proposed to introduce individuals, corporations and other business entities to others for the purpose of enabling such parties to negotiate mergers, consolidations, other forms of business acquisitions and the purchase and sale of business assets. Prospective "buyers" who would subscribe to the finder's service were asked to submit a written description of the types of business entities or assets they were seeking, and the manner and terms upon which they propose to purchase or acquire such entities or assets. Prospective "sellers" who subscribed to the finder's service were asked to submit a written statement describing the natures of their businesses, their capital structures, their financial conditions and past performances, and the manner and terms upon which they wished to raise additional capital or be acquired. The finder also proposed to introduce persons and business entities who have indicated a desire to meet each other for the purpose of directly negotiating lawful transactions in particular securities. The SEC did not make a ruling on whether the finder needed to register as a broker-dealer, but rather concluded that the finder needed to register as a investment advisor under the Investment Advisers Act of 1940. The SEC stated that "the proposed service of disseminating information submitted by subscribing 'buyers' and 'sellers' by means of a publication would appear to involve issuing or promulgating analyses or reports concerning securities within the meaning of the Act."[96]

B. SEC'S MODIFICATION OF POSITION

The SEC modified its position on transaction-based compensation in 1986 when it issued a no-action letter to International Business Exchange Corporation.[97] IBEC was a business broker

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[94] Jack Northrup Assocs., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 1487 (Feb. 9, 1972).
[95] F. Willard Griffith, II, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 68 (Jan. 8, 1975).
[96] *Id.* at *1.
[97] *IBEC Letter*, 1986 SEC No-Act. LEXIS 3065.

in Texas and registered as a real estate broker in the states where it operated. It sold assets of businesses that were going concerns through advertising in national publications. Sometimes the only way to effect the sale was through a business entity, such as a closely held corporation, partnership, etc. This meant that stock or other securities might be involved in the transaction. For its services IBEC would get a commission based on the sales price, computed on the gross asset value. For purposes of computing the commission, all sales are treated as asset sales, free and clear of all indebtedness. IBEC did provide information supplied by the seller to the buyer. IBEC also informed the buyer that IBEC neither verified the seller's information nor made any representations or warranties about the seller's information. At the request of buyers, IBEC would provide a list of potential lenders that have expressed an interest in extending credit, but IBEC did not assist buyers in obtaining financing. IBEC's only involvement in the parties' negotiations was transmitting documents between the parties.

In addition, IBEC advised the seller and the buyer that it was not a NASD registered broker-dealer, and it would not offer a security under the law for sale. Further, IBEC specifically stated in its listing agreement that the sale of a security constituted default in its agreement. Buyers were advised and encouraged to make a thorough investigation of any company, including visiting and inspecting the property offered for sale. Both parties were advised to seek independent counsel before entering into any binding agreement.

Until 1985, this kind of a transaction would often be deemed not to involve a security. However, in that year the U.S. Supreme Court, in *Landreth Timber Co. v. Landreth*,[98] held that the sale of a business effected by transferring ownership of 100% of a company's stock constituted a securities transaction with all the protections of the securities laws.[99]

To address the anticipated concerns of the SEC, IBEC stated that it would not do any of the following:

- List corporate stock for sale.
- Advertise corporate stock for sale.
- Have the authority to sell (close) on the seller's behalf.
- Have the authority to purchase on the seller's behalf.
- Handle any funds on account of either buyer or seller.
- Offer stock as an investment.
- Negotiate the terms and conditions of acquisitions to be made for securities issued by the acquiring company.
- Advise the company to be acquired or its shareholders as to the value of the securities to be issued in the acquisition.

After reviewing IBEC's list, the SEC staff said that it would not recommend enforcement action. The staff added that this position was taken because:

- IBEC has a limited role in negotiations between the purchaser and seller.
- The businesses sold were going concerns and not shell corporations.
- Only the assets of the companies were being offered.
- If transactions involved the sale of securities, IBEC would not provide any assistance.
- IBEC did not advise the parties whether to issue securities or assess the value of any securities sold.

[98] Landreth Timber Co. v. Landreth, 471 U.S. 681, 697 (1985).
[99] *Id*. at 697.

- IBEC's compensation did not vary depending on the form of conveyance (e.g. securities rather than assets).
- IBEC had limited involvement in assisting purchasers to obtain financing. The IBEC letter has been cited by parties seeking No-Action relief as standing for the proposition that individuals that do nothing more than find issuers of securities, and who do not participate in negotiating the sale of securities nor share in the profits realized, are not brokers or dealers and are not required to register as such.[100]

C. SEC'S CURRENT POSITION

In the *Polanin* article,[101] the author[102] states that only two no-action letters have been favorably issued on the topic of transaction based compensation for finders who bring buyers and sellers of businesses together.[103] The two letters cited are *IBEC* and *Victoria Bancroft* (both discussed above). The article hypothesizes that "[t]he absence of any additional letters since those were issued may indicate that the staff would prefer counsel to be guided by the statements in those letters rather than request individual No-Action positions."[104] What the author is suggesting could very well be the reason why there has not been a No-Action letter since then on this specific topic. In *IBEC*, the SEC set out a definitive list of factors to be considered in determining whether someone acting as a finder or business broker needed to be registered as a broker-dealer.

The SEC declined to make a decision on whether an accountant, that advises a client on how to structure the sale of its business, needs to be registered as a broker-dealer under Section 15(a).[105] There, the SEC stated that if the accountant advised any other person on the value of the stock or the advisability of investing in the stock, then that person might have to be registered as a broker-dealer. The SEC enclosed the IBEC No-Action letter so the person could conduct its own analysis.

D. CONCLUSION

IBEC still seems to be an accurate representation of the SEC's view on what a finder can do without having to register as a broker-dealer. The SEC has not stated that the factors set out in that letter should not be relied upon. In fact, the SEC used the letter as a guide to what is permissible.[106]

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[100] John R.Wirthlin, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 83 (Jan. 19, 1999) (denied No-Action relief for acting as a finder for a broker-dealer); Mid-Atlantic Inv. Network, SEC No-Action Letter, [1993 Transfer Binder], ¶ 76,651, at 77,779 (May 18, 1993) (receiving no-action relief for a not-for-profit organization to identify sources for funds to be invested in small businesses); L and N Land Corp., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2215 (June 7, 1987) (receiving noaction relief to offer and sell guaranty letters of credit as guaranties of the principal and interest on tax-exempt municipal obligations).

[101] *Polanin* article, *supra* note 77 at 817–821.

[102] John Polanin Jr. held the SEC position of Branch Chief, Office of Chief Counsel, Division of Market Regulation.

[103] In a no-action letter, the SEC cited the *Polanin* article as being a comprehensive discussion on finders. *Hamilton & Company*, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 492 (April 21, 1995).

[104] *Polanin* article, *supra* note 77 at 819.

[105] Magnuson, McHugh & Company, P.A., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 1182 (Nov. 13, 1989).

[106] *Id*. at *2–3.

It appears that the law is sufficiently settled in this area that the SEC should consider promulgation of a rule, or at the very least an interpretive release, adopting *IBEC* and giving further guidance to those finders, issuers, and counsel who struggle with the extent of permissible compensation and the consequences for paying it. The sale of a business or real estate can often evolve to an equity transaction even though the initial listing is just for the sale of the business as an asset. We believe that it is appropriate for the SEC to provide further guidance to the various industry groups, such as realtors and conventional business brokers, that are affected by decisions driven by tax law, and for which the structure of the transaction as equity or asset sale is largely irrelevant other than to meet purchaser's or seller's unique tax needs.

While this area is not a principal focus of this Report, the obvious question is whether *IBEC* represents a decision of form over substance, and whether as part of this process, it may be appropriate for the SEC to consider broadening the scope of that letter to permit equity transactions as long as the other safeguards form the *IBEC* letter remain in place. Alternatively, some very simple form of registration, outside the scope of NASD regulation, might serve to permit this apparently beneficial activity to occur.

IV. LITIGATION

"So what?" In conversations with attorneys this is the most frequently asked question. In essence, what are the consequences of participation by a non-registered broker-dealer in a transaction? This segment of the Report will set forth some of the considerations for counsel in analyzing the consequences of such an involvement.

A. FEDERAL SECURITIES LAW

The starting place in the analysis is with the potential for action by the SEC. If the Division of Enforcement staff at the SEC identifies an unregistered broker-dealer and there has been no fraudulent act committed, the staff is likely to urge registration and if that is forthcoming, close the matter. If there is fraud, it is far more likely that an enforcement action will be commenced.

The SEC Divisions of Enforcement and Market Regulation do not have the staff to conduct the level of surveillance necessary to detect even a remote percentage of financial intermediary activity. An examination of websites for many of the unregistered financial intermediaries clearly discloses the activity, but there has been no sweep aimed at addressing the issue.

Our review of SEC enforcement cases indicates that most relevant cases name the issuer as well as the broker-dealer in the suit. However, these suits rarely deal exclusively with using an unregistered broker-dealer. On the contrary, the lawsuits generally involve multiple counts, including violations of the registration provisions for the securities themselves as well as violating the requirement that a broker-dealer be registered. The results of the lawsuits are driven primarily however, by the allegations of fraud and misrepresentation.

Often the cases deal with a situation where an individual creates a scheme, and then sells the idea to unwitting investors. The investor's money is then used to pay off previous investors in a Ponzi scheme or to pay for personal purchases. We found no cases where a finder crossed the line into broker-dealer activity for which the issuer was then punished in the absence of such fraud.

Finders and unregistered broker-dealers have been subject to permanent injunctions for failing to register and then selling securities. When fraud is involved, the SEC pursues disgorgement of the funds as well as civil penalties. These civil penalties are allowed pursuant to the 1990 Civil Remedies Act,[107] the point of which was to punish perpetrators of fraud rather than simply putting them back in the position they would have been in had they not committed the fraudulent act. In one case, an individual who was not found to be a part of the fraudulent operations was still required to pay disgorgement on a theory of unjust enrichment.[108]

B. CIVIL LIABILITY UNDER FEDERAL SECURITIES LAWS

Unlike many state limited offering or equivalent exemptions, federal private offering exemptions do not condition the use of the exemption on the absence of payments to unregistered broker-dealers or finders. Thus, the issuer does not automatically lose its exemption pursuant to a violation of the securities registration provisions of federal securities laws. Instead, one must look to a three-part analysis in determining potential civil liability.

1. Is the Person Engaging in the Activity of a Broker-Dealer?

Section 3(a)(4) of the Exchange Act defines the term “broker.” In the Division of Market Regulation October 1998 *Compliance Guide to the Registration and Regulation of Broker-Dealers*[109] found on the SEC website, there is ambivalence about “finders.” This is surprising in light of the history of no-action letters. The guide suggests that the determination of whether one is or is not a broker depends a number of factors, and suggests that “‘finders,’ or those who find buyers and sellers of securities of business or find investors for registered-broker-dealers and issuers need analyze three issues:

a. Do you participate in important parts of a securities transaction, including solicitation, negotiation or execution of the transaction?
b. Does your compensation for participation in the transaction depend upon the amount or outcome of the transaction? In other words, do you receive transaction-based compensation?
c. Do you handle the securities or funds of others?

If the answer to any of these is “yes” then the reader is cautioned that *you may* need to register as a broker. Those who are uncertain are told that they may want to review SEC interpretations, consult with private counsel, or ask for advice from the SEC.[110] This is far more ambivalent than the no-action letters suggest is appropriate. In those letters, as later in this Report, there is little equivocation. We suggest finders should be specifically instructed that they are required to register unless they meet specific safe harbors created by the SEC in recognition of existing no action letters or acceptance of recommendations from this Report or other commentators.

We do not believe that it is necessary to review here the case law relating to broker-dealer status. Rather, we are assuming that the presence of transaction-based compensation coupled with any active involvement with the issuer or a broker-dealer, will trigger registration requirements absent an exception or appropriate ruling. We believe that fairly characterizes the Division of Market Regulation’s present position.

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[107] 15 U.S.C. § 78(u) (2000).
[108] *See, e.g.*, SEC v. Cross Fin. Servs., 908 F. Supp. 718 (C.D. Cal. 1995).
[109] SEC, *Guide to Broker-Dealer Registration, available at* http://www.sec.gov/divisions/marketreg/bdguide.htm (last modified Sept. 1, 2001).
[110] *Id.*

If a person is required to register as a broker-dealer, and fails to do so while having active participation coupled with transaction-based compensation, what are the consequences?

Section 29(b) of the Exchange Act provides that "Every contract made in violation of any provision of this title or any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of [the Exchange Act] or any rule or regulation thereunder, shall be void: (1) as regards the rights of any persons who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract."[111] A maximum three year or one year from date of discovery statute of limitations is applied.

This section suggests that in any civil litigation an unregistered agent acting on behalf of the issuer will be compelled to return their commissions, fees and expenses; and that the issuer may justifiably refuse to pay commissions, fees and expenses at closing or recoup them at a later time.[112] It also raises the question of whether the issuer can be compelled to repay these funds to an investor, since the unregistered broker-dealer is acting on behalf of the issuer.

The investor may also be entitled to return of his or her investment, since the purchase contract between the issuer and the investor is a contract which is part of an illegal arrangement with the unregistered financial intermediary, and that intermediary is engaged in the offer and sale of the security to the investor. The language to Section 29(b) is broad enough to permit such an interpretation.[113]

Our research found little guidance on this type of case. Experience tells us that litigation involving unregistered broker-dealers or agents is often quickly settled. Furthermore, a reference to a state regulatory authority or the SEC will often produce compelling pressure for prompt return of the funds.

2. Federal Case Law

a. SEC v. Alliance Leasing Corporation[114]

This case involved the sale of equipment leases. The leases were considered investment contracts, and securities within the definition of the Securities Act of 1934. The significant parties to the suit were the leasing corporation, the entity that acted as broker-dealer (Prime Atlantic), and the principal shareholders of the leasing company (the Brownes).

Alliance Leasing Corporation was based in San Diego, California. It recruited over 1,500 individuals throughout the country to invest in its venture. The idea was to purchase commercial office and kitchen equipment with investor funds, and then lease that equipment out to third-party lessees. The lease payments were to be paid out to investors monthly for two years, with a balloon payment at the end of the two years. Investors were told that the investment was low risk and that it would garner a 14% per year return.

The SEC brought an action against Alliance, claiming that the packages being sold were investment contracts that were unlicensed securities. The parties were also charged with

[111] 15 U.S.C. § 78cc(b) (2000).

[112] *See* Boguslavsky v. Kaplan, 159 F.3d 715, 722 (2d Cir. 1998); Regional Properties, Inc. v. Financial and Real Estate Consulting Co., 752 F.2d 178, 182 (5th Cir. 1985); Eastside Church of Christ v. National Plan, Inc., 391 F.2d 357, 362 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968); Couldock and Bohan, Inc. v. Societe Generale Securities Corp., 93 F. Supp. 2d 220, 223 (D. Conn. 2000).

[113] *See* 15 U.S.C. § 78cc(b) (2000).

[114] SEC v. Alliance Leasing Corp., 2000 U.S. Dist. LEXIS 5227 (S.D. Cal. 2000), *aff 'd*, 28 Fed. Appx. 648 (9th Cir. 2001).

misrepresenting information critical to an investor's informed decision to invest. Prime Atlantic ("Prime") was charged with selling securities as an unregistered broker-dealer, selling unregistered securities, and fraud in failing to report that it received a 30% commission. The case was disposed of on a motion for summary judgment in favor of the SEC.

The charge for violating section 15(a)(1) of the Exchange Act was targeted solely at Prime and its owners. The court granted summary judgment against Prime, as there was no dispute of material fact that the company was acting as a broker with regard to the investment contracts. All other charges were directed at all defendants, and summary judgment was also granted on each of the other claims.

The owners of Alliance were repeat offenders who had no remorse for their activities. The court therefore issued a permanent injunction against them. However, it did not feel that Prime deserved such harsh penalties. There were no securities violations in its past. Also, Prime had relied on advice of counsel, who told Prime that the contracts were not securities. Therefore, the court found that there was very little intent on the part of Prime to violate securities laws, with the exception of the lack of disclosure with regard to commissions.

All parties were ordered to pay disgorgement plus interest, as well as the maximum civil penalty. It is hard to isolate exactly how much of the costs for Prime had to do with the fact that it was unregistered. There was no discussion of holding the issuer responsible for using an unlicensed broker-dealer.

b. SEC v. Interlink Data Network[115]

InterLink solicited more than $21 million from over 700 investors across the country.[116] They failed to comply with securities registration requirements, misused investor funds, and operated a Ponzi scheme. The SEC filed a complaint for temporary and permanent injunctions. The SEC commenced an action against the defendants, complaining that they were operating a nationwide fraudulent scheme. The defendants included InterLink Data Network and its two partnerships, InterLink Fiber Optic Partners, L.P. and InterLink Video Phone Partners, L.P. (the "defendant issuers"). Michael Gartner, a principal officer of InterLink, was also named in his individual capacity. The SEC also alleged that the defendants were conducting an unregistered brokerage operation. The SEC alleged that hey had set up a boiler-room operation and were acting as unregistered broker-dealers.

The subject of the InterLink investment scheme was telecommunications. The idea was marketed as a concept to develop "private, fully integrated telecommunication networks and video phone systems."[117] The sales pitch was that investor funds would be used to lay fiber-optic cable in Los Angeles, as well as to manufacture video telephones. Neither of these activities actually occurred. Rather, the funds were used to pay previous investors. Subsequent offerings promised much of the same—that the money would be used to invest in telecommunications technology, and that the returns would be anywhere from 12 to 18%.

There were no registration statements filed for the securities. Defendants attempted to rely on exemptions from registration, including Regulation D. However, defendants were not eligible for these exemptions because the offerings were not limited to accredited investors (in fact, defendants knowingly sold to unaccredited investors). They had also engaged in general solicitations for sales, an activity generally not permitted under Regulation D.

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[115] SEC v. Interlink Data Network, 1993 U.S. Dist. LEXIS 20163 (C.D. Cal. 1993).
[116] *Id.* at *1–3.
[117] *Id.* at *4.

There were several material misrepresentations made by the defendants in selling the securities. Potential investors were told that InterLink possessed several patents for the video phone technology, though it actually owned none of these patents. Potential investors were also told that fiber optic lines were being run in Los Angeles, that InterLink securities were publicly traded on AMEX or NASDAQ, and they were given unsupported guarantees of investment returns, among other misrepresentations.

Defendants arranged with Portfolio Asset Management ("PAM"), a registered broker-dealer, to provide a shield for the activities of more than 80 unregistered salespersons who were working the phones in the two boiler-rooms the defendants had set up. However, there was little distinction between PAMand Interlink. Interlink paid PAM's overhead, all sales documents were kept by InterLink, Gartner hired the sales force used to sell Interlink securities, and investor checks were sent directly to InterLink and not to PAM.

The court granted the SEC's motion for summary judgment on all issues. Gartner failed to file an answer, and he refused to respond to discovery requests, asserting his Fifth Amendment privilege against self-incrimination. Defendant issuers did not respond to discovery requests, stating that there was no one left at the companies to respond except Gartner, who again asserted his Fifth Amendment privilege. The court found that the defendant issuers and Gartner had engaged in selling unregistered securities, they had engaged in fraud and misrepresentation in the course of those sales, they had used investor funds improperly, and they sold securities without being registered broker-dealers.

The court found that the facts of this case were particularly deplorable. Hundreds of individuals, trusts, and corporations invested funds in InterLink. Many of the investors were retirees living on fixed incomes. The defendants were aware of the impropriety of their activities, and they showed little remorse for their transgressions.

The court granted several forms of relief. First, it granted a permanent injunction, stating that the "defendants' violations were intentional and calculated, and occurred repeatedly for years."[118] All defendants were permanently enjoined from future violations of the Securities and Exchange Act at issue in this case, namely sections 17(a) and 10(b) of the Securities Act and section 15(a) and Rule 10b-5 of the Exchange Act.[119]

The court also ordered disgorgement of the illegally raised monies, amounting to just over $12 million. Defendants were held jointly and severally liable for the return of all funds raised. Because the violations were so blatant, the court awarded prejudgment interest as well.

Finally, the court also imposed civil penalties against the defendant issuers. Against a non-natural person, the court could impose a fine of $500,000 or the gross amount of the monetary gain. In this instance, the court fined the defendant issuers another $12,285,035, the total amount of the gain. The SEC withdrew its request to fine Gartner, but the court noted that it would be warranted in doing so under the facts of the case.

c. SEC v. Walsh[120]

The SEC sued former Tyco director and the chairman of its Compensation Committee for signing a Tyco registration statement that he knew contained material misrepresentations. The SEC alleged that at the time Walsh signed the registration statement, he knew that Tyco's CEO

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[118] Interlink Data Network, 1993 U.S. Dist. LEXIS 20163 at *50–51.
[119] *Id*. at *52.
[120] SEC Lit. Rel. 17896 (December 17, 2002) (*available at* http://www.sec.gov/litigation/litreleases/lr17896.htm).

Kozlowski had proposed that if a merger transaction was successful, Walsh would be paid a finder's fee for having arranged a meeting of the companies' CEOs to discuss the possible merger. At successful conclusion of the merger, Walsh received $10 million in cash and another $10 million was donated to a designated charity. Walsh, without admitting or denying the allegations, settled the suit concurrently with the SEC filing.

This case stresses the importance of disclosure of finder's compensation. The SEC noted that Mr. Walsh took secret compensation and kept shareholders in the dark.

C. CIVIL LIABILITY UNDER STATE SECURITIES LAW

Section 402(b)(9) of the Uniform Securities Act[121] as roughly adopted in most states provides generally that an exemption for a limited offering (usually to a small maximum number of persons) is permitted if no commission or similar remuneration is paid for the offer or sale of the securities other than to a registered broker-dealer or agent of the issuer. Some states have added a specific prohibition for payments to "finders." Thus a multi-state transaction done under Sections 4(2) or 3(b) of the 1933 Act will often require use of the 402(b)(9) state exemption to meet state law requirements. Thus, the ability of either the state or an investor to sue to recover or prevent payment of commissions is clear. Likewise, many states have adopted the Uniform Limited Offering Exemption ("ULOE")[122] which applies to offerings under Rule 505 of Regulation D,[123] and the ULOE precludes payments in a manner similar to 402(b)(9). While Rule 505 is rarely used for offerings today, the state *animus* toward finders is reflected in the rules which incorporate the prohibition. Exemptions are also available under state law for sales to institutional investors (the definition varies somewhat from state to state); existing securities holders (in some states there is a numerical cap on the number of persons to whom sales can be made under this exemption); and in some states under the Model Accredited Investor exemption developed by NASAA.

The principal problem for aggrieved investors under state law arises in transactions done under Rule 506 of Regulation D.[124] Since Section 18(b)(4)(D) of the 1933 Act[125] preempts much of state law relating to requiring registration of or an exemption for certain classes of securities, including offerings under Rule 506, the states lack the power to impose the prohibition of the payment of commissions to unregistered persons as a condition of the exemption which is found in several Uniform Act exemptions.

The states still have a window under Rule 506 however. Generally under Section 18(b)(4)(D)[126] the states may receive a form, require the payment of a fee, and continue to police fraud. However, if an issuer fails to comply with the disclosure requirements of Rule 502[127] where appropriate, the exemption under Rule 506[128] is lost, and the issuer must then frequently fall back on the Section 402(b)(9) exemption.[129] Hence even in a purported Rule 506 exemption, there is risk of state proceedings for failure to meet the information requirements. Further, the

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[121] Uniform Securities Act § 402(b)(9) (1956).
[122] NASSA Reports (CCH) ¶ 6201.
[123] 17 C.F.R. § 230.505 (2004).
[124] 17 C.F.R. § 230.506 (2004).
[125] 15 U.S.C. § 77r(b)(4)(D) (2000).
[126] *Id*.
[127] 17 C.F.R. § 230.502 (2004).
[128] 17 C.F.R. § 230.506 (2004).
[129] Uniform Securities Act § 402(b)(9) (1956).

failure to accurately disclose compensation to an unregistered financial intermediary on Form D will almost certainly be found to be a material non-disclosure, and a fraud claim will lie for that omission. As noted previously, states are now examining the Form D's to spot payments to unregistered finders.

Another consideration under Regulation D is the issue of establishing a prior relationship with investors. There are several SEC No-Action letters giving comfort to registered broker-dealers in developing relationships which can serve as the basis for establishing a "pre-existing relationship" with these investors. These letters, however, do not extend to unregistered financial intermediaries.

Sales in violation of the registration provisions of Section 101 of the Uniform Securities Act and sales by unregistered broker-dealers or agents are also voidable pursuant to an action under Section 410 of the Uniform Securities Act.[130]

D. RESEARCH

Commentators have addressed these issues as follows:

1. Analytical Materials

a. Blue Sky Regulation, Civil Liabilities, 2-9 BSKYRG § 9.03 *Non-Seller Liability* (*Matthew Bender*, 2001)[131]

According to this chapter:

> In addition to the Uniform Securities Act and states having a comparable provision, Illinois has a statute[132] that makes persons liable strictly by virtue of their relationship to the seller. This statute imposes liability per se on the issuer, controlling person, underwriter, dealer, or other person by or on behalf of whom the sale is made. Other underwriters, dealers, or salesman who participated or aided in any way in making the sale may be held liable as may officers, directors, and similar persons of the issuer, controlling person, underwriter, dealer, or other organization by or on whose behalf the sale was made only if such persons participated or aided in making the sale.

However, none of this analysis specifically deals with liability for using an unregistered broker-dealer. Rather, the discussion is couched in general terms. The discussion states that "civil liability for sales of securities in violation of the Blue Sky law can extend to persons who do not actually sell the securities."[133] No cases cited in these materials deals directly with the issue of the civil liability of an issuer in using an unregistered broker-dealer.

b. *Louis Loss and Joel Seligman*, Securities Regulation, Civil Liability, 11-B-4, *Voidability Provisions* (3d ed., 2001)[134]

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[130] Uniform Securities Act § 410 (1956).

[131] Similar but not identical language is found in Blue Sky Regulation, Civil Liabilities, 2-15 Blue Sky Reg. § 15.03 (Matthew Bender, 2004).

[132] 815 ILL. COMP. STAT. 5/13 (2003).

[133] 2-15 Blue Sky Reg., *supra* note 131, § 15.03.

Six state statutes contain voidability provisions, all of which specifically give a right of rescission to the buyer.[135] Four states make any sale made in violation of any provision of the Blue Sky statutes voidable. "Arizona limits its voidability provision to the sale of unregistered securities, transactions by unregistered dealers, or specified fraudulent practices; Florida and Illinois extend rescission to violation of the securities dealer, associated person, and investment adviser registration provisions."[136]

2. Sample State Cases

a. State of West Virginia v. Fairchild; State of West Virginia v. Damron[137]

Defendant Damron was convicted of soliciting the sale of securities without being registered as a broker-dealer, selling unregistered securities, and the sale of securities by fraud or deceit. Defendant Fairchild was convicted of aiding and abetting in the sale of unregistered securities, and aiding and abetting by fraud and deceit. Both appealed the conviction; only Damron's appeal is relevant.

The appellant Damron purchased the exclusive rights to market film packages in the state of Kentucky. The franchise agreement was made in Damron's personal capacity, but he later incorporated the business. His plan was to seek investors. He contacted Fairchild, who agreed to provide a list of potential investor's names and show Damron where they lived. Damron solicited funds several times from two brothers. The brothers were told that dividends would be paid within four months, and they would recoup their investment within a year. One of the brothers became suspicious about the apparent lack of progress in the venture after Damron's continued solicitation of funds, so he contact the Securities Division of the State Auditor's office. An investigation began.

The count relevant to this Report is a small part of the overall case. Essentially, on Damron's conviction for being an unregistered broker-dealer, Damron tried to argue as his defense that he was not a broker-dealer, but an issuer. The Court disagreed, holding that the sales solicited by Damron were for stock to be issued by the company Home Movies, Inc., not by Damron in his personal capacity. The Court found this sufficient enough evidence for impartial minds to conclude that Damron was acting as a broker-dealer.[138]

b. State of Colorado v. Milne[139]

Defendant acquired an interest in and became president of a small corporation, Valley Loan Association, in 1963. In 1968, he acquired complete ownership. The corporation issued 'investment notes' to purchasers. The revenue from these notes was used to finance consumer purchase money loans. When VLA was suffering financial problems, these proceeds also went to meet interest payments on outstanding notes. Ultimately, VLA declared bankruptcy. Unpaid note

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[134] LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION, CIVIL LIABILITY, 11-B-4, Voidability Provisions (3d ed., 2001).

[135] A seventh state, California, adopted new legislation in 2004 granting rescission rights, attorneys fees, and treble damages to persons who purchase from or sell to an unregistered broker-dealer. *See* 2004 Calif. Legis. Serv. Ch. 575 (West) (AB 2167).

[136] LOSS & SELIGMAN, *supra* note 134.

[137] State v. Fairchild; State v. Damron, 298 S.E.2d 110 (W. Va. 1982).

[138] *Id*. at 123.

[139] People v. Milne, 690 P.2d 829 (1984).

holders complained to the district attorney, and criminal charges were filed which charged Milne with failure to register securities, selling securities without a license, fraud by check, and violations of the Colorado Savings and Loan Act. The only guilty verdict was on the licensing charge.

Defendant was convicted of selling securities without a license. He appealed, arguing that he had no obligation to become licensed because he was dealing in exempt securities or exempt transactions. The Court affirmed the conviction, finding that the relevant statute did not expressly exempt sellers of exempted securities from the licensing requirements.[140]

c. Deets v. Hamilton Management Corp.[141]

Financial Programs, Inc. sold its nationwide capital sales organization to the defendant corporation, Hamilton. The sales agreement authorized Financial employees to sell Hamilton funds, commissions from which were to be paid directly to each agent by Hamilton. Defendant Peggy Dailey accepted employment with Hamilton as part of this agreement. Dailey had been convicted of forgery and had falsified her registration applications to the Kansas Securities Commission and NASD by denying she had any convictions. She had been suspended for selling securities for six months by both agencies because of this. At the time of the transactions at issue in this case, Dailey was not a duly registered agent. The issue was whether the corporation was liable for the acts of Dailey.

The court held that Hamilton controlled Dailey as an employee. In fact, the court was of the opinion that Hamilton had materially aided Dailey in the fraudulent transactions by supplying her with forms and brochures. This made it appear to the plaintiff that Dailey was authorized to offer the special 'deal' that was a part of her fraud. The court found that 'there is substantial competent evidence to support the trial court's finding as to the defendant corporation's liability."

d. Bramblewood Investors, Ltd. v. C&G Associates[142]

Plaintiff Bramblewood sought summary judgment for the amount allegedly owed by the defendant. Bramblewood offered limited partnerships in an apartment complex in High Point, North Carolina. C&G executed promissory notes for three partnership interests in 1985. In 1989, C&G allegedly defaulted on the loans. Among other claims, C&G argued that it had the right to rescind because United Capital Securities, the general partner of Bramblewood, failed to register as an agent under the New Jersey Uniform Securities Law.

The court found that all of C&G's counterclaims were time-barred. Even if the allegations surrounding the failure to register as an agent were true and not timebarred, the court pointed out that the facts alleged did not have any nexus to the defendant's claims. Defendants refer to two individuals who were not defendants in this case and their contact in New Jersey with a United Capital representative. The court pointed out that, while those two individuals may be entitled to rescission, the defendants in this case were not. They had no claim under the statute for sales by an unregistered broker because they did not purchase from one.

e. Edwards v. Trules[143]

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[140] *Id*. at 834.
[141] Deets v. Hamilton Management Corp., 581 P.2d 826 (Kan. Ct. App. 1978).
[142] Bramblewood Investors, Ltd. v. C&G Associated, 619 A.2d 1332 (N.J. Super. Ct. Law Div. 1992).

A finder sued a corporation based on an oral contract to locate investors for a corporate offering. Citing several cases from other states, the court held that the contract was contrary to public policy and accordingly void.

V. ENCOURAGING REGISTRATION

There is a major conflict between the objectives of bringing persons into compliance and then punishing them for past conduct when they are being encouraged to come to the Regulator and register. In the broker-dealer arena, there is a significant division of approach. Some states take the view that it is best to get a firm registered, and that asking about prior conduct is counter-productive to getting maximum compliance. Others take the view that improper conduct should always be punished and that in order to be allowed to enter the "legitimate" side of the business one be scourged to expunge prior sins. This latter approach is normally done through an order and fine, though in some instances the prior conduct may be sufficient to prevent registration.

The arguments for encouraging registration are:

- The ultimate objective of the regulatory system is to achieve compliance. If the firm and its principals are coming to the Regulator attempting to comply, and they don't have prior disqualifying events (e.g., under Section 204 of the Uniform Securities Act and under the Exchange Act) to report on the Form BD or the accompanying U-4s for the owners and representatives, then it better serves the regulatory purpose to permit registration without prior inquiry.
- The act of registration does not cleanse prior misconduct, and if the Regulator later learns of improper action it has both its prior powers and the new ability to impose sanctions against a registration.
- Later inspections are likely to disclose any serious misconduct that may have occurred.
- Customers with problems understand that they should contact specific regulatory bodies which are identified more clearly to them.
- Registration will alert those with whom they have dealt in the past to the issue of whether registration was required in previous transactions involving the finder, and hence to any rights they may have arising out of those transactions in the event the investment has turned sour.

The arguments for disclose and sanction are:

- Wrong-doing has occurred, and we as Regulators are responsible for punishing wrong-doing.
- It is better to identify any problems before the broker-dealer is permitted to do business in this state.
- The deterrent effect of such sanctions will discourage improper conduct by others.

We suggest that there are compelling reasons to take the more lenient approach. Our objective, and hopefully that of Regulators, will be to establish an environment in which at least several hundred entities and individuals will come forward to register either as broker-dealers or as agents of those broker-dealers. We believe that the number of potential registrants runs to well over 1000, though the capacity in which they register is yet to be determined.

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[143] Edwards v. Trulis, 212 So. 2d 893 (Fla. Dist. Ct. App. 1968).

The manner in which the states treat disclosures of prior sales by unregistered persons vary. In some states, any disclosure of prior conduct without registration will involve enforcement action, though the sanction may be small, involving only a fine or possibly a censure. The concern for a new registrant is more of reputational harm than for the amount of the fine. In other instances states will simply issue a letter of caution or get an informal commitment regarding future compliance. This latter approach raises far less of a concern. Finally, if the level of participation in prior securities transactions is substantial, the state sanction may also be substantial, which is a major deterrent for voluntary compliance when no complaints have been made to the regulators.[144]

We urge a temporary policy of not asking about prior transaction to accommodate this opportunity to bring financial intermediaries into compliance, as least for a reasonable window of time. This would allow broker-dealers to register without having to disclose the details of any prior unregistered conduct as part of the registration process. This reduces the risk that potential registrants will eschew the registration process and continue to engage in activities without registration. This policy would obviously not prevent a regulator from taking action in light of information independently gathered.

There are also equitable reasons for considering a more lenient approach. The question of required broker-dealer registration in states is not as well-pronounced as that at the federal level. There is much lore about the number of permitted “deals” before broker-dealer registration is required.

VI. EXEMPTIONS FOR UNREGISTERED BROKER DEALERS

Some attorneys have suggested that providing for a registration exemption for a category of financial intermediaries which engage in finder activity on a limited basis (which has not been flushed out with further discussion) is a better alternative than a regulatory/registration scheme of the type we are proposing.

Given initial resistance from the Regulators with whom we discussed this issue, and the fact that providing a broker-dealer registration national exemption is not going to address all of the current abuses involving unlicensed financial intermediaries, creating an exemption is not currently a better alternative to a more narrowly focused regulatory scheme. We believe that an absolute exemption would be rejected by Regulators summarily.

Although providing for a limited exemption for PPBD activities is a possible alternative, we believe that there are practical, and more importantly, political considerations that would make the ultimate viability of an exemption alternative extremely unlikely outside of the context of an intrastate offering. We advocate permitting a group of states within a region to develop a registration procedure exempt from federal broker-dealer registration, so that metro areas involving multiple states can still have this source of capital formation available. The question of regional or metro exemption has been an area of controversy in determining the scope of Rule 147,[145] but it clearly merits consideration in this context.

There have been suggestions that creating an exemption that would encompass certain PPBD activity would be a straightforward method for addressing the issues that have been raised by the

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[144] We have identified 13 NASAA member organizations that require “come clean” letters at present, though since such requirements are not set out in rules or statute, it is difficult to identify all states accurately, and positions may change with change of administrator. The states are Alabama, Connecticut, the District of Columbia, Iowa, Maryland, Montana, Nebraska, North Dakota, New Mexico, Ohio, Rhode Island, Virginia and Puerto Rico.

[145] 17 C.F.R. § 230.147 (2004).

Task Force. It has been suggested that the Task Force follow an approach similar to that used for the Rule 3a4-1[146] broker-dealer exemption for certain employees of an issuer with compensation permitted. It is far from clear that there could be agreement as to what limited conduct would qualify for the exemption. For example, some would propose an exemption which applied to simply introducing buyers to sellers no more than three times in any one twelve month period and refraining from any advertising or general solicitation of new business. There might be caps on number of investors or dollars amounts. We believe that an exemption narrow enough to satisfy the Regulators would not cover a wide enough range of conduct to be meaningful to the universe of unlicensed finders.

In addition, an exemption would not address the current concern regarding the number of unscrupulous parties that are engaged in these activities. Indeed, creating an exemption would be likely to exacerbate the situation by permitting these parties to hide behind the available exemption. In contrast, a registration system would permit parties to determine whether the individuals they are contracting with to provide finder services are in compliance with applicable registration requirements. Even if an exemption is available, it would not solve the problem of NASD registered brokers being prohibited from co-venturing (share commissions) with exempt finders because the exempt parties would not be members of the NASD.

Notwithstanding these practical hurdles, we perceive that regulators view creating an exemption as unlikely because of the current political and regulatory environment and the impact it would have on the existing regulatory scheme. In informal meetings with Regulators, PPBD Task Force members have discussed the logical regulatory structure for PPBD activities with representatives of the various regulators and were told that creating an exemption was not a practical solution. It was made clear to the Task Force that in order to reduce requirements in the broker-dealer registration process, the NASD would require a review of the entire registration process for broker-dealers. Also, creating an exemption would raise the political question among NASD members as to why an exemption was being made available to address one type of broker-dealer activity and not others. In general, some Regulators to whom we spoke were of the view that the current regulatory scheme adequately addressed the finder concern. As a result, the possibility of achieving a solution through a relaxed registration process that weighs risk and benefit appears to be far more likely than providing for an exemption to the existing regulatory scheme.

Even if a federal exemption were created, the coordination among the state regulatory agencies for any exemption that is created remains an issue. Without federal preemption (which clearly would not occur given the local nature of many of the offerings and the concerns over fraudulent conduct of some financial intermediaries discussed above) each of the states would have to adopt the form of exemption that is created at the federal level. Obtaining uniformity among the states can be a major challenge as evidenced in the variations in state uniform offering exemptions.

VII. PROBLEMS IN COMPLIANCE WITH THE PRESENT REGULATORY SYSTEM FOR UNREGISTERED FINANCIAL INTERMEDIARIES

The present broker-dealer registration system, and especially the NASD membership application process, are disproportionately complex for someone acting only as a “finder” or one who is locating companies as potential merger candidates. Even more burdensome and irrelevant

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[146] 17 C.F.R. § 240.3a4-1 (2004).

are some of the ongoing regulatory requirements, which are more appropriate to a full-service broker-dealer, or one that engages in market making, over-the-counter trading for customers, proprietary trading, holding custody, making margin loans, etc. Some specific examples follow.

Clarification of the Scope of Broker-Dealer Registration Requirements. As a first step, it would be highly desirable for the SEC to publish a clear statement of registration requirements, with a reasoned basis, unlike the 2000 withdrawal of the *Dominion Resources*[147] no-action letter which was virtually without an articulated rationale. The current emphasis on receipt of transaction-related compensation is understandable in that it is usually readily identifiable and creates an incentive for abusive sales practices. On the other hand, it is often unrealistic to expect issuers to pay consultants and other service-providers a fixed fee irrespective of the success of the proposed transaction. It appears that any activity that is helpful in the structuring or consummation of a private placement, plus a "success fee," may be enough for the SEC now to find that an intermediary or consultant is a broker subject to registration requirements. A possible alternative would be to treat a success fee based on the "fair market value" of consulting services as not being "transaction-related" so long as the consultant does not engage in direct selling activities, as distinguished from advice about structuring or marketing of an offering.

Hiatus of Inquiry Into Prior Unregistered Brokerage Activity. Once the guidelines were made more clear and were widely disseminated, there may be some finders who will be able to limit their conduct to legitimately avoid (not evade) broker-dealer registration requirements. However, to make it practical for the remaining finders to come forward and register as PPBDs, as we have noted above, it would be extremely valuable for states to refrain from their current policies of scrutinizing the prior activities of applicants for possible registration violations with potentially draconian consequences. This would not require the states (or other regulators) to ignore potential fraud or other sales practice violations, or to screen applicants for prior criminal conduct, regulatory sanctions, customer complaints, or other factors that truly present a risk to the investors as well as to the issuers whom the PPBDs may represent.

Application Procedures. The SEC broker-dealer registration process has been almost completely relegated to the NASD. Virtually all of the review process takes place in the form of the NASD membership application. NASD Rule 1013(a)(4)[148] requires the staff to reject an application that is not "substantially complete" after deducting $350 for the initial review to determine the inadequacy of the filing. Given the simplicity of the business of most PPBDs, it should be possible to develop a simpler format for NASD membership applications, with maximum use of a "check the box" or "fill in the blanks" questionnaire. If the level of complexity and demands for expertise found in the present 1013 review process were applied to the financial intermediaries engaged in finder activity, virtually no one would consider going through the process.

Application Expenses. The NASD membership application fee for a PPBD is $3,000. Most consulting firms will charge at least $5,000 for assistance with a simple application process, and sophisticated legal counsel is normally far more expensive. The simplified questionnaire application format would not only be less burdensome to the PPBD but could streamline the NASD review process, potentially justifying a lower application fee and requiring less costly professional assistance to the applicant. Fees, however, are not the major stumbling block to registration.

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[147] SEC No-Action Letter, 2000 SEC No-Act. LEXIS 848, *1 (Sept. 19, 2000) (stating Dominion Resources Letter of 1985 is withdrawn).

[148] NASD Manual 1013(a)(4) (2005).

Registration Examinations. There are now limited representative examinations and registration categories for individuals who only sell corporate securities in private placements (Series 82).[149] This examination as written does not appear well-designed for this purpose, and a revision or alternative should be considered. However, there is no equivalent limited principal examination, and the supervisor of a firm selling only private placements must pass the Series 24 exam.[150] A more relevant examination and less onerous exam requirement for principals would be appropriate. This examination could cover the following topics:

- Section 5 of the 1933 Act and Section 301 of the Uniform Securities Act.
- Ethics.
- Books and records that are relevant to PPBD business.
- Anti-fraud requirements and appropriate disclosures in private offerings.
- Regulation D, Section 4(2) and Section 3(a)(11).
- Escrow requirements under 15c2-4.
- Section 10b-9 of the 1934 Act.
- NTM 87-91 and other appropriate NTMs addressing private placements and compliance obligations.
- Advertising.
- State limited offering and related exemptions.
- Prohibited conduct.

Capitalization and Financial Recordkeeping and Reporting Requirements. The net capital rule, 15c3-1,[151] requires a PPBD to have only $5000 of net capital and 1934 Act Rule 17a-11[152] would increase this requirement to only $6000. NASD Rule 3020[153] requires a fidelity bond with coverage of only $25,000. These amounts do little to provide investor protection. However, they bring with them the requirement to make and maintain financial books and records specified in 1934 Act Rules 17a-3 and 17a-4,[154] the requirement to file FOCUS Reports on a quarterly basis, the requirement of an annual audit, and the obligation to have a Financial and Operations Principal (FINOP) who has passed either the Series 27 or the Series 28 exam and who is subject to ongoing continuing education requirements. The goal of investor protection would be better served by requiring a more substantial bond, perhaps scaled to correspond to the dollar value of transactions "brokered" in a year or other time period, but eliminating the requirement and expense of a FINOP, an independent auditor, and many of the financial record-keeping requirements. It may be more effective to concentrate on escrow requirements, general solicitation issues, offering documentation (in order to be able to affirmatively establish the availability of the exemption), the inability of the broker-dealer to rely on issuer's counsel for broker-dealer compliance procedures, etc.

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[149] NASD Notice to Members, 2001 NASD LEXIS 43, *1 (2001).

[150] There are limited representative and limited principal exams for persons who sell only "direct participation program" securities, which are equity securities of "tax transparent" issuers such as limited partnerships and limited liability companies. However, the only corporations whose securities would be in this category are Subchapter S corporations.

[151] 17 C.F.R. § 240.15c3-1 (2004).

[152] 17 C.F.R. § 240.17a-11 (2004).

[153] NASD Manual 3020 (2005).

[154] 17 C.F.R. § 240.17a-3 (2004); 17 C.F.R. § 240.17a-4 (2004).

At the very least the FINOP requirement should be waived for smaller firms. The designated principal could complete simplified training which would cover the very limited skills and knowledge required for this type of broker-dealer.

It should be clear that the moderated treatment for PPBDs would be available only for applicants that would have no actual or imputed custody of investor assets. Either funds would go directly to the issuer or, in the case of a contingent offering, to a bank escrow account as required by 1934 Act Rule 15c2-4.[155] Quarterly financial reports could be required, as well as an annual financial statement.

Written Supervisory Procedures. One of the requirements for approval as an NASD member and for ongoing compliance with NASD rules relating to supervision, principally Rule 3010,[156] is a set of written supervisory procedures (WSP). Many consulting firms supply "canned" procedures that are not appropriately customized to the needs of a particular category of broker-dealer, let alone to a specific individual firm. The NASD has offered significant assistance to small firms by publishing a Template for anti-money laundering WSP. A similar template for other parts of the WSP could result in a better product at less cost to the applicants.

State Registration Procedures. The criteria for broker-dealer Blue Sky registration is very uneven across the U.S. and the filing requirements are far from uniform. In some states all that is required is to check the appropriate box on Form BD and file it with the CRD. Other states, such as Missouri, have detailed questionnaires about the type of business to be conducted by an applicant, much of which is irrelevant to the business of a PPBD. If the SEC (by rule) were to create a separate category of registration for PPBDs and the NASD were to adopt an analogous category of limited PPBD membership, it would be appropriate for states to adopt a similar limited registration status, which could be achieved simply by filing Form BD with the CRD, with the addition of a consent to service of process and appropriate U-4s. This would parallel the status of federal registered investment advisers who are required only to file a notice with states, and which is done through Web IARD using the same Form ADV that is filed with the SEC. Such an expedited filing might be limited only to those persons with a clean regulatory record.

Ongoing Regulatory Surveillance. A PPBD should be subject to SEC, NASD, and state examination for sales practices and reporting requirements to ensure that it is maintaining an appropriate fidelity bond. However, the simplification of fiscal requirements will reduce or eliminate the need to maintain certain kinds of financial records and will reduce the burden on regulators to inspect for and enforce unnecessary and inapplicable provisions of the net capital rule.

Regulatory Element of Continuing Education. A registered representative is required periodically to do the S101 or S101 computer based training exercise, and a general securities principal is required to do the S201 exercise. These programs, which may be well designed for personnel of a general securities firm are not very relevant to the limited activities of a PPBD. Either they could be waived, or a more pertinent form of regulatory element continuing education could be substituted.

Time Considerations. There is a significant disincentive for a financial intermediary to come forward and voluntarily move into compliance. The present time to establish a broker-dealer can involve 4-6 months prior to registration, and if the financial intermediary has to shut down for that length of time, it will lose its people and clients. Substantial time will be spent in

[155] 17 C.F.R. § 240.15c2-4 (2004).
[156] NASD Manual 3010 (2005).

answering questions about prior activity and the basis for forward looking financial information which is based on that historic performance. If we are to encourage voluntary compliance, it will be essential to do so on a prompt basis if a competently prepared membership package is submitted.

The present broker-dealer registration process at the NASD takes several months, and is highly complex. The questions are often tailored for a full-service broker-dealer, and the staff can experience difficulty in dealing with firms that limit their activities to mergers and acquisitions, and periodic private placements. In the search for the perfect system, the present procedure is not well-designed for a firm with such limited activities.

VIII. RECOMMENDATIONS OF SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION

The Final Report of the 22nd Annual SEC Government-Business Forum on Small Business Capital Formation (December 2003) recognized the need for a new approach to the regulation of finders. Their top recommendation stated:

1. The SEC should work with NASAA and the NASD to undertake the following:
   (a) address the regulatory status of finders;
   (b) facilitate an appropriate role for finders in the capital-raising process; and
   (c) clarify the circumstances under which issuers and others can legally compensate finders and other capital formation specialists who meet minimum standards.

In undertaking this effort, the SEC staff should focus specifically on whether to create an exemption from broker-dealer and/or investment adviser registration requirements for certain finders or instead issue a new regulation enabling these finders to register under a simplified regime aimed at regulating finders engaging in a defined category of activities. Factors that should be considered in crafting such an exemption or regulation should include:

(a) whether NASD membership should be required;
(b) the form of the application (such as the one proposed by the ABA Task Force Draft Form 1010EZ dated July 9, 2002, referred to as "Form 1010-EZ—Private Placement Broker-Dealer");
(c) lower fees for application and (annual) renewal;
(d) appropriate testing requirements;
(e) certification as to no "bad boy" disqualifications;
(f) no custody of client funds or securities permitted;
(g) no minimum net capital requirements;
(h) appropriate bonding requirements;
(i) explicit recognition that transaction-based remuneration is permitted;
(j) no discretionary authority permitted for investments;
(k) appropriate record-keeping requirements; and
(l) applicable sales practice rules.

Further to this initiative, the SEC staff should:

(a) consider the findings and recommendations in the upcoming final report on the subject of finders of the Subcommittee on Small Business Issuers of the Federal Regulation of Securities Committee of the ABA Section of Business Law; and
(b) within the next 12 months issue a concept release addressing the adoption of a finder exemption and soliciting comment from the small business community and other interested parties.

The 2004 Forum, likewise, noted the importance of this Recommendation in its preliminary findings. Forum participants, excluding regulator participants, were asked to rank the 2004 Forum recommendations. The highest ranked recommendation was to adopt the number one recommendation of the 2003 Forum—to resolve various issues related to the use of and payment of “finders” in capital formation transactions.

ATTACHMENT A

[PROPOSED] NASD FORM 1010-EZ: PRIVATE PLACEMENT BROKER-DEALER INSTRUCTIONS

A. You may use this form to apply for NASD membership as a Private Placement Broker-Dealer ("PPBD") if you intend to engage ONLY in the following brokerage activities:

- acting as private placement agent for a corporation, limited liability company, limited partnership or other entity offering securities in a private placement exempt from registration requirements of the Securities Act of 1933.

B. You must answer all questions on the Form (except Item 10, which is optional). You can type the answers or write in the answers neatly in black or blue ink. Do not use pencil.

C. You must file all exhibits mentioned in this Form when you file the form with the NASD.

D. You must send a check with the form to cover all applicable filing fees. The fees are:

- $ for the Applicant
- $85 for each Form U4 to register an individual. If the Applicant is an individual he or she must complete both a Form BD and a Form U4.
- $35 for processing the fingerprint card of each individual for whom a Form U4 is being filed. Individuals who are not being registered may also need to be fingerprinted. Consult the NASD District Office if you need advice about fingerprint requirements.

E. When you have completed this form, send it with ALL of the Exhibits listed in the form, to the NASD District Office, in which the Applicant's principal place of business is located. To identify the proper District Office see www. nasdr.com.

F. The Applicant and its personnel may also need to be registered under state "blue sky" laws. The filing fees vary from state to state. You should call the blue sky officials in the state(s) in which you are interested for information about filing requirements and fees. A list of blue sky offices can be found at www.nasaa.com.

FORM 1010-EZ

1. Identification of the Applicant

Name of Applicant: ______________________________________

NOTE: If the business will be conducted by an individual as a sole proprietorship, with or without other employees, give the name of the sole proprietor. If the business will be conducted by an entity (corporation, partnership, LLC, or other) give the name of the entity; in this case the entity is the "Applicant."

Address of Applicant: ___________________________________

____

____

Executive Representative: ________________________________
Telephone number: ________________________________
Fax number: ________________________________
E-mail: ________________________________

2. Identification of People Who Will Be Working for the Applicant

List the names of all individuals who will be involved on behalf of the Applicant in structuring private placements, communicating with prospective investors, or otherwise engaged in the management or operation of the Applicant's business as an NASD PPBD member.

- Indicate which of these individuals will have Executive Responsibility for the business of the Applicant. "Executive Responsibility" means authority to sign contracts or make binding decisions for the Applicant.
- Indicate which of these individuals will have Supervisory Responsibility within the Applicant. "Supervisory Responsibility" means the duty of training other workers and reviewing and checking their work to be sure that it complies with all applicable laws and rules and with the internal policies of the Applicant.

If you need more space, attach additional page(s) marked Rider 2.

Name	Social Security No.	CRD No. (if any)	Executive/ Supervisory?

3. Executive and Supervisory Personnel

For each individual identified in Item 2 as an Executive or Supervisory person, give a brief statement of what his/her duties and authority will be. Also give a brief statement of the experience that you think qualifies each Executive or Supervisory person for his/her assignment. Attach additional pages as Rider 3 if necessary.

Chief Executive: ________________________________
Chief Compliance Officer: ________________________________
Chief Financial Officer: ________________________________
AML Compliance Officer: ________________________________
Other key personnel: ________________________________

4. Types of Securities to Be Offered and Sold

Check the boxes below to indicate what kinds of securities the Applicant intends to sell. Check all categories that describe the proposed business of the Applicant.

Corporate stock

Corporate debt securities

Other corporate securities (explain on Rider 4)

Limited partnership interests

LLC interests

Other securities (explain).

5. **Types of Issuers**

Give a brief description of the type of business(es) whose securities the Applicant intends to offer. For example, if the issuers will be in a manufacturing business, state the primary products manufactured. If the issuers will be in service businesses, state the types of services performed.

If you have identified any specific issuers for which you intend to act as a private placement agent, give this information here, and attach any written agreements with those issuer(s).

6. **Types of Investors**

Indicate what kinds of investors the Applicant expects to solicit and sell to.

Institutional investors, i.e., organizations that have internal professional money managers and a net worth of at least $2 million [?].

High-net-worth individuals, i.e., people who have personal net worth of at least $1 million [?].

Individuals or entities that have a net worth of less than $1 million.

Other (explain).

7. **How Will the Applicant Locate Prospective Investors?**

Check all applicable boxes.

Prior business associates of the Applicant or its executives?

Social contacts of the Applicant or its executives?

Relatives of the Applicant or its executives?

Prospects whose names will be supplied by the issuer?

Prospects whose names will be supplied by other sources? (If this box is checked, state what other sources will be used.)

Prospects obtained via the Internet? Reminder: USE OF THE INTERNET MAY RESULT IN LOSS OF PRIVATE PLACEMENT STATUS.

8. Recordkeeping

Describe the Applicant's proposed recordkeeping system.

Financial books and records will be kept on a computer. (If so, state what kind of software will be used.)

Financial books and records will be kept manually.

Applicant will use the services of an outside accountant or service bureau to help it keep financial records. (If so, identify the service provider(s) and attach a copy of any written agreement with them).

9. Professional Counsel

Give the name of any legal counsel or other consultant the Applicant has retained (or expects to retain) to advise it about NASD membership or its proposed business as a PPBD.

Name of adviser: ____
Name of firm: ____
Address: ____
____

10. Other Information

Attach any other information or descriptive material that you think is relevant to show that Applicant is qualified to conduct business as Limited Broker-Dealer member of the NASD. This item is OPTIONAL.

EXHIBITS

ALL of the Exhibits listed below must accompany Form 1010-EZ when it is filed with the NASD District Office.

Exhibit 1 Form BD. An original signed and notarized paper Form BD.

Exhibit 2 Form U4. An original signed paper U4 for each individual for whom NASD registration is being requested, including the Applicant if the Applicant is an individual.[157]

Exhibit 3 Fingerprints. An original fingerprint card for each person required to be fingerprinted.

Exhibit 4 **Financial Statement.** A balance sheet as of a date not more than 30 days before this form will be received by the NASD District Office.

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[157] The current practice for any membership application is that the Form U4 is submitted electronically and filed after the membership application is accepted and a CRD file is opened for the applicant.

Exhibit 5	**Income and Expense Projection.** A projection of the Applicant's income and expenses from the securities business for the first 12 months of operation as an NASD member. This should be done on a month-by-month basis, with some explanation of the basis for each element of income and expense.
Exhibit 6	**Written Supervisory Procedures.** A copy of any internal procedures adopted by the Applicant for supervision of its personnel or for compliance with applicable laws and rules. If no procedures have been adopted, state this. This Exhibit is not required for any PPBD which proposes to have only one person for whom a Form U4 is required to be submitted.
Exhibit 7	**Anti-money Laundering Procedures.** A copy of any internal procedures adopted by the Applicant for supervision of its personnel or for compliance with applicable anti-money laundering laws and rules. If no procedures have been adopted, state this.
Exhibit 8	**Continuing Education.** A copy of the Applicant's plan for continuing education. The continuing education plan must address the regulatory element and the firm element. For advice about how this plan should be constructed, see www.nasd.com.
Exhibit 9	**Business Continuity Plan.** A copy of the plan and procedures to be implemented in the event of a significant business disruption affecting the Applicant. For advice on how this should be constructed, see www.nasd.com.

ATTACHMENT B

NASD MEMBERSHIP APPLICATION CHECKLIST WITH COMMENTARY

All documents must be filed with the NASD at the District Office where the Applicant will have its principal office.

Rule[158]	Item	Comment
2(A)	Original signed and notarized paper Form BD	1. This is not burdensome. 2. It is necessary to identify any "bad boy" affiliates, which information is elicited in Items 11 and 10A. 3. The Applicant can check 12WPLA for private placement of securities. This does not require identification of the type of securities to be sold. 4. Normally, after the initial paper filing all subsequent filings must be done electronically through CRD. Perhaps PPBD's could be excused from CRD and be able to file amendments on paper.
2(B)	Original signed paper U4s	1. This is not burdensome. 2. It is necessary to elicit "bad boy" information about the individuals. Also, Form U4 contains a consent to NASD arbitration with customers (or broker-dealer employees). 3. If a new kind of exam will be permitted for PPBD's, there would have to be a space for it in Item 11. 4. See comment 4 in 2(A).
2(C)	Original fingerprint Card for each person required to be fingerprinted under Sec. Exch. Act Rule 17f-2	1. This is not burdensome. 2. It is necessary/desirable to identify "bad boys."

[158] References are to subparagraphs of NASD Rule 1013(a).

2(D)	New member assessment report	This is usually a waste of time for any applicant. It asks for information about revenues in the preceding fiscal year. Especially if we adopt a “don’t ask, don’t tell” approach, the amount of last year’s revenues should be irrelevant and this requirement should be eliminated for PPBD’s.
2(E)	Filing Fees	Normal fees for a broker-dealer that does not engage in clearing activities are: $3000—NASD membership application; $85—each Form U4, if no DRPs $35—each fingerprint card Fees to cover state registrations & any exams needed
2(F)	A detailed business plan, including plans for future business expansion, and:	
(i)	Trial balance, balance sheet, supporting schedules, net capital computation, each as of a date not more than 30 days before filing date of the application.	If PPBD’s will be exempted from the net capital rule, it may not be relevant to ask for a balance sheet, etc. However, in the event there is no net capital requirement, it may be reasonable for the NASD to ask may be reasonable for the NASD to ask for, and the PPBD to demonstrate, some level of net worth.
(ii)	Monthly projection of income and expenses, with a supporting rationale, for the first 12 months of operations	This becomes relevant if the PPBD will not be subject to the net capital rule. One hopes that even a PPBD would make some analysis of its probable expenses vs. probable income.
(iii)	Organizational chart	Normally supplied in the form of an Exhibit to the Written Supervisory Procedures (WSP). Even if WSP’s are not required, it is not unreasonable for the NASD to ask who will work for the PPBD, and it should not be

		difficult for the finder to supply this information.
(iv)	Intended location of principal place of business and all other offices, whether or not required to be registered, and names of persons in charge of each	This is not burdensome and has, at least, some relevance.
(v)	Types of securities to be sold and types of retail or institutional customers	This should not be hard for the PPBD to state, and would definitely be relevant to eligibility for some form of limited membership.
(vi)	Description of methods and media to be used to develop a customer base and offer/sell products; specific reference to cold calling, use of Internet, etc.	This is not burdensome and is relevant.
(vii)	Description of business facilities and copy of any proposed or final lease	This is probably unnecessary and can be in the mild-nuisance burden category. Most likely, many PPBD's will probably work out of their homes, or as a sideline to another business.
(viii)	Number of markets to be made, if any; type and volatility of products; anticipated maximum inventory positions	The answer is "N/A;" no need to eliminate the question.
(ix)	Any plans to enter into contractual commitments such as underwriting	The proposed form of Private Placement Agreement should be submitted.
(x)	Any plan to distribute or maintain securities products in proprietary positions, and the risks, volatility, liquidity, and speculative nature of the products	The answer is "N/A;" no need to eliminate the question.
(xi)	"Any other activity" that Applicant may engage in that reasonably could have a material impact on net capital within the first 12 months of business	The answer is probably "none" or "N/A;" no need to eliminate the question.
(xii)	A description of the communications and operational systems the Applicant will employ to conduct business with	The answer is probably "none" or "N/A;" no need to eliminate the question.

	customers or other members and the plans and procedures the Applicant will employ to ensure business continuity, including: system capacity to handle the anticipated level of usage; contingency plans in the event of systems or other technological or communications problems or failures that may impede customer usage or firm order entry or execution; system redundancies; disaster recovery plans; system security; disclosures to be made to potential and existing customers who may use such systems; and supervisory or customer protection measures that may apply to customer use of, or access to such systems.	
2(G)	Copy of any adverse regulatory action affecting registration or licensing	This is relevant and should be retained, even if it is "burdensome."
2(H)	List of all Associated Persons (APs)	Relevant and not burdensome.
2(I)	Documentation of the following events, unless already reported to CRD:	All parts of 2(I) are relevant and necessary, even if burdensome.
(i)	Regulatory action against Applicant or APs	
(ii)	Investment-related civil action for damages or injunction against Applicant or Associated Person that is pending, adjudicated or settled	
(iii)	Investment-related customer complaint or arbitration that is required to be reported on Form U4	
(iv)	Criminal action (other than minor traffic violations) against Applicant or AP that is pending, adjudicated, or resulted in guilty or no-contest plea	
(v)	A copy of any document evidencing termination for cause	

	or permitted resignation after investigation of alleged violation of federal or state securities law, rule, or SRO rule or standard of conduct	
2(J)	Description of any remedial action, e.g., special training, Cont. Ed., or “heightened supervision” imposed on an AP by state or federal authority or SRO	Same as 2(I).
2(K)	Written acknowledgment that heightened supervision may be required pursuant to NTM 97-19 for any AP whose record reflects disciplinary actions or sales practice events	Relevant and usually not burdensome.
2(L)	A copy of final or proposed contracts with banks, clearing agents, or service bureaus, and general description of any other final or proposed contracts	Probably requires submission of proposed Escrow Agreement with qualified escrow agent if offerings with specified minimum levels are contemplated, as would almost certainly be the case for a PPBD.
2(M)	Description of nature and source of capital with supporting documentation, including a list of all persons who have contributed or plan to contribute financing, the terms of such arrangements, the risk to net capital presented by Applicant’s proposed business, and any arrangement for additional capital should need arise	If there is no net capital requirement for a PPBD, this could be eliminated. However, that the NASD is looking for applicants “fronting” for backers who should not be in the securities business, since PPBD’s generally have not significant need for capital, the question of financial backers would probably be largely irrelevant.
2(N)	Description of financial controls	This is probably N/A as the PPBD will never have custody of assets of customers, issuers, selling security holders, or others.
2(O)	Description of supervisory system and copy of WSP, internal operating procedures, internal inspections plan, written approval process, and qualifications investigations required by Rule	This is generally one of the biggest elements of work in a Membership Application. It is also frequently done very badly. However, at least some minimal procedures are appropriate. The main topics would

	3010	include: (1) registration, training and supervision of employees; (2) prohibition of commissionsharing with unregistered persons; (3) money-laundering provisions; (4) whatever reporting/recordkeeping will be required; (5) insider trading policies to comply with ITSFEA; (6) private placement procedures, such as Reg. D *Rules 10b-9 & 15c2-4.
2(P)	Description of number, experience, and qualification of supervisory personnel and of persons to be supervised by each of them; other responsibilities of supervisors and principals, including full- or part-time status, other business, hours per week to be devoted to outside activities, and explanation of how person will be able to discharge duties to Applicant if not a full-time employee	This is not burdensome or irrelevant, but can be marked N/A where the PPBD will have only one U4 person.
2(Q)	Description of proposed recordkeeping system	This can be a very simple statement, such as “Applicant will keep its books on an IBMcompatible computer using Quickbooks software” or “Applicant will keep manual books and records.”
2(R)	Web CRD entitlement request form and a Member Contact Questionnaire user access request form	Possibly there should be a requirement that the PPBD have e-mail access.

ADDITIONAL MATERIAL

The following items, not mentioned in Rule 1013, are required by SEC or NASD rules.

• Designation of accountant	If there is no audit requirement, this should be eliminated.
• FINS number	This definitely should be eliminated because there should be no SIC registration required.

• Proof of SIC registration	Should be eliminated.
• Fidelity bond	This bond protects the Member against loss, damage, etc. by its employees. It probably could be dispensed with for PBD's and certainly should be for a PPBD with only one U-4 person.
• NASD Certification	This is a statement that the applicant will comply with applicable NASD rules. It should be required of all PPBD's.
• FOCUS Filing Certification	See the comment in Rule 2(R) above about use of the Web.
• Web FOCUS Registration	See the comment in Rule 2(R) above about use of the Web.
• Securities Sales Activity Statement	This can probably be eliminated. It is a statement that the Applicant has not yet engaged in securities business and will not do so before becoming an NASD Member. It would be inconsistent with a "don't ask, don't tell" policy.
• Copy of organic documents of applicant (Board resolutions, LLC Agreements, Partnership Agreements, etc.) & similar documents for any parent entity	This should be required of each PPBD that is not a sole proprietorship.