



2009 Annual Conference



Monitoring the Middlemen: Enhancing the Regulation of Third Party Finders

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**NASAA'S
92ND ANNUAL CONFERENCE**

**PANEL THREE: MONITORING THE MIDDLEMEN:
ENHANCING THE REGULATION OF THIRD PARTY FINDERS**

**September 14, 2009
10:45 a.m. – 12:00 p.m.**

**REGULATION OF THIRD PARTY FINDERS:
THE ILLUSION, THE NEEDS, AND THE PROSPECTS**

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I. OVERVIEW:

The Securities Exchange Act of 1934 (“Exchange Act”) defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” 15 U.S.C. § 78(c)(4). The definition under state securities law is virtually identical in each state.

There is no federal statutory definition of “finder,” though over the years the Securities and Exchange Commission (“SEC”) has issued many no-action letters involving finders—many declining to grant the requested relief. *See, e.g., Hallmark Capital Corporation*, 2007 SEC No-Act. LEXIS 509 (June 11, 2007). Finders have been the subject of many SEC administrative, civil and criminal proceedings, most of which have alleged fraud violations in addition to broker registration violations. Among the states, only Michigan and Texas have defined “finders” by law or by rule, though neither states’ views are binding upon the SEC. There is probably permissible “finders” activity, and I have heard SEC speakers suggest that there are

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some finders who need not register with the Commission. Where the line between a finder and a broker may be located, no one yet has spelled it out clearly.

Finders must restrict themselves to a very narrow set of activities in order to avoid being characterized as a “broker” under federal and state securities laws. A court will consider several factors in determining whether a person has acted as a “broker.” As summarized in a recent federal court decision, “[t]hese factors include whether the person: (1) actively solicited investors; (2) advised investors as to the merits of an investment; (3) acted with ‘certain regularity of participation in securities transactions; and (4) received commissions or transaction-based remuneration.’” *SEC v. U.S. Pension Trust Corp.*, No. 07-22570-CIV, 2009 WL 2365702, at *9 (S.D. Fla. July 30, 2009) (quoting *SEC v. Corporate Relations Group, Inc.*, No. 99-CV-1222, 2003 WL 25570113, at *17 (M.D. Fla. 2003)).

The name “Paul Anka” is frequently bandied about in securities circles, but not for his singing, which is a pity because he was more successful singing than helping to raise capital when acting as a finder. The *Paul Anka* no-action letter, 1991 SEC No-Act. LEXIS 925 (July 24, 1991), provides the unusual case where a commission-like fee has been allowed to stand (for the moment). The staff’s favorable position was apparently attributable to the uniquely limited role of Mr. Anka as a finder in the case. 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 no-action request to the SEC he would have made the initial contact with prospective investors. That role was dropped from the final no-action request letter, which the SEC staff eventually granted.

According to the no-action request, in exchange for his services, Mr. Anka would be paid a finder’s fee equal to 10 percent of any sales traceable to the names in his rolodex. 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 SEC Rule 3a4-1 (safe harbor for an 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.

Based on these facts, the SEC indicated that it would not recommend enforcement action if Anka received compensation based on the capital raised by the Senators without him registering as a broker with the SEC.

Flash forward 18 years. In a speech at the SEC's Government-Business Forum on Small Business Capital Formation held on November 20, 2008, a staff member of the SEC Division of Trading and Markets observed that:

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

Thus, while the *Anka* letter has not been withdrawn by the SEC staff, it is now clear that the *Anka* letter provides almost no support or guidance for finder activity except, perhaps, in the unusual circumstance where the finder's role in the capital raising effort is essentially passive.

Attorneys in the Business Law Section of the American Bar Association have struggled with the problems associated with the activities of unregistered finders for a number of years. In response, it formed a Task Force, which I headed for a couple of years, and which was followed by Mary Sjoquist and then by the present chairs, Faith Colish and Greg Yadley. A comprehensive report of the problem, the existing law and recommended solutions was published as *The Report and Recommendations of the Private Placement Broker-Dealer Task Force*, 60 BUS. LAWYER 959-1028 (2005). The report has been cited, without endorsement, by the SEC staff as a summary of the views of private counsel about the SEC staff's historical guidance. See *Hallmark Capital, supra*.

The Task Force determined to proceed with only one of a series of recommendations from the Report, and that was to create a private placement broker regulatory regime which would provide meaningful assistance to those who wanted to simply start firms to raise capital for small businesses. From that effort emerged model forms and a model rule which has been before the staff of the Division of Trading and Markets for the past two years, and last November seemed ready to emerge into daylight until overshadowed by the demands upon the Commission's attention to deal with the national financial crisis.

The leading national and regional professional associations of merger and acquisition intermediaries and business brokers picked up on the Task Force's second recommendation,

that pertaining to the need for a much simplified set of regulatory requirements for merger and acquisition intermediaries and business brokers (collectively, “M&A Brokers”) involved with buying and selling companies whose stock is not publicly traded (“Private M&A transactions”). Their efforts are described below.

The third leg of the Report has not been addressed, and that related to the simple, one-off capital-raise by a “not in the business” type of finder—sometimes referred to as a “celebrity finder,” harkening back to Mr. Anka’s limited activities. These are finders who might only make introductions of investors they personally know on a single or occasional basis. There is no progress to report in that area except for the adoption of the finder’s rule in Texas last year.

Public confusion about the regulation of these activities has existed for years, in part because of the wide range of securities-related activities that may be performed by a finder and, in part, due to the lack of clear legal pronouncements. For example, it was not until the U.S. Supreme Court’s 1985 decision in *Landreth Timber Co. v. Landreth* that the “sale of a business” doctrine was rejected with the Court’s holding that Private M&A Transactions involving the sale of corporate stock are subject to federal securities laws. However, the *Landreth Timber* case did not address federal regulation of an M&A Broker’s activities in a Private M&A Transaction. Subsequent court decisions have not provided clarity.

II. THE FINDERS’ WORLD OF TODAY

A. The Ever-Changing Universe

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 and Texas being the only exceptions). The SEC and state securities regulators are free to modify the scope of these limited exceptions at any time.

In recent years the SEC has been narrowing the permitted scope of permissible finder activities. Indeed, in the last six 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 with securities issuers citing, among other things, advances in technology that have permitted other types of persons to become involved in securities-related activities. About one interesting development occurs each year with the issuance or modification of the SEC staff’s no-action letters.

B. Financial Intermediaries

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

Although no single factor is necessarily dispositive of the question of whether a finder is engaged in the activities of a broker, 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. See Alan J. Berkeley and Alissa A. Parisi, Frequently Asked Questions About the Resale of Restricted Securities (ALI-ABA 2008). 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 Trading and Markets 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 compensation 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.

Herbruck, Alder & Co., 2002 SEC No-Act. LEXIS 598 (June 4, 2002); see also, e.g., *Birchtree Financial Services, Inc.*, 1998 SEC No-Act. LEXIS 875 (Sept. 22, 1998) (registered representative's personal service corporations); *Ist Global, Inc.*, 2001 SEC No-Act. LEXIS 557 (May 7, 2001) (unregistered CPA firms); *Richard S. Appel*, 1983 SEC No-Act. LEXIS 2035 (Feb. 14, 1983) (1031 exchange transactions; requiring registration because finder would receive commission-based compensation on sales).

Transaction-based compensation would trigger broker-dealer registration requirements in *Mike Bantuveris*, 1975 SEC No-Act. LEXIS 2158 (Oct. 23, 1975). The SEC staff declined to grant relief 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.” *See also, John M. McGivney Securities, Inc.*, 1985 SEC No-Act. LEXIS 2159 (May 20, 1985).

The SEC has left open whether a commission-like fee arrangement, standing alone, will always constitute grounds for registration as a broker-dealer, though that appears the likely result. Although the SEC’s position in the *Anka* letter was not premised on the 1985 *Dominion Resources* letter (discussed below and in Section IV), the revocation of *Dominion Resources* in 2000 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 illogical 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. *See, e.g., Mike Bantuveris*, 1975 SEC No-Act. LEXIS 2158 (Oct. 23, 1975) (requiring registration); *May-Pac Management Co.*, 1973 SEC No-Act. LEXIS 1117 (Dec. 20, 1973), and 1974 SEC No-Act. LEXIS 2415 (May-13, 1974) (both letters requiring registration); *Fulham & Co.*, 1972 SEC No-Act. LEXIS 4488 (Dec. 20, 1972) (requiring registration); cf. *Caplin & Drysdale, Chartered*, 1982 SEC No-Act. LEXIS 2291 (Apr. 8, 1982) (not requiring registration where finders neither negotiated nor provided advice); *Leonard-Trapp & Assocs. Consultants*, 1972 SEC No-Act. LEXIS 3203 (Aug. 25, 1972) (requiring registration). 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.” *May-Pac Management Co.*, *supra*. 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. *Samuel Black*, 1977 SEC No-Act. LEXIS 104 (Jan. 20, 1977).

For example, in two no-action letters the requested relief was denied in *May-Pac Management Co.*, *supra*. May-Pac was an intermediary 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 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.

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. *Victoria Bancroft*, 1987 SEC No-Act. LEXIS 2517 (August 9, 1987). The *Bancroft* letter 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 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. *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*, 1974 SEC No-Act. LEXIS 1823 (Mar. 24, 1974), 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) of the Exchange Act. 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 on your behalf.” See also *SEC v. Schmidt*, Fed. Sec. L. Rep. 93,202 (S.D.N.Y. 1971) (finder was determined to be a broker-dealer when he placed advertisements in a daily newspaper offering savings on commissions); *Joseph McCulley*, CCH Fed. Sec. L. Rep., 78,982 (Sept. 1, 1972) (requiring registration based on mere repeated advertising to buy and sell securities).

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. See *Ewing Capital, Inc.*, 1985 SEC No-Act. LEXIS

1597 (Jan. 22, 1985). 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. See, e.g., *Victoria Bancroft, supra*; *Mike Bantuveris, supra*; *F. Willard Griffith, II*, 1974 SEC No-Act. LEXIS 457 (Oct. 7, 1974).

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.*, 1982 SEC No-Act. LEXIS 2978 (Nov. 7, 1982). 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 Exchange 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. Cf., *John DiMeno*, 1979 SEC No-Act. LEXIS 2791 (April 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").

In 1998, the SEC brought an action against Michael Milken and MC Group 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 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.

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. *Dominion Resources, Inc.*, 2000 SEC No-Act. LEXIS 304 (March 7, 2000). 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. *Dominion Resources, Inc.*, 1985 SEC No-Act. LEXIS 2627 (August 24, 1985). If the nature of the financing so required, Dominion Resources was allowed to introduce the issuer to a commercial bank (which may have a pre-existing 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 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 there-

after. 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 Exchange Act. Since that time, the staff has denied no-action requests in situations similar to the activities described in the *Dominion Resources* August 22, 1985, letter, e.g., *John Wirthlin*, 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.*, 1993 SEC No-Act. LEXIS 624 (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.*, 1990 SEC No-Act. LEXIS 1408 (July 20, 1989) (broker-dealer registration required 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).

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 Resources* letter 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* were the basis for 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 may receive additional scrutiny.

D. 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 ob-

taining 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, in *Russell R. Miller & Co., Inc.*, 1977 SEC No-Act. LEXIS 2059 (Aug. 15, 1977), 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. See also *International Business Exchange Corp.*, 1986 SEC No-Act. LEXIS 3065 (December 12, 1986) (“IBEC”).

Compensation for consulting services was also the subject of *Caplin & Drysdale, Chartered*, *supra*. 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 Exchange Act.

E. Compensation Sharing Arrangements

Registered broker-dealers and their registered representatives are not permitted to share commissions or transaction-based compensation with unregistered persons. In 2001, this was made clear in the context of CPAs and their CPA firms in *1st Global, Inc.*, *supra*.

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 had entered into agreements with their CPA firms that required them to account to the firm all revenues generated from firm clients. After firm expenses were paid, the remaining profits were to be allocated to all the partners under an allocation formula. The other partners, shareholders, or members that would 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:

1. The broker-dealer 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. The broker-dealer 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. The broker-dealer 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. The broker-dealer 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 customer's 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.

The staff stated that this position was consistent with its *Freytag, LaForce, Teofan and Falik*, 1988 SEC No-Act. LEXIS 1346 (Jan. 4, 1988), 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 circumstances that underlie the *Birchtree* letters assuage the core regulatory concerns raised by the receipt of transaction-based compensation.

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.

F. THE *COUNTRY BUSINESS* LETTER

1. Summary of the Letter

In the evolving world of finders, the latest interpretive development of note is the *Country Business, Inc.* ("CBI") no-action letter, 2006 SEC No-Act. LEXIS 669 (November 8, 2006). Based on the facts and representations set forth in CBI's request letter, the SEC staff concluded that it would not recommend enforcement action to the Commission under Section 15(a) of the Exchange Act if CBI engages in the activities described without registering as a broker-dealer. The SEC staff noted CBI's factual representations, which reflect the principal factual predicates for its conclusion. These factual predicates, as well as those cross-referenced in CBI's request, are critically important to follow if the staff is to reach the same conclusion with respect to another person's unregistered activities. These factual predicates include:

- (1) The business broker will be engaged by the seller (or its owners) to sell the business. If a decision is made to effect the transaction by a sale of securities, the broker will have a limited role in negotiations between the seller and potential purchasers or their representatives and will not have the power to bind either party in the transaction; the business broker's role will be limited to:
 - a. transmitting documents between the parties;
 - b. valuing the assets of the business as a going concern;
 - c. providing the seller with administrative support; and
 - d. assisting the seller with preparation of financial statements.
- (2) The business will be sold as a going concern and will not be a "shell" organization.
- (3) The seller must satisfy the size standards for a "small business" pursuant to the Small Business Size Regulations issued by the U.S. Small Business Administration (<http://www.sba.gov/contractingopportunities/officials/-size/index.html>).
- (4) The business broker may publish listings of the business being for sale in print or on the Internet, but only assets will be advertised or otherwise offered for sale; the seller's securities will not be offered for sale.
- (5) If the transaction is effected by means of securities, it will be a conveyance of all of the business's equity securities to a single purchaser or group of purchasers formed without assistance from the broker.
- (6) The broker will not advise either of the parties whether to issue securities or to effect the sale by transferring the seller's securities, nor will the broker assess the value of any securities sold (other than by valuing the assets of the business as a going concern).
- (7) The broker's compensation will be determined prior to the decision on how to structure the sale of the business; it will be a fixed fee, hourly fee, a commission, or a combination thereof, that is based upon the consideration received by the seller, regardless of the structure used to effect the transaction and will not vary according to the form of conveyance (i.e., sale of securities rather than assets).
- (8) The broker's compensation will only be paid in cash; the broker may defer the timing of its compensation to track with the buyer's payments and the broker's payment may be conditioned on future events.

- (9) The broker will not assist purchasers with obtaining financing, other than providing uncompensated introductions to third-party lenders or help with completing the paperwork associated with loan applications.

The *CBI* letter is, in many respects, similar to the SEC's no-action letter to *International Business Exchange Corp.*, *supra*; however, it adds the condition that the business to be sold meets the definition of a "small business" under SBA standards.

2. What the *CBI* Letter Does

The no-action letter reaffirms and "freshens" the SEC staff's views expressed in the *IBEC* no-action letter. The *IBEC* letter was issued in 1986 and, subsequently, the SEC withdrew its letter in *Dominion Resources*, casting some doubt on its current position—the SEC thus affirmed its long-standing position, albeit subject to a new size limitation.

Both the *CBI* letter and the *IBEC* letter refer to the intermediary as being a "business broker"—this reaffirms the SEC staff's recognition of the role of a business broker in the sale of a business where the transaction is effected through the transfer of the seller's securities under the facts, conditions, and limitations stated in these letters.

The SEC staff did not object to *CBI*'s description of the broker's role in assisting a seller to prepare a due diligence or offering package. As described by *CBI*, any information assembled by the broker would include a cautionary statement that the broker is not making any representations about the accuracy of the information provided.

The predicate facts, conditions, and limitations stated in the two no-action letters are very similar—the *CBI* letter adds a new wrinkle: the "small business" size limitation. The other specific factors are, essentially, the same. The *CBI* letter adds some detail to the compensation factor—allowing for a deferral and potential future adjustment of the broker's compensation—and affirms that the unregistered broker can receive transaction-related compensation in what would otherwise be a securities transaction.

The *CBI* letter covers many common scenarios for the role of business brokers with small business clients. There are, however, many common activities of intermediaries that are not within the scope of the letter.

3. What the *CBI* Letter Does Not Do

The letter has limited effect on the interpretation or application of state securities laws. Many states are actively considering rulemaking on the role of "finders" in securities transactions, with the likely result being a patchwork of widely varying requirements and conditions—anyone with a broad or national M&A practice will need to know the requirements in multiple states.

The *CBI* letter generally addresses sell-side engagements. The letter references a nominal role with respect to assisting a business buyer in obtaining commercial financing, but does not address other activities in a buy-side engagement.

The *CBI* letter does not permit the business broker to give advice about the structure of the transaction—i.e., asset sale vs. stock sale vs. corporate merger—nor advice about structuring the transaction with a new stock issuance and a related redemption. The intermediary cannot give advice about the value of the seller’s business in a public offering of its securities or if its securities are publicly traded. Advice about the transaction’s structure—an integral part of the related tax and risk management considerations—would otherwise be a significant value to intermediary’s role in a transaction, particularly where there is no attorney or CPA involved. If advice on these topics is given, it could be a basis upon which a disgruntled client might challenge the intermediary’s engagement contract and fees.

The *CBI* letter allows only cash compensation to the broker—this would not permit the broker to receive any stock, options, or warrants in the transaction.

As soon as a transaction looks like it will be a securities transaction, the intermediary’s role is severely limited. The business broker is not permitted to participate in the negotiation of deal terms and conditions in a securities transaction.

Only engagements where the seller’s entire ownership interest is transferred are covered by the *CBI* letter. The letter does not allow for a seller-retained interest. The broker cannot play any role in bringing together multiple purchasers nor multiple participants in a single purchaser entity. The broker cannot handle funds in the transaction nor act on behalf of any of the parties.

No forms of compensation can be received by the intermediary from banks and commercial lenders. Referral fees from title companies or other third-party vendors are not described in the letter, but receipt of such compensation could jeopardize a broker’s reliance on the *CBI* letter.

III. THE PRESENT REGULATORY SYSTEM—THE SEVEN HUMPED CAMEL

Our present regulatory system is set up to establish substantial barriers, not the least of which is enormous cost, to form and operate as a registered broker-dealer, which necessarily includes membership in a self-regulatory organization such as the Financial Industry Regulatory Authority (“FINRA” f/k/a NASD). The vast percentage of the laws, rules, requirements, and forms are aimed at full service brokerage firms, and FINRA has not adapted to this difference, nor have many states. There are many, many examples of why the current system for regulating M&A Brokers in Private M&A Transactions is misunderstood and is not working. At the most basic level, a broker-dealer registrant must indicate in Item 12 of Form BD one or more of the 25 specific types of services to be performed, which cover a wide range of retail and institutional broker and dealer activities. None of these 25 activities describe mergers, acquisition, business sales, or similar investment banking activities nor are these activities addressed in the

form's instructions—a registrant must independently know enough to check the “other” box and manually describe these activities in their own words.

M&A and business brokerage firms don't trade, don't market mutual fund or variables, don't manage accounts, and don't do 98 percent of things that they are tested and required to have systems for. Nonetheless, regulators insist that to enter the business, you have the kind of knowledge that is expected of Merrill Lynch. Your capital requirements may exceed \$1 million dollars, because if you are in the M&A business, you may work for nine months before your first pay check comes in. Customers are not at risk during this time, but the net capital requirements apply as if they were.

How long does it take to form a broker-dealer? Six months if you are good and get a cooperative FINRA examiner. Part of the problem is FINRA backlog, part is the unique questions and requirements that people don't know about until they form a couple of brokerage firms, part is the hideous complexity and the irrelevancy of large portions of the requirements, and the final part is the difficulty of spending six to nine months without working while you get the clearance so you can proceed. The system needs radical, logical reform to regulate what people really do in advising sellers and buyers of privately held businesses.

There is a new FINRA limited classification of “investment banking representatives” (NASD Rule 1032(i)) and a related Series 79 examination (*See* FINRA Regulatory Notice 09-41, *Investment Banking Representative*). This registration will be required for anyone engaged in (1) advising on or facilitating debt or equity securities offerings through a private placement or a public offering, including but not limited to origination, underwriting, marketing, structuring, syndication, and pricing of such securities and managing the allocation and stabilization activities of such offerings; or (2) advising on or facilitating mergers and acquisitions, tender offers, financial restructurings, asset sales, divestitures or other corporate reorganizations or business combination transactions, including but not limited to rendering a fairness, solvency or similar opinion. According to the new exam's study guide, testing will cover both of these broad substantive areas. Underwriting, syndicating, and market stabilization activities of publicly traded securities are a far cry from the professional knowledge that M&A and business brokers need to handle to serve privately owned companies. FINRA's new classification is designed to allow, among others, current holders of “Series 7 equivalent exams” to opt into the new classification without taking the new Series 79 exam, allowing representatives currently registered in the United Kingdom (Series 17) and Canada (Series 37/38) to become registered with FINRA in the U.S. without having to take another exam. The new classification is a good idea—for multinational wirehouses—and that is where the new classification was aimed by FINRA and its large member firms. No input was sought from smaller firms and no attention given to their needs and concerns. What kind of message does that send to those who want to get into compliance and are frustrated?

The perception of many ABA Business Law Section members, representatives of state bar association securities law committees, and state regulators with whom I have discussed this issue, is that the vast preponderance of finders in private, corporate, or similar finance transactions are in reality unregistered broker-dealers. 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 finder problem. In addition to concern for their clients, attorneys often expressed frustration over the ability of promoters to obtain advice by attorneys that finder activity involving negotiation and transaction-based compensation was lawfully rendered. These attorneys were (i) unaware of the vast accumulation of SEC no-action letters dating back for decades; (ii) unable to spend several working days to find, read, and make sense of them all; or (iii) simply chose to ignore them because of their view that these issues appear to have little priority with the SEC staff. In the context of M&A transactions, the parties negotiate their respective representations, rights, and remedies in their transaction documents and would rarely, if ever, even consider contacting the SEC or a state securities regulator to complain about a transaction gone bad.

Most finders are unaware or ignore registration and related regulation for a variety of reasons, expressed to many members of the ABA Business Law Section over time, including:

- Forms and rules required of conventional broker-dealers that have little to do with their activities.
- Required tests have even less to do with their activities.
- Belief that regulators have little or no enforcement interest in their activities.
- Little fear of loss of commissions in legal action, based on the “good deal” defense or lack of understanding of the provisions of the Exchange Act.
- Misinformation provided by counsel with lack of understanding of, or indifference to, securities laws and the interpretations of the SEC and the states.
- Inability to comply because of regulatory orders or other disqualifying events preventing entry into the business in a legitimate fashion.
- Past transactions which would result in punishment and adverse publicity if the intermediary now seeks to register with state securities regulators.
- No-action letters appear or are read to grant adequate comfort that registration is not necessary.

There is a legitimate concern that there is no effective way for small businesses to locate assistance in capital formation from ethical financial intermediaries. Congress and the SEC have carved out areas of regulation in which the SEC defers primarily to the states for regulation, such as Regulation D, Rule 504; the intra-state offering exemption under 3(a)(11) and Rule 147; the division of responsibility between the SEC and the states for the regulation of investment advisers; and the regulation of registration of brokerage firms and registered representatives. This system is also presently archaic, but that is an argument for another day.

IV. REGULATION, YES; ENFORCEMENT, NOT SO MUCH

Yes, today's system of federal and state securities regulation applies to the activities of finders. But, for amusement, I encourage you to type the words "Investment Banking Services" on Google and see what turns up. Indeed, a number of registered broker-dealers appear, as expected. But an equal number of unregistered finders likewise show up. While I am sure that for the most part they are good companies, some of which are quite large and have been in business for many years, the owners/managers/principals of these firms often have come from wirehouse firms where they were required to be registered. One firm boasts of principals from a major New York law firm and another from a large public accounting firm. The services that they tender involve "investment banking," private placements, mergers and acquisitions, stock and options trading ideas, representation of leading private equity and venture capital firms, and a diverse array of buyers and investors. There are glowing customer and corporate endorsements. Somehow, I bet that the management of none of the deals that went sour was asked for endorsements. Ah, it must be that the principals don't know that they need to be registered. I am from Michigan and we have a bridge between the Lower and Upper Peninsula that I would like to sell you a part interest in if you believe these principals don't know exactly what the law is and that they are skirting it. Then why do they do so?

First, let us ask if they are doing harm. In many cases, they actually provide a desperately needed service. Smaller and middle market businesses find it extraordinarily difficult to raise capital in ordinary times, and presently it rises to the level of virtual impossibility. Commercial credit all but dried up in the last 12 months as the U.S. economy and banking industry tanked. The federal bail-out money went to Wall Street. No one in Washington appeared to be even thinking about Main Street.

Picture a typical small business owner from your state. They manufacture a magnetic transponder device that when linked to a magnetic field established in a small hole allows golfers to make a hole in one on every shot. They call it the Bengal Forest Automatic Ball Sinker. Sales for this company increased to the point that at the end of 2007 they had risen to \$25 million and the company made a profit of \$7 million. They employ 42 people and are based in small town. Last year and into this year sales have dropped off as one would expect in a recession, and the company is operating closer to break-even. The initial capital consisted of money from insiders, their parents, a famous rich golfer who dropped \$10,000 in cash on the fairway accidentally as he played the local course, and a bank loan. Unfortunately, the banker has received TARP money and is really not making or renewing any loans with risk. The local community does not have wealthy people, and the relatives of management have all been recently laid off by the auto industry. Management knows that to survive it must advertise its products, package them better, get a national endorsement (even if it means returning the dropped cash), and it must pay back its bank loan to prevent foreclosure. Where do they turn?

Obviously, the first place is to a wirehouse, since they do offerings every day and would be happy to help raise the \$10,000,000 that is needed. Or will they? Not really, since the minimum size offering they would have considered in better times was about \$25 million to \$50 million and their minimum fees start no less than \$500,000 to \$1,000,000 plus expenses.

BFABS is not in position to use, let alone afford, all that new money and would not merit funding at that level.

But there must be other banks willing to lend some of the funds. Think again in this environment! Risky new business, in a downturn, in an uncertain economy, with no relationship with the bank or its management. Don't hold your breath!

No problem, we will turn to Regional Brokerage Firms. A couple of years ago there were a small number of firms that might have considered this kind of venture, taking it perhaps to London to see the "fair-ly" inconsequential AIM market, or they may have raised money from an existing investor group who looked for venture deals. Well, investors have put their cash under mattresses today and are not willing to pull it out.

So what? We will go to the Venture Capital Market. I think that was recently renamed a Growth Capital Market for those who remained in the business and BFABS has been growing in the wrong direction and is not likely to give the kinds of yields they want, or to have the depth of management needed.

But things are still looking up, as there are "angels" up above. Perhaps this is the best bet if one can find an angel network willing to do deals of the needed size (most don't) and, if so, what must management give up?

Well things aren't all that desperate, yet. A nice man called and said that he could sell us a public shell corporation which was still registered as a 1934 Act company into which we could merge, and as a public company we won't have any trouble raising money. Our attorney said it was strange that the nice man did not mention the enormous cost of being a public-reporting company and the need for annual audits, periodic reporting, and on-going disclosure of material events. He also was surprised that we could not trace the holdings of a substantial amount of shares which the nice man assured us were not being held by insiders or his group. My attorney mentioned investing in a bridge in Northern Michigan.

Let's try another example. Stanley Sparkum has owned his company in a mid-sized city in your state for 50 years. He inherited it from his father, and as a youth he grew up in the company. Over his lifetime he has worked 12-15 hours per day in the business. Stanley has no sons, and for that matter no daughters, so there is no-one to inherit the business. His employees don't have enough cash to buy him out. How is he to get the value of a lifetime out of his business? Who can he turn to for help? If the business were small enough, a business broker could probably assist, assuming there were a number of similar businesses in the area. But Stanley has a larger business. It grossed \$25 million in sales last year, but with a profit of only \$3 million. Stanley has reached the stage where for health reasons and slowing down with age, he is no longer able to keep the pace at which he has been working and he is considering retiring—a "senior" deserving special regulatory protection by today's standards—but how does he get value for his lifetime of investment? How does he keep the company going and keep his many employees/friends in their jobs? Where can he get the expertise to help him put his company in order so it can be sold? What do sellers need? How does he get to market? Today, he often has to turn to "investment bankers" for help, and the chances are pretty good that he will receive it in

a highly beneficial way, as there are M&A experts across the country, the vast preponderance of whom are unregistered finders! Without them, Stanley probably won't sell his business and he will remain at the helm until the ship sinks or he does. Demographers estimate that "baby boomers" will transfer roughly \$10 trillion of accumulated wealth when they retire (assuming the economy bounces back at least somewhat). For these seniors, their largest single investment is likely their own business and the sales of the business are a once-in-a-lifetime event. For many small business owners, the minimum transactions costs and fees charged by registered broker-dealers are prohibitively expensive and many of those broker-dealers will not touch the "smaller" deals.

That brings Stanley—and thousands of other small business owners like him—to using unregistered finders. Who are they? Unlike today's system of federal and state securities regulation, one size doesn't fit all. Finders can be anyone:

- Individuals or entities.
- Experienced or not.
- Professionals in or previously in the securities business.
- Bankers or former bankers.
- Insurance agents.
- Accountants.
- Commercial real estate agents.
- Laid-off, retired, and working corporate executives.
- People with money who know other people with money (the country club circuit).
- Former operators of venture or investment funds.
- People who do it everyday for a living and people who do it once in a lifetime.

In the context of buying and selling businesses, unregistered finders perform valuable, cost-effective professional services that are critically important to buyers and sellers in Private M&A Transactions. The services of M&A Brokers enhance the liquidity of accumulated capital and thereby foster continued economic development, growth, and innovation. There are inherent investor protections in the context of Private M&A Transactions. Most are negotiated among active, knowledgeable, and sophisticated parties and involve attorneys, accountants, bankers, and other advisors in addition to the M&A Brokers. Transaction documents typically contain specific representations, warranties, covenants, and remedies. Typically, M&A Brokers do not handle funds or securities exchanged in these transactions. Aggrieved parties typically pursue their contractual, common law, and statutory remedies in court or through private arbitration, rather than by complaining to a securities regulator. Few frauds or scams involving M&A Brokers in Private M&A Transactions have been reported and most of those have involved "public shell" corporations. These activities are already regulated at the state level through business or real estate brokerage licensing and regulation, as well as state securities laws.

Lest you believe that I think the finders' world is made up entirely of saints, let me quickly disabuse you of the thought. Out there waiting to victimize the public are the purveyors of public shells who seek to use the small business as a device to help with market ma-

nipulation; the finders who charge substantial advance fees and then disappear in the old “advance fee” racket; the people who have been kicked out of the securities industry and hide in the shadows of finders activity; the finders who have grossly onerous contracts and charge large up-front fees and then have you enter into contracts which bind you to their mercies for any capital deal in the future, including those where others raise capital for you; the touting services who will flood emails about your company and try to get investors to come to you; the finders who will conduct public offerings under a claim of private offering and advertise to get “plate lickers” to come to meetings so they can be fleeced with grossly inadequate information; the finders who want to help launder money and connect you to the mob; and the list goes on. This is a world of saints and sinners, but it is the saints we want to bring into compliance and the sinners that we want to identify and flush out. We need to make it far more difficult for the sinners to dupe people but provide legitimate alternatives.

A misapprehension exists that the SEC and states do not bring many cases against finders. This is clearly incorrect, but the manner in which these cases are plead, and accompanying releases are couched, tends to minimize the unregistered activity and stress the juicy fraudulent actions. The finder aspects get buried in the other verbiage. However, a few recent cases have been getting attention.

V. RECENT KEY CASES

Many finders use the term “investment banker” to describe their activities, which connotes registration and regulation as a broker-dealer, though many are trying hard to fly below the regulatory radar and avoid registration. That wish is becoming increasingly illusory as the cases described below indicate:

A. *SEC v. U.S. Pension Trust Corp.*

The SEC filed an action against U.S. Pension Trust and individual corporate defendants, alleging, among other charges, that the corporate defendants acted as unregistered securities broker-dealers. *SEC v. U.S. Pension Trust Corp.*, No. 07-22570-CIV, 2009 WL 2365702, at *1 (S.D. Fla. July 30, 2009). The defendants offered a plan to investors to invest in mutual funds through a trust. The defendants claimed that they merely marketed the trust agreements between investors and the trustee bank, and that they did not sell the mutual funds or purchase them for investors. In other words, the defendants claimed that they marketed the mutual funds as “finders.” The court applied the four-factor test described above and found that the defendants received commissions and transaction-based compensation, actively solicited investors, and regularly participated in securities transactions. There was, however, a dispute of fact as to whether the defendants advised investors as to the merits of their investments. The court held that this dispute of fact over one of four factors was sufficient to deny summary judgment on the issue, so the case remained unresolved at the time of this decision.

B. *Black Diamond Fund, LLLP v. Joseph*

Colorado Securities Commissioner and present NASAA President, Fred Joseph, brought an action against Black Diamond Fund, LLLP (“BDF”), for violation of the securities registration, licensing, and anti-fraud provisions of the Colorado Securities Act. *Black Diamond Fund,*

LLLP v. Joseph, No. 08-CA-0883, 2009 WL 1477223, at *1 (Colo. App. May 28, 2009). BDF made an offering of up to \$10 million in partnership interests, which they offered through “finders.” These finders received a five percent commission for each investment placed with BDF. William Gay acted as a finder although he was not licensed as sales representative under Colorado securities law; in fact, not only was Gay unregistered, but his prior license had been revoked by the Colorado Division of Securities. BDF argued that Gay did not act as a sales representative, because he did not “effect or attempt to effect the purchases or sales of securities” in violation of C.R.S. 11-51-201(14). The court rejected this argument, finding that the definition of “sales representative” in Colorado law was similar to the definition of “broker” under federal securities law, and that the “SEC has identified transaction-based compensation as indicative of whether one is broker because such compensation is triggered by the ‘effecting’ of a sale.” The court noted that “[e]ffecting transactions in securities is shown by actively soliciting clients, selling securities to the clients, and participating in securities transactions ‘at key points in the chain of distribution.’” (quoting *SEC v. Nat’l Executive Planners, Ltd.*, 503 F. Supp. 1066, 1073 (M.D. N.C. 1980)), and, therefore, William Gay violated the Colorado Securities Act by locating investors, discussing the investments with prospective investors, and obtaining checks and signed subscription agreements to send to BDF without a license. As a result, the court affirmed the Commissioner’s order that defendants cease and desist from violating the Colorado Securities Act. The court observed, noting the failure to disclose the non-registration status as a sales representative, that closing one’s eyes to true facts does not justify a material omission.

C. *SEC v. Radical Bunny*

On July 28, 2009, the SEC filed a complaint against Radical Bunny, LLC, and its principals. *SEC v. Radical Bunny*, Complaint for SEC (D. Ariz. July 28, 2009) (No. 2:09-CV-01560-SRB). The complaint alleged that defendants had made material misrepresentations to investors in connection with its securities offering, sold unregistered securities, and violated Section 15(a) of the Exchange Act by failing to register as a broker or dealer. The defendants allegedly solicited investors for making loans to Mortgages, Ltd., a private lender that used the money to make high-interest, short-term loans to real estate developers. The investors were to receive 11 percent interest on their investments and the individual defendants were to retain a 2 percent interest on the loans as a “vender fee.” The SEC alleged that despite contrary advice from their attorneys, none of the individual defendants were currently registered with the SEC, in violation of the broker-dealer registration requirements. Two of the defendants had held prior securities licenses. The SEC requested that the court issue judgments enjoining the defendants from further violations; order the defendants to disgorge all compensation; and to pay civil penalties under both the Securities Act of 1933 and the Exchange Act.

D. *In re Ram Capital Resources, LLC*

In an administrative proceeding against Ram Capital Resources, LLC, and its principals, the SEC ordered that the individual defendants, who had violated the broker-dealer registration provisions of Section 15(a) of the Exchange Act, disgorge the money they had earned as unregistered brokers and cease and desist from their behavior in violation of the Exchange Act. *In re Ram Capital Resources, LLC*, Administrative Proceeding File No. 3-13524, at 5 (June 19, 2009). Furthermore, both individual defendants were suspended from association with any broker or dealer for a specified period of time. Unlike other cases against finders, where the finder’s violation of broker registration requirements was secondary to allegations of

fraud or misrepresentation, the violation of Section 15(a) of the Exchange Act was the primary cause for the SEC's action in this case. The individual defendants worked to identify potential investors for PIPE (private investment in public equities) offerings and were paid 3.5 percent of each investment as compensation. The defendants' actions went beyond identifying investors and included structuring and negotiating the terms of offerings. Based on this conduct, the SEC found that Ram and its principals acted as brokers without being registered, in violation of the Exchange Act.

E. Salamon v. Teleplus Enterprises, Inc.

Salamon was involved in finding financing for companies unable to obtain traditional bank loans. *Salamon v. Teleplus Enters., Inc.*, No. 05-2058, 2008 WL 2277094, at *1 (D. N.J. June 2, 2008). In July 2002, Salamon entered into an agreement with Cornell, a private lender, by which Salamon agreed to find business opportunities for Cornell. Cornell was to compensate Salamon in the amount of ten percent of the gross stock compensation received by Cornell in a transaction. Subsequently, Salamon entered into an agreement with Teleplus, a distributor of cellular devices and service, under which Teleplus agreed to compensate Salamon a finder's fee of ten percent of the total funding Teleplus received through sources provided by Salamon. Salamon then introduced Teleplus to Cornell, and a securities purchase agreement was later signed. Teleplus argued that Salamon played a substantial role in negotiations, and therefore, Salamon had "effectuated" securities transactions such that he had the status of a broker. Because Salamon was not a registered broker-dealer, Teleplus claimed that its agreement with Salamon was void under Section 29(b) of the Exchange Act as a "contract [that] involved a prohibited transaction," because Salamon violated Section 15(a) of the Exchange Act. The court found that there was a factual issue that precluded summary judgment, as the finder of fact must determine whether Salamon's status was that of a broker or finder, so the case remained unresolved at the time of this decision.

F. Torsiello Capital Partners, LLC v. Sunshine State Holding Corp.

First International, a predecessor firm of Torsiello Capital (hereafter "Torsiello"), made an agreement with Sunshine State Holding Corp. to act as the agent for the private placement of Sunshine State's securities. *Torsiello Capital Partners, LLC v. Sunshine State Holding Corp.*, slip op. at 1 (N.Y. Sup. Ct. Apr. 1, 2008). The parties agreed that Sunshine State would pay Torsiello a retainer, along with 3.5 percent of the total purchase price paid on the sale of Sunshine State, if the sale occurred during the contract term or within 18 months of its termination. In January 2003, Sunshine State terminated its agreement with Torsiello, and in May 2004, Sunshine State's outstanding stock was acquired by a third party who was a prior investor in Sunshine. Torsiello demanded payment of its 3.5 percent fee and Sunshine State refused. Torsiello then brought an action against Sunshine State for breach of contract. Sunshine State defended its refusal to pay Torsiello by claiming that its agreement with was void under Sections 15(a) and 29 of the Exchange Act, because Torsiello was not a registered securities broker. The court found that the stated purpose of the contract was to market securities, an activity that may only be performed by a registered broker. Therefore, the contract was in violation of Section 15(a) of the Exchange Act and void under Section 29 as a result. The court also found that the contract was unenforceable under the common law doctrine of illegality, rationalizing that a

party to an illegal bargain may not seek to enforce it, and noting that it is unnecessary for the words of the contract to disclose the illegality as long as the contract is closely connected with an unlawful action. In addition to rescinding the contract for the 3.5 percent fee, the court also ordered Torsiello to refund the \$50,000 retainer Sunshine State had paid at the beginning of the engagement.

VI. POTENTIAL FOR SOLUTION

A. Private Placement Broker

As noted above, the ABA Private Placement Broker Task Force has been in active negotiation with the Division of Trading and Markets staff and the NASAA Finders Project Group in an attempt to arrive at a system which will provide a more logical regulatory approach for those finders who only want to be involved in raising capital for small business.

There is much logic in this approach. Registered brokerage firms have been drying up like prunes turning to raisins with the acquisitions by banks and larger firms, have changed their product lines to selling mostly mutual funds and variable products, and getting out of the corporate finance business altogether. The risk, the cost, and the time in relation to other activities, have driven larger firms out of this business. As a country, we need brokerage firms which will raise capital to provide for the foundation of small business growth. Instead, we are losing firms at a frightening rate. We need to seed more emerging brokerage firms! We need to restore small corporate finance to where it was 20 years ago.

Some things we don't need—the lack of sophistication in the brokerage community that rushed “unripened fruit” to market in the form of the “.coms.” Interestingly, the financing from the proposed “private placement brokers” would not take the form of public offerings at all—that would be left to conventional registered broker-dealers. Rather these small firms will be raising capital privately or through the small capital exemptions provided in Rule 504 of Regulation D, in Regulation A, or under SEC Rule 147 for intrastate offerings.

The ABA Private Placement Broker Task Force has drafted a model rule and model forms. However, we are all awaiting anxiously the birth of the idea when it is finally permitted by the Commission to emerge for comment. The Task Force's 2005 Report, published in the *Business Lawyer*, *supra*, summarizes most of the ideas to date.

B. M&A Broker

The Alliance of Merger and Acquisition Advisors (“AM&AA”), in conjunction with 14 of the leading national and regional professional associations of mergers and acquisitions intermediaries and business brokers has offered draft rules language (the “Federal M&A Broker Rules”) for consideration by the SEC. The proposed federal rules would be complemented by state-level rules and related regulation (the “State M&A Broker Rules”) that have been proposed to NASAA.² Together, these federal and state rules would create a regulatory regimen for M&A

² The proposed Federal and State *M&A Broker rules* can be downloaded from the AM&AA's website at: <http://www.amaaonline.com/advocacy>. The proposed rules have been shared with both the SEC and NASAA. NASAA's Find-

Brokers as described in a Concept Outline For a Proposed Federal Broker Registration Exemption For Certain Business Brokers and M&A Intermediaries (Rev. 3/17/07).³

A primary objective of the Federal and State M&A Broker Rules is to enhance investor protection by improving the unregistered persons understanding of steps necessary for compliance with federal and state securities laws and by creating a new classification of “broker” under the 1934 Act, in coordination with state securities laws, that will appropriately regulate the securities-related activities of M&A Brokers in Private M&A transactions in view of the limited scope of their activities and the public interest in facilitating the free flow of capital to and from existing small business owners.

This proposed rulemaking ranked among the top three recommendations of the Final Reports of the 2006, 2007, and 2008 SEC Government-Business Forums on Small Business Capital Formation annually hosted by the SEC. The proposed rules would complement other regulatory reforms to benefit small businesses announced by the SEC on May 23, 2007 (see the Proposed Modernization of Smaller Company Capital-Raising and Disclosure Requirements, Press Release 2007-102). If the proposed rules are adopted, small business sellers and buyers would be better assured of receiving assistance from legitimate, compliant professional advisors in their sale transactions. The number of small business sale transactions has been increasing as baby boomers seek to retire and liquidate what is typically their single largest investment. While many of those transactions are legally structured as asset sales which are generally outside the scope of federal and state securities regulation, some of those transactions involve securities and, accordingly, are within the jurisdictional scope of those laws and related rules. It is critically important to understand that most, if not all, M&A Brokers primarily handle asset sale transactions but, in order to properly advise and serve their clients’ needs and objectives, also need to be able to handle transactions where the sale of a business or business unit is accomplished through the sale of securities. Without relief, we have a classic form over substance situation. In light of that, the proposed regulatory regimen is designed to be efficient and cost-effective for both regulators and M&A Brokers.

Another objective of the Federal and State M&A Broker Rules is to create a uniform system of state rules, to coordinate with the federal rule, so that the system of regulation is well defined and commonly understood by M&A Brokers, business buyers and sellers, their accountants, legal and financial advisers, and the general public. Uniformity will also aid in efficient administration of the rules and reduce costs for regulators and regulated persons. Therefore, the Commission’s rules would be complemented at the state level through model rulemaking coordinated through NASAA and recommended for adoption by the states. This rulemaking proposal is patterned after the bifurcated regulatory model created by Congress, and implemented by the SEC and the states, for the regulation of investment advisers pursuant to the National Securities Markets Improvement Act of 1996.

ers Project Group has been meeting with SEC staff, and co-panelist Illinois Securities Commissioner Tanya Solov can discuss those details.

³ The Concept Outline and the Comparison of Current and Proposed Regulation of Broker-Dealer Activities can also be downloaded from the AM&AA’s website at: <http://www.amaonline.com/advocacy>.

FINRA has little interest in adding several thousand additional members who do not do traditional securities business. Accordingly, the rules have been designed to avoid the requirements of FINRA membership.

C. Small Business Sale Transaction Exemption

The AM&AA, International Business Brokers Association, and other professional associations have also proposed that the SEC codify the SEC's letter to *Country Business, Inc.*, *supra*, discussed above, into a Commission-adopted rule, called the "Small Business Sale Transaction Exemption." The proposed exemption incorporates all of the concepts contained the no-action letter and, in addition to sell-side engagements, would also cover buy-side engagements. A similar model rule has been proposed to NASAA for adoption at the state level.

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