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FINDERS BUT NOT KEEPERS: THE REGULATION OF UNLICENSED FINDERS IN SMALL PRIVATE CAPITAL RAISES

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Small businesses and start-ups desperately need outside capital investment in order to survive, particularly during their tenuous early phases of growth. Linking up small enterprises with investors willing to help them grow is a difficult task. It often falls outside the experience and competency of business owners struggling to keep up with daily demands. Investment capital finders play a vital role in survival and success of small business. They receive consideration for steering investors toward deals and enterprises that are beneath the interest of big private equity and venture capital firms. Finders receive consideration for their important service, but SEC rules loom as a constant threat to their activities. Bent on protecting big investment firms, the SEC (a) ignores finders as a distinct business class; (b) lumps their activities in under the inaccurate heading of "broker-dealers"; (c) makes it unclear whether some finders must even register as such; and (d) metes out

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harsh punishments when it adjudges that a finder's activities have crossed the undefined boundaries of broker-dealer territory. Thus, finders face a two-edged regulatory sword: either register as broker-dealers at considerable cost, or forego registration at considerable peril. Recissions, disgorgements, fines, and sometimes even criminal liability can follow an SEC pronouncement of unlicensed broker-dealer activity. In this article, we argue that a more rational finder regime is long overdue at the federal level.

That regime should be modelled on the successful regulatory framework which is now well established in the state of California. California recognizes finders and their activities as distinct from broker-dealers. Finder registration is easy and inexpensive in California. California finder regulation is far less onerous than broker-dealer rules imposed by the SEC. They serve the purpose which the SEC so far fails to achieve: to protect small businesses and small-deal investors alike. A similar regime enacted nationwide would obviate overlapping state rules. It would serve the public's vital interest in fostering the small-business sector, the bedrock of America's economy.

Introduction

Many small businesses walk an equity tightrope. The ability to raise investment capital can mean the difference between expansion and extinction for a small business which relies upon growth to survive. Yet—caught up in quotidian affairs—finding investors who can take the enterprise to the next level is something entrepreneurs and small business owners have neither the bandwidth nor the expertise to do.

Enter the "Finder." The function of a finder, at its most basic, is to link businesses seeking equity with investors, and the finder gets a fee in return. Finders may need to register with the U.S. Securities and Exchange Commission ("SEC"). Sometimes they must register with other regulatory bodies as well, often under the rubric of brokers or dealers. This process can require significant time, and incur significant costs. Small businesses may need outside professional help if they are to

meet capital requirements, but the costs associated with SEC registration can outstrip the finder's own profits. Thus, many finders avoid operating in this space—or simply risk the consequences of ignoring registration.

The SEC provides inadequate guidance in this area, despite a long history of commentators raising the problem. In a largely unsuccessful proposal (that has since been ignored) the SEC belatedly addressed the issue of finder registration in 2020. Even if a clear definition of finder is ultimately codified,[1] federal rules will likely remain unclear. Finders can only discern their regulatory obligations by navigating a ream of cases and inconsistent no-action letters.[2] At its heart, the problem is that many participants in the industry do not understand how overbroad registration requirements can be, or the severity of the consequences when these provisions are breached.

We believe California, a long-time leader in venture capital investment, has implemented a more rational regime at the state level than the SEC's. The California regime makes a clear distinction between finder and broker-dealer activities, and it provides an intrastate broker-dealer registration exemption for operators acting exclusively as finders according to state rules. In this article, we aim to set forth both the current federal rules and the current California rules, and argue that federal lawmakers should use California as a model for enacting a clearer and fairer regulatory framework for finders and broker-dealers alike.

I.
How Does it Work?

A. *Small Business and the U.S. Economy*

It is almost trite to say that funding and growing small businesses is critical to the U.S. economy. But this is more than just a political talking point. Many people are unaware of just how critical this vast and diverse sector is to the nation's economic life. A few statistics might help.

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1. *See* Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders, Exchange Act Release No. 34-90112 (Oct. 7, 2020).

2. This confusion is often exacerbated by the lack of detailed reasoning provided in many of these letters.

Small businesses:[3]

- represent 99.7% of all employer firms, and employ approximately 50% of all private sector employees (roughly 120 million employees);
- pay more than 45% of US payrolls;
- comprise 97% of all exporters (as at 2008);[4] and
- comprise 99.9% of all businesses in the U.S., with 39% of them owned by women.[5]

When it comes to the financing and growth of small businesses:

- Angel investors provide 90% of outside equity raised by start-ups and are usually their only source of seed funding;[6]
- 75% to 80% are self-financed through savings and personal loans, or borrowings from family and friends;[7] and
- 50% fail within five years, with the most common reason being a lack of capital.[8]

Because small businesses are clearly the engine room of the U.S. economy, finders play a vital role in keeping us moving ahead at full steam.

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3. Small businesses are businesses with less than 500 employees.

4. Jeffery D. Chadwick, *Finders Sleepers: Why Recent State Regulation of Financial Intermediaries Should Rouse the Federal Government From its Slumber* 12 RICH. J.L. & PUB. INT. 57, 75 (2008), https://scholarship.richmond.edu/jolpi/vol12/iss1/6.

5. *Small Business Statistics*, U.S. CHAMBER OF COM., https://www.chamberofcommerce.org/small-business-statistics (last visited Aug. 15, 2020).

6. In 2013, angels invested $25 billion in 71,000 companies. GREGORY C. YADLEY, NOTABLE BY THEIR ABSENCE: FINDERS AND OTHER FINANCIAL INTERMEDIARIES IN SMALL BUSINESS CAPITAL FORMATION 1 (June 3, 2015), https://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf.

7. *See Small Business Statistics*, *supra* note 5.

8. G. Dautovic, *Examining What Percentage of Small Businesses Fail*, FORTUNLY (Feb. 4, 2022), https://fortunly.com/articles/what-percentage-of-small-businesses-fail/#gref.

II.
FINDER OR BROKER-DEALER? HOW DOES IT WORK?

A. *Federal Legislation*

Section 15(a)(1) of the *Securities Exchange Act 1934* ("Exchange Act") provides:

> It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of any security (other than an exempted security or commercial paper, bankers acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.[9]

The term "broker" is defined in Section 3B(4)(A) of the Exchange Act:

> The term "broker" means any person[10] engaged in the business of effecting transactions in securities for the account of others.

Exceptions from the broker definition[11] are detailed in Section 3B(4)(B) for certain banking activities.[12] The term "dealer" is defined in Section 3(5)A as:

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9. 15 U.S.C. § 78o. *See* Couldock & Bohan, Inc. v. Societe Generale SEC Corp., 93 F.2d 220, 230 (2000) (discussing the registration requirements and the interplay of Federal and State requirements).

10. The term "*person*" is defined in Section 3(9) as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." Securities Exchange Act of 1934 § 3(9), 15 U.S.C. § 78c.

11. A territorial approach is adopted (both for broker-dealers and customers located in the United States) in respect of foreign broker dealers under Rule 15a-6. *See* SEC. EXCH. COMM'N, GUIDE TO BROKER-DEALER REGISTRATION (Apr. 2008), https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html [hereinafter "GUIDE TO BROKER-DEALER REGISTRATION"].

12. Securities Exchange Act §3(6). The term "*bank*" is defined in Section 3(6) of the Exchange Act.

> The term "dealer" means any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person's own account through a broker or otherwise.[13]

Exceptions to the dealer definition include persons trading certain securities on their own account, and certain banking activities.

The term "security" is defined broadly in Section 3(10) to include notes, debentures, stock and treasury stock, derivative securities and investment contracts.[14] Some of the other terms used in the broker and dealer definitions are not defined at all. For example, the term "engaged in the business" is used extensively throughout the legislation, but is not defined in either the Exchange Act or in the rules promulgated under the Act. The term "effecting transactions" raises a similar issue. Courts have criticized this weakness on several occasions, yet there has been no concerted effort to address vague language in the legislation.[15]

In *SEC v. Kenton Capital, Ltd.*,[16] the U.S. District Court for the District of Columbia considered the meaning of "engaged in the business" in the context of the broker registration provisions. Several factors were examined:

> 'Engaged in the business' is not defined by statute. Cases and SEC No-Action letters interpreting the phrase have indicated that regularity of participation is the primary indicia of being "engaged in the business" . . . Regularity of participation has been demonstrated by such factors as the dollar amount of the securities sold. . . and the extent to which advertisement and investor solicitation were used. . . A corpo-

13. Securities Exchange Act §3(5)(B)–(C).

14. The courts have interpreted the meaning of "*security*" broadly. Determining whether a particular arrangement meets the definition of can be a complicated process in itself and is beyond the scope of this paper. *See generally* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

15. This is evidenced by the need to resort to indicia outlined in the cases. *See* SEC v. Kramer, 778 F. Supp. 2d 1320, 1337 (M.D. Fla. 2011).

16. SEC v. Kenton Cap. Ltd., 69 F. Supp. 2d 1, 12–13 (D.D.C. 1998).

ration could be a broker even though securities transactions are only a small part of its business activity.[17]

In particular, the court found that a single isolated case of advertising may not be enough to require registration, while active or substantial solicitation is a strong indication of business engagement.[18] It is important to note that statutes are largely agnostic as to the scale of broker-dealer activity. It need only be a business; the fact that the activity amounts to just a small part of that business would be irrelevant to the registration requirement.[19]

The "*engaged in the business*" test remains a live issue. The SEC continues to use it in complaints against those it deems broker-dealers[20] attempting to skirt registration. It is worth noting that while the SEC does not require associated persons of broker-dealers (e.g., employees or independent contractors working within a broker-dealer business) to be separately registered, the agency requires their supervision by a person who is registered.[21] In regards to registration, litigants argue that the SEC interprets its powers broadly, drafts its rules vaguely, and overreaches.[22]

B. *Finders*

There is currently no federal legislative definition of a capital "finder,"[23] and no clear distinction between a finder

17. *Id.*

18. The Court left open the possibility that a single transaction could amount to 'engaged in the business' if it ". . . comprised a first step in a larger enterprise." *Id.* at 13.

19. *See* Securities Exchange Act §3(5)(A).

20. *See* Complaint at 9, SEC v. Keener, 2020 WL 1434134 (S.D. Fla. Mar. 24, 2020), https://www.sec.gov/litigation/complaints/2020/comp24779.pdf.

21. There are a number of regulations dealing with associates that should be considered. GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11.

22. *See* Complaint at 2, Platform Real Est. Inc. v. SEC, No. 19-CV-2575 (S.D.N.Y 2020) (where the complainant took the view that the SEC had misunderstood the registration requirements in Section 15(a) of the Exchange Act, and that registration of finders was not required where no use was to be made of securities exchanges or over the counter trading). A subsequent attempt to relitigate was dismissed by the NY District Court. *See id.*

23. *See* Release No. 34-90112, *supra* note 1, at 22–23 (aims to remedy the lack of definition of the word finder).

and a broker-dealer. Any person or organization deemed a broker-dealer by the SEC must be registered, regardless of whether they consider themselves a finder or not. Failure to register carries significant consequences (discussed below).[24] Thus (a) the onus is on the finder to determine whether their activities require registration with the SEC; and (b) this self-identification must be made in the absence of clear guidance.

A more consistent approach towards "success-based compensation" has emerged from recent court decisions regarding SEC no-action letters. But courts often consider these letters just one element among many in deciding whether a finder is obligated to register with the Financial Industry Regulatory Authority ("FINRA"). Finders are bedevilled by the fact that many older no-action letters appear to conflict, and contain little explanation of the reasoning which led courts to conclude registration was not necessary. Finders are not always aware that no-action letters are nonbinding and can be withdrawn.[25] It is risky for a finder to do business under the assumption that a court will not change its stance. In fact, courts have done so without being encumbered with precedent and without clear explanation.

As recently as April 2020,[26] state regulators, such as New York's, have attempted to clarify the definition of "finder" within their own purview. But intrastate finder provisions can create more problems than they solve; critics have noted significant conflict between rules from one state to another. However well-intentioned, these finder provisions can create yet another roadblock for small businesses desperate for invest-

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24. *See* In the Matter of Ranieri Partners, LLC, Exchange Act Release No. 69091 (Mar. 8, 2013).

25. *See e.g.*, Dominion Res., Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000) [hereinafter "Dominion Res., SEC No-Action Letter"]. The less than satisfactory reasons given in that letter included "technological advances, including the advent of the internet, as well as other developments in the securities markets[.]" *Id.* This leaves open the possibility that further technological advances could result in the revocation of other no-action letters.

26. Press Release, Letitia James, N.Y. Att'y Gen., Attorney General James Moves to Modernize and Streamline Securities Filings in NYS (Apr. 6, 2020), https://ag.ny.gov/press-release/2020/attorney-general-james-moves-modernize-and-streamline-securities-filings-nys.

ment capital. Many are ill equipped to navigate the complexity of rules in interstate commerce.[27]

C. *Exceptions to Registration Requirements*

There are a few scenarios where broker-dealer registration is not required at the federal level. This article discusses some of the more common of these situations.[28] But we cannot overstress the fundamental problem: while the SEC demands strict adherence to its rules in order to avoid federal penalties, those rules are often vague, ill-constructed, or—as in the case of no-action letters—persuasive but not precedential. We strongly recommend that finders engage an attorney who is competent in the area rather than merely assume they fall within the parameters of any exception.

1. *Intrastate Broker-dealers*

Intrastate broker-dealers can claim a narrow exemption to the registration requirement. A person who (a) conducts all of their business in one state and (b) does not use a national securities exchange does not have to register with the SEC.[29] But this exemption leaves finders with the burden of ascertaining where all of their customers are "located" according to the guidelines of the Exchange Act. This will often require significant and costly inquiry on the part of the finder and a significant duty of disclaimer to their clients.

Rules 147 and 147A of the Securities Act of 1933 ("Securities Act") provide additional guidance on the requirements of this exemption.[30]

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27. *See* Matthew W. Bower, *Using "Finders" to Find Capital: Avoiding Problems for Your Company*, VARNUM LAW INSIGHTS (July 28, 2021), https://www.varnumlaw.com/newsroom-publications-using-finders-to-find-capital-avoiding-problems-for-your-company; *see also* Pransky v. Falcon Grp., Inc., 874 N.W.2d 367, 384 (Mich. Ct. App. 2015) (where the Michigan Court of Appeals held that finders (as defined under the Michigan Uniform Securities Act) were not required to register in Michigan as a broker-dealer, agent or investment advisor).

28. Others not included here include funding portals for crowdfunding arrangements and merger and acquisition brokers involved in selling whole businesses.

29. Note that the position taken by the SEC will not have an impact on the relevant State legislation that may require registration.

30. Exemptions to Facilitate Intrastate and Regional Securities Offering, Securities Act Release No. 33-10238; Exchange Act No. 34-79161, 81 Fed.

2. *"Associated Persons" of Brokers*

"Associated persons"[31] of broker-dealers do not have to register, provided they are properly supervised by a registered person. Typically, employees and independent contractors are considered associated persons.[32]

3. *Business Limited to Exempted Securities*

The term "exempted security" is defined in Section 3(12)(A) of the Exchange Act by reference to specific classes of securities. Government and municipal securities typically fall into this category. Exempted securities are not subject to the same regulations. The mere fact that a security is exempt from registration under the Exchange Act does not imply that the security automatically falls within the meaning of the exemption.[33] For example, a person selling securities under Regulation D offerings must still be registered as a broker-dealer.

A broker-dealer that deals only in commercial paper, banker's acceptances or commercial bills does not need to register under the Exchange Act. However, broker-dealers involved with some classes of exempted securities, while not required to register as broker-dealers, may still be required to register under other provisions of the Exchange Act.[34]

4. *Issuers Exemption*

Issuers selling their own securities on their own account are generally not considered brokers or dealers, and thus are not required to register with the SEC. But issuers must still take precautions regarding associated persons involved in the sale of securities on the issuer's behalf, commonly the issuer's employees. Associated persons should not receive commissions on the sale, and may only engage in certain delineated activities.[35]

Reg. 83494, 83495, 83494 (Nov. 21, 2016), https://www.sec.gov/rules/final/2016/33-10238.pdf.

31. *See* Securities Exchange Act §3(18) (defined broadly to include partners, directors, employees and any persons controlled (directly or indirectly) by a broker-dealer).

32. *See* In re William V. Giordano, Exchange Act Release No. 36742 (Jan. 19, 1996), https://www.sec.gov/litigation/admin/1996/34-36742.pdf.

33. *See* GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11.

34. *See, e.g.*, Securities Exchange Act § 15.

35. 17 C.F.R. § 240.15a-6.

5. *Foreign Broker-dealers*[36]

As a general rule, all broker-dealers located in the United States that are involved in broker-dealer activities—even if those activities are directed only at foreign investors—must register with the SEC. Broker-dealers located offshore must also register if they aim any of their activities at persons within the United States.[37] The Exchange Act contains a specific provision addressing certain foreign broker-dealers that limit their activities in accordance with Exchange Act Rule 15a-6, such as effecting unsolicited transactions, certain dealings with major U.S. institutional investors or foreign residents temporarily in the United States, among others.[38]

III.
WHY IS IT AN ISSUE?

It is common knowledge that small businesses struggle to attract capital, most of all during their early phases of growth. The launch phase of a small business is when the highest need for capital dovetails with the lowest level of competence when it comes to capital raising, and most start-ups fail. Thus, many start-ups engage finders as much for *what* they know as for *who* they know: their relationship with investors willing to consider small, early-stage ventures. This is an important attribute; they must network to survive. The American Bar Association ("ABA") has emphasized that finders play a critical role for the American economy. Without their involvement, an even greater percentage of small businesses would never be successful in raising enough capital to stay in business.[39]

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36. *Id.*

37. *See* GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11.

38. *Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers,* U.S. SEC. AND EXCH. COMM'N (Mar. 21, 2013), https://www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm (commentary on the administration of Exchange Act Rule 15a-6).

39. "Early stage" refers to raising amounts of less than $5 million. These small deals are less attractive to venture capital funds, or licensed members of NASD, as the returns are too limited to justify the risk. *See* Task Force on Private Placement Broker-Deals, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-dealers*, 60 BUS. LAW. 959 (June 20, 2005), https://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf [hereinafter "A.B.A. Report"].

The U.S. Small Business Administration reported that an astonishing 25% of start-ups have no capital whatsoever. An additional 20% have insufficient capital, which is commonly reported as the main roadblock to their growth and success.[40] Statistics for start-up capital sources reveal that 64% of start-ups used personal or family savings as capital; only 18% succeeded in obtaining financing from banks or other lending institutions.

The federal government has, until recently, refused to even consider legitimizing the burgeoning role of unregistered financial intermediaries in the capital-raising process,[41] despite repeated pleas from the small-business community.[42] The ABA has stated that there is a major disconnect between the various laws and regulations applicable to brokerage activities and the common practices employed in the vast majority of early-stage business capital raising.[43] Businesses want the cheapest, most efficient means of raising capital, while the Exchange Act aims to provide security for investors. This sets up an inevitable clash between theory and practice. The SEC's legislative aim was set forth in *SEC v. Kramer*, where the court stated that:

> The Exchange Act is intended 'to protect investors. . . through regulation of transactions upon securities exchanges and in over-the-counter markets' against manipulation of share process. . . The broker-dealer registration requirement is of the utmost importance in effecting the purpose of the [Exchange] Act 'because registration facilitates both discipline 'over those who may engage in the securities business' and oversight 'by which necessary standards may be estab-

40. Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 33-10649, Exchange Act Release No. 34-86129, Investment Company Act Release No. 33512, 84 Fed. Reg. 30,460 (June 18, 2019), https://www.sec.gov/rules/concept/2019/33-10649.pdf.

41. *See* Release No. 34-90112, *supra* note 1.

42. In 2015, Yadley noted that private placement broker proposals were decades old. 6 years later, at the time of this writing, Yadley's arguments carry even greater weight. YADLEY, *supra* note 6, at 3.

43. *See Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers*, *supra* note 38, at 1.

> lished with respect to training, experience and records'.[44]

Thus, the SEC scrutinizes activities that resemble operating a securities business, only mindful of investor interests. The difficulty for finders lies in the fact that their activities often occupy a grey area between formally managing investor money, like a brokerage would, and mere networking. Agency rules are blind to common reality. Most businesses are small, most businesses are beneath the notice of ordinary venture capital, and most businesses are looking for modest investments from their local communities—not the high-net-worth individual on a superyacht.

IV.
The SEC's Approach – When Is Registration Required?

Reaching a consensus on the generally agreed definition of "finder" is challenging. It has been defined in academic literature 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"[45] and by the New York Court of Appeals as:

> . . . a finder is not a broker, although they perform some related functions. Distinguishing between a broker and finder involves an evaluation of the quality and quantity of services rendered. The finder is required to introduce and bring the parties together without any obligation or power to negotiate the transaction in order to earn the finder's fee.[46]

Determining whether a particular participant in the financial markets is a true "finder" who does not need to be registered—rather than a broker who does—is often a question of degree. Merely labelling oneself "finder" is not enough.[47] A

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44. *See* Kramer, 778 F. Supp. 2d at 1337.

45. *See* Guide to Broker-Dealer Registration, *supra* note 11.

46. Ne. Gen. Corp. v. Wellington Advert., Inc., 82 N.Y.2d 158, 162–63 (N.Y. 1993).

47. *See* Ernest E. Badway, *NY State Attorney General Targets Finders and Business Brokers in Pandemic Rule-Making*, Fox Rothschild LLP (July 16, 2020), https://www.foxrothschild.com/publications/ny-state-attorney-general-targets-finders-and-business-brokers-in-pandemic-rule-making.

prosecutor at the SEC or the U.S. Department of Justice would readily prosecute an individual who receives commission-based compensation in the twenty to thirty percentage range for bringing an investor to a company, if that individual is not registered, or if the commission was not disclosed to the potential investor. The evolving attitude of the SEC in this area may be discerned from the multitude of no-action letters the SEC has published. Although no-action letters are not legal precedent, they do carry some weight. In a footnote in the 2008 decision *Torsiello Capital Partners LLC v. Sunshine State Holding Corporation,* Judge Herman Cahn stated:

> Securities and Exchange Commission no-action letters are prepared by SEC staff counsel; they are purely advisory and do not constitute binding precedent. . . However, they may be found "persuasive" in the interpretation of the federal securities laws and regulations. . .[48]

While each matter is considered on its particular facts,[49] the SEC consistently focuses on several factors in determining whether a person is an unregistered broker-dealer rather than a true "finder."[50] These include:

A. Receipt of transaction-based compensation;
B. Involvement in the securities transaction;
C. Solicitation of investors; and
D. Evidence of prior securities business activities.

The SEC appears to repeatedly take the stance that triggering any of these four elements can be sufficient to require registration.

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48. Torsiello Cap. Partners LLC v. Sunshine State Holding Corp., 2008 N.Y. Misc. LEXIS 2879 (N.Y. Sup. Ct. 2008).

49. New York Supreme Ct. Justice Herman Cahn noted,

> In determining whether SEC registration is required, the courts look to a variety of factors, including: the receipt of transaction-based compensation as opposed to a flat fee; the rendering of advice about the structure, price or desirability of a securities transaction; the finding of investors actively rather than passively; advertisement or solicitation on behalf of the issuer of the securities; becoming involved in negotiations between an issuer and investors; engaging in the foregoing with regularity; being an employee of the issuer, and possessing client funds and securities.

See id. at 12–13.

50. *See* Release No. 34-90112, *supra* note 1.

A. *Receipt of Transaction-Based Compensation*

The single most important factor to the SEC in making the finder/broker-dealer distinction appears to be whether there was any consideration in the nature of a commission, a success-based fee, or any fee relatable to the number of introductions made on their client's behalf. This element comes up frequently in SEC no-action letters.[51] The SEC outlined the importance of this element in *Partial Denial of No-action Request of 1st Global, Inc* (May 7, 2001):

> Receipt of transaction-based compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer. . . Persons who receive transaction-based compensation generally have to register as Broker-dealers under the Exchange Act because, among other reasons, registration helps ensure that persons with a "salesman's stake" in a securities transaction operate in a manner consistent with customer protection standards. . .[52]

The fact that the commission's recipient is a member of an internal corporate sales team does not obviate the registration requirement.[53]

It is important to note that the SEC extends its prohibition against receiving transaction-based compensation to any sharing of such commission with an unregistered person, even if the commission was paid to a registered broker-dealer. This can severely complicate ordinary business arrangements with professional advisors such as CPAs.[54] But compensation related to assets under management are unlikely to require registration; thus, the cost and burden falls to the finder to care-

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51. *See, e.g.*, FundersClub, Inc. and FundersClub Mgmt. LLC., SEC Staff No-Action Letter, 2013 SEC No-Act. LEXIS 271 (Mar. 26, 2013), https://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf.

52. Partial Denial of No-Action Request of 1st Global Inc., SEC Staff No-Action Letter (May 7, 2001), https://www.sec.gov/divisions/marketreg/mr-noaction/2001/1st-global-050701-15a.pdf [hereinafter "1st Global Inc., SEC No-Action Letter"].

53. *See* SEC v. Hansen, 1984 WL 2413, at *10 (S.D.N.Y Apr. 6, 1984) (receipt of commission, rather than salary, was noted as an indication of broker activity).

54. 1st Global Inc., SEC No-Action Letter, *supra* note 52.

fully consider the circumstances of each separate arrangement.[55]

While there are instances in which transaction-based compensation alone was insufficient to require registration, those instances appear to be exceptions to the rule and not something the SEC is likely to accept at the present time.[56]

B. *Involvement in the Securities Transaction*

Commentary and attempted definitions of finders, while varying in many respects, generally agree that a finder's role is limited to facilitating introductions. Finders do not have a stake in the transaction. Evidence of greater involvement in the transaction is likely to be seen by the SEC as an indication that the purported finder is actually an unregistered broker or dealer. Such activities can include:

- Providing documentation,[57] advice and information;[58]
- Assisting in negotiating a deal;
- Advising on the merits of a proposal;[59]
- Recommending or designing financing methods or recommending an investment;[60]

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55. *See* Dana Inv. Advisors, Inc., SEC Staff No-Action Letter, 1994 WL 718968 (Oct. 12, 1994).

56. *See* Paul Anka, SEC Staff No-Action Letter, 1991 WL 176891 (July 24, 1991). In addition to the Paul Anka letter there are instances of the courts viewing transaction-based compensation by itself as insufficient to require registration under Section 15(a). *See* Kramer, 778 F. Supp. 2d at 1339. However, the SEC does not appear to share this position. *See, e.g.*, Brumberg, Mackey & Wall, P.L.C., SEC Staff No-Action Letter, 2010 WL 1976174 (May 17, 2010) (stating receipt of transaction based compensation was sufficient grounds to require registration). In the event Release No. 34-90112, *supra* note 1, is adopted, this position will change for some finders.

57. For an relevant arrangement with pro-forma documentation where a No-Action Letter was granted, see AngelList LLC, SEC Staff No-Action Letter, 2013 WL 1279194 (Mar. 28, 2013).

58. In the Matter of William M. Stephens, Exchange Act Release No. 30417 (Mar. 8, 2013).

59. May-Pac Mgmt. Co., SEC Staff No-Action Letter, 1973 WL 10806 (Dec. 20, 1973); Chadwick, *supra* note 4.

60. Cornhusker Energy Lexington, LLC. v. Prospect St. Ventures, 2006 WL 2620985, at 6 (D. Neb. Sept. 12, 2006).

- Participating in a selling group, underwriting, carrying an inventory or having a regular clientele of customers.[61]

Ordinary tax, legal and business consulting will not usually require registration, provided there is no transaction-based compensation.[62] The usual fixed fee or time-based charging methods are less likely to attract SEC scrutiny. More entrepreneurial arrangements (e.g., a consultant sets up an entire telemarketing program to solicit investors) come with great risk for both the finder and the company. Finders working under a variable-fee, equity, or percentage-based arrangement should seriously consider obtaining a no-action letter, and there are instances in which courts decided that finder involvement was insufficient to require registration.[63] Insofar as a consistent scheme can be inferred from no-action letters, the SEC appears to consider it a qualitative question to be determined case-by-case using the factors discussed above. Staking one's enterprise on the hope of getting similar treatment by the SEC—as divined from past no-action letters—is to risk an adverse finding in the individual case, together with the consequences.

C. *Solicitation of Investors*

The SEC is likely to frown on any activity that involves soliciting third parties, especially if it involves emailed or written material.

In *SEC v. Kramer*, the United States District Court for the Middle District of Florida considered the defendant's degree of solicitation in determining whether the defendant was operating as an unregistered broker. The court concluded that re-

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61. Dana G. Fleischman et al., *'Finders' and the 'Issuers Exemption': The SEC Sheds New Light on an Old Subject*, LATHAM & WATKINS LLP (Apr. 24, 2013), https://web.archive.org/web/20150829084216/http://www.lw.com/thoughtLeadership/sec-finders-issuers-exemption.

62. A.B.A. Report, *supra* note 39, at 980. The references in the report, while favourable to the applicant, date from the 1970's and early 1980s. Given the age of these letters specific advice should be sought if there is any uncertainty.

63. *See* Kramer, 778 F. Supp. 2d at 1340. In *Maiden Lane Partners v. Perseus Realty Partners*, the court was unable to determine whether the involvement of the "finder" in that instance was sufficient to qualify them as a broker, and thus require registration. 2011 WL 2342734 (Mass. Super. Ct. May 31, 2011).

gistration was not required in that instance, noting that the "solicitation" was limited to discussing an investment with close friends and family, and directing them to a website. However, the court did outline a number of elements that, had they been evidenced, might have led to a different result:

- Participation in the purchase or sale of securities;
- Providing advice or other information about the investment;
- Advertising or distributing promotional material for the investment;
- Sponsoring a seminar or social event at which he promoted the investment;
- Hiring employees to contact potential investors regarding the investment;
- Calling potential investors (other than family or close friends); or
- Encouraging a broker to sell the investment.[64]

The elements above suggest an active form of solicitation. If any of these elements are present, a finder is likely to have a problem.

D. *Evidence of Prior Securities Business Activity*

Any evidence that the finder has previously been involved in the securities industry as a broker is closely reviewed by the SEC under the supposition that it could be evidence of a *de facto* securities business. In such cases, the SEC's aim is to weed out unregistered brokers who might be "flying under the radar"[65] and to prevent past offenders from gaining backdoor access to the industry, thereby putting investors at risk.[66]

1. *Risk to Finders*

A principal issue for many unregistered brokers is that they have preconceived ideas of what broker-dealers are, and they do not consider themselves as falling within this category. Many do not grasp the breadth of activity that could trigger a

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64. *See* Kramer, 778 F. Supp. 2d at 1340.

65. YADLEY, *supra* note 6, at 2–3 ("[I]t is the position of the SEC . . . 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 required to be registered as . . . a broker-dealer.").

66. A.B.A. Report, *supra* note 39, at 980.

registration requirement. Examples of individuals who could unwittingly breach the requirement include transaction lawyers, insurance agents, real estate brokers, private fund advisors, investment bankers, business consultants, investor networks and CPAs.[67] Even some crypto assets can be deemed "securities" depending on their structure, and crypto promoters may be surprised to learn they must register as broker-dealers.[68]

Thus, it is critical for promoters, large and small, to obtain legal advice before they consider raising capital for another business. Failure to comply with registration requirements can trigger severe consequences. Noncompliance can cripple an entity's ability to raise additional finance, and in some circumstances it can even lead to prison[69] time. Experienced attorneys can be vital in keeping operators and advisors informed of the SEC's current position insofar as that position can be discerned from recent no-action letters. The fact that an activity was deemed to fall outside the broker-dealer rubric in the past does not imply that the same activity will escape SEC regulation in the future; thus, an experienced attorney can give clients a cleareyed risk assessment.[70]

2. *Why Not Just Register?*

Businesses who hire finders to raise capital must evaluate whether their relationship with the consultant finder complies

67. *Id.* at 11.

68. A detailed analysis of the registration requirements relating to crypto-assets is beyond the scope of this article, however the treatment of digital assets has been considered on numerous occasions by the SEC, and a number of no-action letters have been issued. *See, e.g.*, TurnKey Jet, Inc., SEC Staff No-Action Letter (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.; Pocketful of Quarters, Inc., SEC Staff No-Action Letter (July 25, 2019), https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1 (showing how treatment of digital assets has been considered on numerous occasions by the SEC); SEC, *Framework for 'Investment Contract' Analysis of Digital Assets*, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets (last modified Apr. 3, 2019) (providing a good analysis by the SEC Strategic Hub for Innovation and Financial Technology of the core issues involved with the treatment of digital assets).

69. *See* Securities Exchange Act, § 32(a).

70. Dominion Res., SEC No-Action Letter, *supra* note 25 (showing how if it is not unknown for the SEC to withdraw no-action letters).

with SEC rules in each separate case. The difficulty is often compounded when consultants also carry on a broader financial advisory practice, dealing with registered broker-dealers or otherwise assisting in deal structuring and receiving success fees. For agents, the question is often, "Why not just register anyway?" and similarly for small businesses, "Why not just use a registered broker-dealer?"

In answer, finders often complain of an onerous and expensive broker-dealer registration process. A 2015 presentation[71] by Gregory Yadley, a member of the SEC Advisory Committee on Small and Emerging Businesses, outlined some of finders' most common issues. Initial costs related to a finder's legal, accounting, and compliance needs alone often exceed $150,000, with ongoing annual costs of around $100,000. Yadley suggested that an exemption or a separate registration process could be adopted specifically for finders. Yadley noted the exceptional burden for small operators, especially when added to the usual costs of establishing a business: staff, insurance, rent, office equipment and so on.

Finders also face a major disincentive with respect to the monumental compliance obligations that attach post-registration.[72] These include complying with antifraud provisions to prevent misstatements or misleading omissions, complying with the duty of fair dealing, ensuring that "suitability" requirements are met (that is, only recommending specific investments or overall investment strategies that are suitable for their customers), ensuring compliance with the duty of best execution (seeking the most favourable terms available under the circumstances), providing customer confirmation details at or before the time of completing a transaction, disclosing credit terms where relevant, maintaining liquidity levels (generally $250,000 or 2% of aggregate debit items for those carrying customer accounts), complying with restrictions on short sales and other trading requirements. Overall, these duties impose a significant burden upon operators whose business relies upon transaction-based compensation.[73]

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71. YADLEY, *supra* note 6.

72. GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11, §§ 7–8.

73. Complaint at 20, Platform Real Estate Inc. v. SEC, 2020 U.S. Dist. LEXIS 137844 (S.D.N.Y 2020) (No. 19 Civ. 2575) (demonstrating the overwhelming nature of the requirements for a small business)

Most small businesses seeking investors are looking for investments of less than $5 million,[74] but the more established brokerage firms often set floors of $25 million.[75] This is because, in most respects, the time, risks, and transaction costs to brokers are similar between smaller and larger deals. Further, an ongoing trend toward broker conglomeration means that many broker dealers who might have once worked with smaller deals have since merged with larger operators. This results in a funding gap for smaller businesses which are denied access to traditional markets so they are funnelled into non-traditional streams.

3. *The 2020 SEC Proposal on Finders*

On October 7 2020, the SEC finally proposed a change that would effectively allow for a limited federal exemption for finders, provided that individuals who seek the exemption meet a strict subset of conditions.[76] The proposed change[77] would create two classes of finders—Tier I and Tier II—and would finally codify "no-action" relief for finders that fall into one of these two categories.[78] This remains a mere proposal; and, given the extensive qualifications required for the exemption, the impact of the proposal in its current form is question-

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> Registering with the SEC as a broker places a heavy burden on small businesses. Initially registration with the SEC requires filing an application form BD together with a statement of financial condition. Once registered, a broker-dealer is required to have audited financial statements, engage compliance personnel and sophisticated counsel, comply with specific record keeping provisions, anti-money laundering statutes, suspicious transaction reporting, and undergo burdensome compliance examinations by various regulators. Broker-dealers are subject to rigorous net worth and capital requirements or make large security deposits with clearing firms.

Id.

74. Laura Anthony, *The Payment of Finders' Fees – An Ongoing Discussion*, SECURITIES LAW BLOG (July 5, 2017), http://securities-law-blog.com/2017/07/05/the-payment-of-finders-fees-an-ongoing-discussion.

75. Chadwick, *supra* note 4, at 60.

76. SEC Release No. 34-90112, *supra* note 1.

77. Securities Exchange Act §§ 15(a)(2), 36(a)(1) (referring to the specific sections upon which the changes rely).

78. *Finders Proposed Exemptive Order: Overview Chart of Tier I Finders, Tier II Finders and Registered Brokers*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/files/overview-chart-of-finders.pdf.

able. Most notably, relief is only available to finders that are natural persons and investors that are "accredited investors."[79]

For the proposed exemption to apply, finders in either tier would have to meet the following prerequisite conditions:

- **Private issuers**: the issuer must be an entity that is not required to file reports under Section 13 or Section 15(d) of the Exchange Act (any issuer with publicly traded securities does not fall within the exemption);
- **Registration exemptions**: the issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act;[80]
- **Solicitation**: the finder does not engage in general solicitation;
- **Accredited Investors**: the potential investor must be an "accredited investor";[81]
- **Documentation**: the finder must provide services pursuant to a written agreement with the issuer. The agreement must include a description of the services provided and of all compensation;
- **Association**: the finder cannot be an "associated person" of a broker-dealer;[82] and

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79. SEC Release No. 34-90112, *supra* note 1, at 19–20; *See* Accredited Investor Definition, Securities Act Release No. 34-89669, (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10824.pdf (expanding the definition of 'accredited investor').

80. *See* SEC Release No. 34-90112, *supra* note 1, at 18.

> An issuer's failure to comply with the conditions of an exemption from registration under the Securities Act for an offering would not, in itself, affect the ability of a Finder to rely on the proposed exemptive order provided the Finder can establish that he or she did not know and, in the exercise of reasonable care, could not have known, that the issuer had failed to comply with the conditions of an exemption.

Id.

81. The finder's "reasonable belief" that an investor satisfies the "accredited investor" requirements will be sufficient, however the "reasonableness" of such a belief will depend on the facts and circumstances of each offering and investor. *Id.* at 19.

82. Securities Exchange Act § 3(a)(18). The SEC explains that this requirement has been included to avoid investor confusion and the potential use of abusive sales tactics if associated persons were to be included. SEC Release No. 34-90112, *supra* note 1, at 22.

- **Disqualification**: the finder cannot be subject to a "statutory disqualification", within the meaning of Section 3(a)(39) of the Exchange Act.

The permitted activities of finders that satisfy the requirements outlined in Release 34-90112 will differ depending on whether they qualify as Tier I or Tier II finders. Both tiers would be permitted to receive transaction-based compensation without being required to register as a broker-dealer.[83]

Tier I finders would be limited to ". . .providing contact information of potential investors in connection with only a single capital raising transaction by a single issuer in a 12-month period."[84] Finders falling into this category may only provide names, telephone numbers, e-mail addresses and social media information regarding potential investors to issuers. Tier I finders would not be permitted to have any further contact with potential investors regarding the issuer.

Tier II finders would be able to provide certain solicitation activities on behalf of issuers. Because Tier II finders would be subject to less restrictions than Tier I finders, it is expected that most finders would likely seek to qualify for the Tier II exemption. However, a number of key limitations would be imposed upon their activities. Tier II finders would only be able to: (1) identify, screen, and contact potential investors; (2) distribute issuer offering materials to investors; (3) discuss issuer information included in any offering materials, as long as the finder does not provide advice regarding the valuation or advisability of the investment; and (5) arrange or participate in meetings with the issuer and the investor.

Because Tier II finders would be able to engage in a broader range of activities, the Commission has proposed that these finders must also satisfy specific disclosure requirements. The finders must provide the following information:

- Their name and the name of the issuer;
- The relationship between the finder and the issuer;
- A statement that the finder is being compensated for his or her services and a description of the services;
- Any material conflicts of interest; and

83. SEC Release No. 34-90112, *supra* note 1, at 23, 27.
84. *Id.* at 22–23.

- A statement affirming that the finder is acting on behalf of the issuer and is not acting as an associated person of a broker-dealer.[85]

The Tier II finder would also need to obtain a dated written acknowledgement of receipt of the required disclosures from the investor.[86]

Both categories of finders would still be subject to the anti-fraud provisions of the securities laws. Also, as with other provisions of the Exchange Act, the proposal would not affect state registration requirements. Finders would still need to be conscious of applicable state laws.[87]

The new proposal received swift criticism, with only three out of the five then-serving Commissioners in support and the two dissenting Commissioners issuing public statements outlining their concerns[88] on the same day that Release No. 34-90112 was published. SEC Commissioner Caroline A. Crenshaw argued that the proposed exemption would allow finders to engage in activities that the SEC has traditionally classified as brokerage activities, and that it would water down the significant investor protections contained in the current regime. Commissioner Crenshaw described this as a "radical departure" from established requirements.[89] Under the proposal, for example, Tier II finders would be allowed to directly contact investors on behalf of issuers and even discuss offering materials with investors. These activities have typically been regarded as core broker activities. The only limitation that the proposal provides is that the finders cannot "provide advice as to the valuation or advisability of the investment." Critics argue

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85. *Id.* at 25–26.

86. *Id.* at 26–27.

87. Duane Wall et al., *Permitted Finder Activities: SEC Proposes Long-Awaited Exemption*, WHITE & CASE (Oct. 15, 2020), https://www.whitecase.com/publications/alert/permitted-finder-activities-sec-proposes-long-awaited-exemption (referring to a summary of the key elements of SEC Release No. 34-90112).

88. Allision Herren Lee, *Regulating in the Dark: What We Don't Know About Finders Can Hurt Us,* U.S. SEC. AND EXCH. COMM'N (Oct. 7, 2020), https://www.sec.gov/news/public-statement/lee-proposed-finders-exemption-2020-10-07; *see also* Caroline A. Crenshaw, *Statement on Proposed Exemptive Relief for Finders,* U.S. SEC. AND EXCH. COMM'N (Oct. 7, 2020), https://www.sec.gov/news/public-statement/crenshaw-finders-2020-10-07.

89. Crenshaw, *supra* note 88.

that finders would have virtually no limits regarding the amount of praise and hype they could give to promote an investment in respect to a start-up, provided they do not conclude their sales pitch with a recommendation to invest."[90]

Commentators outside the SEC voiced similar concerns. William F. Galvin, Secretary of the Commonwealth of Massachusetts, the top securities regulator in the state, wrote in a letter to the SEC arguing that the proposed exemption would enrich sellers seeking to skirt regulation and would lead to inevitable conflicts of interest if and when finders are tempted to cross the line between networking and promotional activities: "While some may argue that finders are different from broker-dealers or agents of brokerage firms based on claims that they are not in the business of effecting transactions in securities, both the nature of their activities and sound policy under the securities laws call for them to be registered."[91] The North American Securities Administrators Association, an industry group, summed up much of the investment community's concern: "This is another instance in which the Commission seeks to expand the private markets with no commensurate effort either to protect investors from the evident risks of fraud, or to understand how an exemption could be abused."[92]

Proponents of the proposal have argued that, because it would only allow finders to solicit accredited investors, the activities permitted would not pose a threat to the investors involved. However, opponents argue that, although accredited investors are presumed to require less protection than typical investors, recent studies have indicated that this is not the case and significant protection is still required.[93] The rationale for "stripping" the protections for accredited investors while re-

90. Lee, *supra* note 88.

91. William F. Galvin, Comment Letter on Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of the Securities Exchange Act (Nov. 12, 2020), https://www.sec.gov/comments/s7-13-20/s71320-8011759-225411.pdf.

92. Lisa Hopkins, Comment Letter on Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders (Nov. 12, 2020), https://www.nasaa.org/wp-content/uploads/2020/11/NASAA-Comment-Letter-on-SEC-Finders-Proposal-111220.pdf.

93. SEC Release No. 34-90112, *supra* note 1.

taining them for others runs contrary to the policy evident in recent SEC publications.

SEC's Acting Chair Allison Herren Lee voiced another concern which many share: while supporters of Release No. 34-90112 have argued the proposal would benefit businesses owned by women and minorities, Lee called these arguments speculative. "The release," Lee stated, "contains no empirical evidence supporting that supposition, and nothing in the proposed order is tailored to that purpose. It simply asserts that this change broadly applies to all businesses, large and small."[94] Commentators have noted that, given the sharp divergence of views by SEC commissioners on the current text of Release No. 34-90112 and the likelihood of significant comment from interested parties, the final form of any relief adopted by the SEC could be significantly different from that outlined in the current proposal.[95]

V.
What Are the Consequences of a Breach?

So, why does this even matter? Why should finders follow internal debate at SEC rather than seek profit with an ask-forgiveness-not-permission attitude?

This is a question many small players in the market face. Cash-strapped, mid-sized enterprises, advisors trying to expand their client base, investment firms with in-house sales teams, and other participants in the financial sector might wonder if the consequences of failing to register could outweigh the costs of compliance. The answer often comes as a shock to issuers and finders alike: failure to register could result in fines, disgorgement, bad actor disqualification,[96] rescission of investment arrangements and, as a corollary, potential bankruptcy. The fact that the issuer or finder may not even be aware that their conduct has violated a law or act is largely irrelevant.[97] The SEC requires issuers and finders to conduct "reasonable

94. Lee, *supra* note 88.

95. Duane Wall et al., *supra* note 87.

96. This becomes relevant when considering the availability of Regulation 506(d) relief. *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 78 Fed. Reg. 44730 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2014)).

97. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

inquiry" as to whether their activities trigger the registration requirement, and failure to do so can suffice for a finding of "wilfulness."[98]

Issuers can have a particularly tough time when it comes to deciding whether to use a registered broker or a cheaper unregistered operator to help them find capital. The fact that many unregistered finders operate openly, sometimes advertising their services, and that neither the SEC nor FINRA has the resources to police the finder industry, makes it nearly impossible for attorneys to convince small issuers that they should avoid such entities.[99] But, however spotty, SEC policing and enforcement is real. A review of enforcement cases by the ABA revealed that SEC enforcement of broker registration named both the issuer and the broker-dealer in suits, and often included multiple counts.[100] SEC compliance actions can be triggered by Form D disclosures of sales commissions and finder's fees,[101] tips from disgruntled investors or competitors, and routine examinations.[102]

A. *Consequences for Issuers*

The most common consequences for issuers using an unregistered broker-dealer are:

- Prosecution;
- Rescission of investment contracts;
- Disgorgement and fines; and
- "Bad actor" consequences.

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98. *Id.* at 414.

99. Laura Anthony, *Attorney Laura Anthony Explains the Payment of Finders' Fees*, THE HUFFINGTON POST, (July 27, 2020, 9:51 PM), https://www.huffpost.com/entry/attorney-laura-anthony-explains-the-payment-of-finders_b_596e350be4b05561da5a5aed.

100. *See* A.B.A. Report, *supra* note 39, at 997.

101. *Form D*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/about/forms/formd.pdf.

102. *See* Matt Kuhn & Arina Shulga, *Finders and Unregistered Broker-dealers: Understanding the Risks and Recent Developments*, STRAFFORD MEDIA (May 15, 2019, 1:00 PM), http://media.straffordpub.com/products/finders-and-unregistered- broker-dealers-understanding-the-risks-and-recent-developments-2019-05-15/presentation.pdf.

1. *Prosecution*

There are two principal areas of issuer prosecution in unregistered broker-dealer actions: (1) actions for fraud; and (2) actions for aiding and abetting a breach of the Exchange Act.

Actions for fraud generally arise in the context of failure to disclose commissions paid to unregistered broker-dealers. The SEC requires disclosure of all compensation paid in relation to a capital raising under Section 10(b) of the Exchange Act[103] and Rule 10b-5. Rule 10b-5 imposes liability for making a materially false or misleading statement, or omitting material facts, in connection with the purchase or sale of securities.[104]

In most cases, fraud claims will be brought not only against the issuing company but also against participating officers and directors of the issuer.[105] For example, in *SEC v. W.P.Carey & Co. LLC et al.*[106] both the former CFO and a former Chief Accounting Officer were named as parties to the proceedings.[107] It is also common for the SEC to prosecute issuers under Section 20(e) of the Exchange Act for aiding and abetting violations.[108] Commentators note that prosecuting the issuing company may be a more effective deterrent

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103. Rule 10b-5 is promulgated by the SEC pursuant to its rule making power under section 10(b) of the Exchange Act. Section 10(b) of the Exchange Act makes it unlawful:

> To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). This has long been interpreted as requiring full disclosure of finder compensation in relation to statements regarding securities. *See* SEC v. Great American Industries, Inc. 407 F.2d 453 (1968).

104. 17 C.F.R. § 240.10b-5.

105. Anthony, *supra* note 99.

106. Complaint at 1, SEC v. W.P. Carey & Co. LLC, No. 08-CV-2846 (S.D.N.Y. filed Mar. 18, 2008).

107. *Id.* at 6–7.

108. Section 20(e) of the Exchange Act reads in part "any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." Securities Exchange Act, *supra* note 10, at § 20(e).

than prosecuting an unlicensed person, who may be difficult to track down.[109]

2. *Rescission*

Section 29(b) of the Exchange Act provides, in part, that contracts made in violation of the substantive provisions of the Act:

> . . . shall be void[110]. . . as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract.

In effect, this means that investors can recover their funds if they were materially misled by a broker or finder.[111] This provision can extend to circumstances where the finder did not inform the investor that they were unlicensed since the legislative protections an investor may have assumed were available were not in fact available. Section 29(b) requires an action to be brought within one year from the discovery of the violation or within three years of the actual sale of the securities, whichever is later. Accordingly, for at least three years after using an unregistered broker-dealer, the issuer could have a contingent liability on their books.

The operation of Section 29(b) was considered by a U.S. District Court in *Celsion Corp. v. Stearns Management Corp.*[112] In that case, Celsion Corp. sought rescission of a series of common stock purchase warrants that it issued to the Stearns Mgt. Corp. and others without the assistance of a registered broker. Although the court applied the three-year time limit in deciding that rescission was not available, it did observe that rescission was a private cause of action and that, since the Exchange Act was intended to protect investors against the manipulation of stock prices, registration of broker-dealers was of utmost importance. *Celsion Corp. v. Stearns Management Corp* makes it

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109. Anthony, *supra* note 99.

110. This has been read as "voidable" at the option of the innocent party by the U.S. Supreme Court. *See* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 387–88 (1970).

111. Additionally, investors can recover their funds where an agreement cannot be performed without violating securities laws. *See* Berckeley Inv. Grp. Ltd v. Colkitt, 455 F.3d 195 (3d Cir. 2006).

112. Celsion Corp v. Stearns Mgmt., 157 F.Supp.2d 942 (N.D. Ill. 2001).

clear that but for the three-year technicality, rescission would have been available.

The 2012 bankruptcy of Neogenix Oncology, Inc. is an example of the possible consequences that follow when a party invokes its right of rescission. After a round of financing for the start-up company, the SEC requested information related to the payment of finder's fees to unregistered third parties. Management at Neogenix was unable to quantify the potential rescission liability. This liability could include not only investment amounts but also interest. Management could not complete preparation of the financial statements, which in turn could not be reviewed by the independent auditor. Because of the unsigned accounts, SEC investigation, and potential rescission liability, the company could not raise additional funds. Chapter 11 bankruptcy became necessary. Although subsequent arrangements allowed the business of Neogenix to be restructured into a clean entity, entities in similar situations may not be able to easily restructure themselves since Chapter 11 bankruptcy is a costly, time-consuming activity that can severely disrupt day-to-day operations.[113]

3. *Disgorgement and Fines*

The imposition of fines and court-ordered disgorgement can have a major impact both from a financial and reputational perspective: Who wants to invest in a business that plays fast and loose with the law?

The purpose of disgorgement is generally to return the perpetrator to the position in which they would have been had the breach not occurred. However, disgorgement can be treated as a penalty for certain legislative purposes.[114] The Supreme Court has acknowledged that disgorgement that does not exceed a wrongdoer's net profits can qualify as equitable relief.[115] Separate provisions in the Exchange Act allow appro-

113. Alexander J. Davie, *Neogenix Oncology: A Good Case Study on Securities Law (Non) Compliance by a High Growth Company: Part 1: How it all Happened*, STRICTLY BUSINESS LAW BLOG, (Oct. 5, 2012), https://www.strictlybusinesslawblog.com/2012/10/05/neogenix-oncology-a-good-case-study-on-securities-law-noncompliance-by-a-high-growth-company-part-1-how-it-all-happened/.

114. A.B.A. Report, *supra* note 39, at 998; *see also* Kokesh v. SEC, 137 S. Ct. 1635, 1645 (2017) (characterizing disgorgement as a penalty for statute of limitations purposes).

115. *See* Liu v. SEC, 140 S. Ct. 1936, 1937 (2020).

priate equitable relief from the imposition of penalties,[116] the specific powers of accounting, and disgorgement in administrative and cease-and-desist proceedings.[117]

The SEC generally pursues disgorgement in conjunction with other actions such as penalties. For example, the SEC proceeding *In the Matter of Edwin Shaw LLC*[118] involved the sale of limited liability company membership interests in a New York taxi and livery company to foreign investors as part of the EB-5 immigrant investor program. Under the arrangement, a principal of Edwin Shaw LLC, who was not registered as a broker-dealer, marketed the interests and received an administrative fee for each successful investment, which was funded out of the investments themselves. Shaw was censured, received a cease-and-desist order in respect of future violations of Section 15(a) of the Exchange Act, was ordered to disgorge $400,000, paid prejudgment interest of $54,209.20, and received a civil penalty of $90,535.

4. *"Bad Actor" Determination*

Regulation D offerings, especially through Rule 506,[119] are a major source of capital raisings for smaller operators due to the limited regulatory burdens when compared with other types of raisings.[120] The popularity of Rule 506(b) is borne out by the statistics. In 2018, the amount raised by Rule 506(b) offerings was $1.5 trillion, much larger than the $1.4 trillion raised through registered offerings.[121] In 2021, the SEC's office of the Advocate for Small Business Capital Formation reported that the amount raised by 506(b) offerings was a whop-

116. *See* Securities Exchange Act of 1934 at § 32[78ff](a) (providing for equitable relief, whereas the penalty regime carries up to 20 years imprisonment and fines of $5 million for natural persons and $25 million for corporations).

117. *See* Securities Exchange Act of 1934 at §§ 21B(e), 21C(e).

118. Edwin Shaw, LLC, Exchange Act Release No. 82805 (Mar. 5, 2018), https://www.sec.gov/litigation/admin/2018/34-82805.pdf.

119. Securities Act of 1933 § 230.506, 15 U.S.C. § 77d.

120. *See* YADLEY, *supra* note 6, at 1-2.

121. Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 40, at 78.

ping $1.9 trillion with both initial public offerings and follow-on registered offerings totaling just over $1.7 trillion.[122]

It is vital for smaller operators to keep the Rule 506(d) avenue open for raising funds as they grow. While several requirements must be met in order to rely on Rule 506, for current purposes, there has been no "bad actor" disqualification.[123] But one important requirement detailed in Rule 506(d) has broad application: no exemption is available if, among other things, the issuer, its predecessors, directors, general partners, managing members, certain executives and participating officers, or any beneficial owners of 20% or more of the voting equities has been convicted of offenses (or received certain specified orders from the SEC) in connection with the sale or purchase of a security, arising out of a business as a broker or dealer, or a breach of anti-fraud provisions. This means that an earlier adverse finding arising from the use of an unregistered broker may well result in losing the Rule 506 advantage. The time limit for prior convictions stretches back ten years, and, given the extension of the requirement to any beneficial owner of 20% or more of the company, a prior conviction could spell disaster for a growing business which relied upon the benefit.

B. *Consequences for Finders*

Many of the consequences faced by issuers are also faced by finders, albeit in a slightly different way. Consequences include:

- Prosecution and fines;
- Disgorgement; and
- Rescission of contracts.

122. U.S. SEC. & EXCH. COMM'N, OFF. ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT FOR FISCAL YEAR 2021, at 11 (2021), https://www.sec.gov/files/2021-OASB-Annual-Report.pdf.

123. U.S. SEC. & EXCH. COMM'N, *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings and Related Disclosure Requirements* (Sep. 19, 2013), https://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide#P9_40.

1. *Prosecution*[124] *and Fines*

The most common prosecution is for breach of Section 15(a) and any attendant breaches (often including fraud under Section 10(b)).[125] Case law has shown[126] that when a prosecution is initiated against an unregistered finder, the SEC will generally pursue a range of remedies including interest, disgorgement[127] (where appropriate) and other actions.

The SEC also uses "follow-on" administrative proceedings which include administrative bars to acting in certain capacities, such as a promoter or finder engaging in activities with brokers related to the issuing or sale of securities.[128]

The 2020 case *SEC v. Biongiorno* provides a recent example of the types of penalties the SEC could impose.[129] The case involved defendants acting as unregistered brokers soliciting investors to buy shares in microcap issuers. The complaint alleged the defendants used aliases in soliciting purchasers, received transaction-based compensation, issued false receipts to obfuscate commissions compensation and (at least in one case) misappropriated client funds. Penalties sought by the SEC included permanent restraining orders for breaching multiple sections of the Exchange Act, including Sections 15 and 10; a prohibition from directly or indirectly soliciting for the sale or purchase of securities (or owning a company that does the same); disgorgement of funds on the basis of unjust enrichment; and civil penalties.

A key takeaway from recent cases is that, while monetary penalties can be significant, the real sting comes in the form of the administrative actions: an administrative bar can effectively

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124. *See* A.B.A. Report, *supra* note 39, at 972 (explaining that States have brought more than 100 actions per year against finders breaching the State security laws).

125. A wilful breach of the Exchange Act can incur a penalty of up to 20 years in prison and fines of $5 million for individuals, or $25 million for corporations. *See* 15 U.S.C. § 78ff(a).

126. *See* Blackstreet Cap. Mgmt., LLC, Exchange Act Release No. 77959 (June 1, 2016); Complaint at 13, SEC. v. Goodman, 2018 WL 6651445 (S.D. Fla. 2018).

127. Blackstreet Cap. Mgmt., *supra* note 126.

128. *See, e.g.*, Wallace, Exchange Act Release No. 83052 (Apr. 16, 2018) (SEC proposing a bar on the Respondent acting as, *inter alia*, a finder or promoter).

129. Complaint at 12, SEC v. Bongiorno, 2020 WL 8259226 (N.D. Ohio 2020).

end a finder's business and any further involvement in the securities industry.

2. *Disgorgement*

As discussed in the "Consequences for Issuers" Section *supra*, disgorgement of gains obtained through unlawful or unjust means is a common remedy pursued by the SEC, particularly where a matter involves fraud.[130] There are numerous examples of such penalties, and even persons not directly involved in fraudulent activities can still be required to disgorge funds.[131] The following matters involve multiple different factual scenarios in which disgorgement was considered appropriate.

The 2013 administrative decision *In the Matter of Ranieri Partners, LLC*[132] involved charges against the New York based private equity firm Ranieri Partners, a former senior executive, and an associate[133] who was operating as an unregistered broker-dealer by actively soliciting investors, receiving transaction-based compensation, sending documentation to potential investors and providing confidential information related to other investors. There was no allegation of fraud. The consequences for the "finder"—unregistered broker-dealer—were several administrative measures, including a cease-and-desist order, and bars on association with certain financial industry participants. The court also ordered the disgorgement of over $2.4 million and prejudgement interest.[134] The disgorgement amount was referable to the amount of transaction-based compensation received by the unregistered broker-dealer.

In the Matter of Retirement Surety LLC[135] ended with a very different arrangement. In that case, approximately $11 million in nine-month promissory notes were issued by a number of

130. *See* SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) (describing disgorgement as within the "catalogue of permissible equitable remedies" available to the SEC).

131. *See* SEC v. Cross Financial Services, Inc., 908 F. Supp. 718 (C.D. Cal. 1995).

132. In the Matter of Ranieri Partners, *supra* note 24.

133. In the Matter of William M. Stephens, *supra* note 58, at 2.

134. This was waived based upon Respondent's financial condition. *Id.* at 7.

135. Retirement Surety LLC, Exchange Act Release No. 1250, at 1 (ALJ Apr. 18, 2018), https://www.sec.gov/alj/aljdec/2018/id1250ce.pdf.

non-registered persons who received 5% commission. When the issuer failed to pay investors under the promissory notes, it engaged the unregistered brokers to contact investors and procure forbearance agreements, for which the brokers received an additional 4% commission. While the forbearance agreements were not securities per se, the profits from extending the terms of the notes were viewed as derivative of the original unregistered sales, and the additional commission was therefore included in the disgorgement amount.

In *SEC v. Hidalgo Mining Corp., et al*,[136] Florida-based mining corporation Hidalgo sold investment contracts in the form of unregistered securities to investors, raising approximately $10.35 million. Neither the company officers nor sales staff were registered as broker-dealers. The staff generally received 10% commission on sales, but there was no disclosure to investors regarding any commissions. The settlement involved permanent injunctions, civil penalties, prejudgment interest, and disgorgement of the commissions by both the company and the principals.

3. *Rescission and Return of Fees*

As detailed above,[137] Section 29(b) of the Exchange Act makes contracts voidable at the option of the innocent party, provided that the innocent party adheres to the strict timelines prescribed by the Act (three years from the offense or one year from the date of discovery of the violation). Courts have applied Section 29(b) not only to contracts that directly violate the terms of the Exchange Act but also to cases where the means of performing the contract involve a violation, such as the use of an unregistered broker.[138]

The consequences of rescission for an unregistered broker-dealer could include a requirement to return commissions, fees and expenses, or, where payment has not yet been

136. Complaint at 1–2, SEC v. Hidalgo Mining Corp., Exchange Release No. 23903 (S.D. Fla. filed Aug. 4, 2017) (No. 17-cv-80916), https://www.sec.gov/litigation/complaints/2017/comp23903.pdf.

137. *See* discussion, *supra* note 58.

138. *See e.g.*, Reg'l Props., Inc. v. Fin. & Real Est. Consulting Co., 752 F.2d 178, 184 (5th Cir. 1985) (applying Section 29(b) to a contract performed by an unregistered broker).

made by the issuer, a refusal to pay in accordance with the agreement.[139]

The consequences of a rescission under Section 29(b) come into focus in the unreported decision of Torsiello Capital Partners LLC v. Sunshine State Holding Corporation,[140] in which the Supreme Court of New York considered Section 29 and the return of a retainer fee on the basis of "unjust enrichment." Sunshine had engaged an advisory firm, First International, to provide advice and banking services for a private placement of Sunshine's securities. First International prepared documents to assist with the security sale, made calls to potential investors, and held meetings. Its finders were unregistered brokers, and their efforts were unsuccessful. When the shares were later sold, First International and Torsiello, as affiliates and successors in interest, sought to enforce the original contract, which carried a retainer of $50,000 and a fee of 3.5% of the purchase price. The Supreme Court found for Sunshine on the basis that the contract was voidable pursuant to Section 29(b),[141] and the retention of the retainer would constitute unjust enrichment. The Court stated:

> . . . [T]he contract is void ab initio by virtue of the plaintiff's lack of registration as a securities broker with the SEC and, therefore, the contract has been rescinded. Therefore, Sunshine is entitled to the return of the $50,000 retainer fee. . .[142]

Family members in receipt of the funds may be required to return monies on the basis of unjust enrichment, even if the family members were not parties to the securities law violation. This is illustrated in the 1993 case *SEC v. Antar*,[143] which in-

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139. Couldock & Bohan, Inc., 93 F.2d at 235; *see also* Transamerica Mortg. Advisors v. Lewis, 444 U.S. 11, 19 (1979) (noting "[w]hen Congress declared. . .. . .that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract, and for restitution.").

140. *See* Torsiello Cap. Partners LLC, 2008 N.Y. Misc. LEXIS 2879, at *29.

141. *Id.* at *16 ("Inasmuch as the contract required First International and its affiliates to provide the types of services that require licensing by the SEC as a securities broker, and they did perform such services while not so licensed, the contract is void ab initio and rescindable").

142. *Id.* at *29.

143. *See* SEC v. Antar, 831 F. Supp. 380, 402 (D.N.J. 1993).

volved an action against the Antar's wife and children even though there had been no securities law violations on their part. Rather, the action against them was for their possession and custody of proceeds from Antar's sale of stock, which had violated the securities laws.

The Court laid out the key principles in such cases:

> [T]he touchstone is whether the non-party's claim to the property is legitimate, not whether the party is innocent of fraud or wrongdoing . . .[144]The nominal defendants cannot keep money that is not theirs. . . Unjust enrichment is present here. The nominal defendants should not be allowed to retain funds that are the products of Eddie Antar's securities fraud. Their enrichment came at the expense of defrauded investors.[145]

The takeaway is that rescission carries consequences not only for the unregistered broker-dealer but also potentially for their family.

VI.
What Does a Prospective Finder Need to Do?

These and other cases demonstrate that the consequences of breaching the Exchange Act's registration requirements can be devastating for both finders and issuers. The following steps outline a process for protecting finders and their clients from inadvertent breaches of the law.

A. *Step 1: Gathering Facts*

It is essential to ensure a grasp of the relevant facts and circumstances because the registration requirement is a fact-driven question. Ask: what is done or proposed to be done, and how will it be carried out?

Preliminary issues include the following:

- Whether the finder is registered as a broker-dealer and whether they are likely to be an "associated person" of a registered broker-dealer;
- What each party to the arrangement expects to get out of the arrangement. Record these expectations in an

144. *Id.* at 399.
145. *Id.* at 402.

agreement that is reviewed prior to execution. Existing contracts should also be reviewed to ensure that a breach has not already occurred. Ask whether there any indemnification clauses, and if so, whether there are enough resources or insurance to cover an indemnifiable event;
- What the precise activities are that will be performed by each party; and
- How remuneration will be calculated and paid.

B. *Step 2: Consider the Specific Facts in Light of Section 15*

Next, analyse whether the SEC would interpret the proposed activities as requiring registration. In particular, consider the questions of transaction-based compensation, involvement in the transaction, and solicitation.

1. *Transaction-Based Consideration*

This is the principal issue that needs to be addressed. There is likely no breach of this requirement where the finder:
- Introduces investors and issuers[146] without any further involvement in the process;[147] and
- The remuneration is a fee referable to time-based rates, a flat fee for the whole service, or fees on a "per-introduction" basis, provided that the success or failure of a particular introduction does not factor into the payment mechanism.

Any form of transaction-based compensation is likely to trigger action by the SEC.

2. *Involvement in the Transaction*

The cases and no-action letters discussed in this article demonstrate that any involvement in the transaction itself is

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146. Apex Glob. Partners, Inc. v. Kaye/Bassman Int'l Corp., 2009 WL 2777869, at *3 (N.D. Tex. Aug. 31, 2009) ("Merely bringing together the parties to transactions, even those involving the purchase and sale of securities, is not enough" to warrant broker registration under Section 15(a)").

147. Victoria Bancroft, SEC Staff No-Action Letter, 1987 WL 108454, at *2 (Aug. 9, 1987) describes activities as "limited merely to the introduction of parties." In that case the applicant did not participate in the establishment of the purchase price or any other negotiations between the parties and only received a flat fee for the introductions. *See also* A.B.A. Report, *supra* note 39, at 19.

considered to be the activity of a broker-dealer, which requires registration. Accordingly, a finder should not:

- Provide advice on the merits, or any detailed information,[148] such as corporate analysis, information memoranda, etc.;
- Be involved in negotiating the issue or sale, or have any input regarding transaction documentation or marketing materials;
- Be involved in any aspect of facilitating an investment or purchase, including handling funds or assisting with third party legal, financial, or business advisors;[149]
- Participate in any negotiations (including during the closing of the sale); or
- Assist purchasers in obtaining financing, other than uncompensated introductions to third party lenders.

3. *Active Solicitation*

The role of the finder is to facilitate introductions rather than convince investors that a particular investment is appropriate for them. Finders may receive transaction-based compensation referred to as what the SEC calls the "*salesman's stake*." Accordingly, a finder should:

- Only facilitate introductions and provide basic outline information (not analysis);
- Not advertise;
- Not distribute promotional material or hold seminars where the investment is promoted; and
- Not engage in broad "cold-calling" as introductions should only be made to suitable potential investors.

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148. The Dominion Resources no action letter was withdrawn on July 3, 2000, which had previously permitted the entity to undertake a number of activities, including analysing the financial needs of issuers, designing financing methods and securities that fit those needs, recommending lawyers to prepare the documents, participating in negotiations, and arranging meetings with banks for financing and underwriting. Dominion Res., SEC No-Action Letter, *supra* note 25. Transaction based fees were also involved. The withdrawal letter did not specify which of the factors had led to the withdrawal and would result in a registration requirement today.

149. Commentators note that uncompensated introductions to third party lenders should not be a problem. Eric R. Smith, *Finders May Pose Risk in Private Capital Raising*, VENABLE, LLP INSIGHTS (July 15, 2020), https://www.venable.com/insights/publications/2013/03/finders-may-pose-risk-in-private-capital-raising.

C. *Step 3: If Uncertainty Remains*

After fact-gathering and analysis in light of Section 15, there may still be uncertainty regarding the registration requirements, especially for more complex arrangements. In such cases, seeking advice from an attorney experienced in securities law may be necessary.

The consequences of breaching the registration provisions are severe. If there is any doubt, it is worthwhile to register or to reconsider the services offered (for a finder) or consider using a registered broker or a finder with a limited suite of services (for an issuer).

VII.
California: A More Rational Regime

The difficulties finders confront are not new. Market participants are forced to make a hard choice: either face expensive, laborious registration, along with subsequent expensive, laborious compliance duties, or run the risk of harsh penalties in a regulatory system that lacks clear guidelines. Although the SEC has finally circulated a proposal for finder exemption, it received only limited support from the Commissioners and triggered considerable pushback from the investor side of the industry.

Seeking to remedy the SEC's vague definition of broker-dealers and lack of definition for finders, some states have implemented their own legislative fixes.[150] The fact that the states of California and Texas have crafted their own regimes demonstrates the weight of the issue, especially given the economic significance of these two states. California and Texas represent tens of billions of dollars in venture capital investment each year, and if they were sovereign nations, they would be the sixth- and tenth-largest economies in the world by gross product.[151] Of particular note is the Californian regime, which has proven successful in addressing many of the issues sur-

150. As well as California, these include Texas (Tex. Admin. Code § 115.1(a)(9)), Michigan (MCL § 451-2102), and South Dakota (SD Codified L § 47-31B-401), with New York reviewing the treatment of finders under State law. *See* Investor Protection Bureau proposal dated April 15, 2020, https://ag.ny.gov/ipb-rule-change.

151. *See* Mark J. Perry, *Economic Output: If States Were Countries, California Would be France*, Newsweek (June 11, 2016, 8:00 AM), https://

rounding finders. California Corporations Code Section 25206.1, passed in 2015, offers a rational regime for distinguishing finders from broker-dealers, registering finders, and regulating finder activities and compliance.[152] While the California model is not above critique, it is more precise than the SEC's regime, and it has produced better results, providing a preferable alternative to the one outlined in the current SEC proposal.

We argue that (1) the SEC must define "finder" and finder activities more clearly and rationally than it does in Release No. 34-90112; (2) the SEC should exempt finders from SEC broker-dealer registration so long as they adhere to new SEC guidelines; and (3) the SEC should use the California regime as a model for making these changes. A more rationalized finder regime implemented at the federal level would foster small business growth and provide small businesses with a wider range of options to raise capital, particularly outside the realm of homogenized, big-deal oriented institutional lenders.

A. *California's Finders Regime*

Legislators in California sought to address the longstanding problem of raising capital for small businesses by allowing unregistered persons to legally act as finders under a set of conditions that are clearer than the SEC's broker-dealer registration requirements.[153]

B. *History of California Corporations Code Section 25206.1*

Before Section 25206.1, California's regime resembled the federal one in that it only permitted registered broker-dealer firms to be compensated for connecting an investor with an investment opportunity.[154] At that time, the only protection an investor had against an unregistered broker-dealer was Corporations Code Section 25501.5, which allows a person who "purchases a security from or sells a security to a broker-dealer that is required to be licensed and has not, at the time of sale of purchase . . . to bring an action for rescission of the

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www.newsweek.com/economic-output-if-states-were-countries-california-would-be-france-467614.

152. *See* CAL. CORP. CODE § 25206.1.

153. Assemb. Comm. On Banking & Fin., A.B. 667, at 5 (Cal. 2015).

154. *Id.*

sale or purchase, if the plaintiff or defendant no longer owns the securities."[155]

In April 2013, Assemblyman Donald Wagner proposed a bill that would exempt a "finder" from the then existing broker regime upon meeting certain requirements.[156] It would have allowed any person who met specific requirements to be classified as a finder instead of as a broker-dealer.[157] Although the bill failed to pass the Senate Appropriations Committee, in July 2015, Wagner presented a substantially similar bill, which passed without opposition.[158] That bill became California's new finder statute, Section 25206.1.[159]

The stated purpose of Section 25206.1 was to eliminate the risks for issuers and investors raising capital through finders by clearly defining the limits and bounds of a finder.[160] The bill's sponsors recognized that,

> Under current law . . . the scope of permitted activities for a finder is poorly defined, often resulting in inadvertent violations of broker-dealer registration requirements. In fact, there is no statutory definition of finder, nor is there any regulation of finders. This lack of clear guidance puts finders and the businesses that rely upon them for crucial funding in jeopardy. It also impedes the State's ability to regulate finders and to hold them accountable.[161]

The bill passed through the Senate Committee on Banking and Financial Institutions with no opposition.[162] The Committee members unanimously supported imposing regulatory requirements upon finders to ". . . ensure better market transparency, proper accountability, and additional investor protection while at the same time facilitating capital formation for

155. CAL. CORP. CODE § 25501.5(a)(1).
156. S. Comm. on Banking & Fin. Insts., A.B. 667 (Cal. 2015).
157. A.B. 713, 2013-2014 Reg. Sess. (Cal. 2013).
158. AB-667 Votes, Cal. Leg. Info., (2015), https://leginfo.legislature.ca.gov/faces/billVotesClient.xhtml?bill_id=201520160AB667.
159. CAL. CORP. CODE § 25501.5(a)(1).
160. Assemb. Comm. on Banking and Fin., A.B. 667, at 8 (Cal. 2015).
161. *Id.*
162. S. Comm. on Banking & Fin. Insts., A.B. 667, at 9 (Cal. 2015).

business entities in California."[163] The bill also passed through the Senate Rules Committee with no opposition.[164]

However, the Senate did make two amendments.[165] The Senate requested that the bill expand the commissioner's authority to make, amend, and rescind rules in order to carry out the provisions. The Senate also amended the bill to empower the commissioner to "classify securities, persons, and matters within his or her jurisdiction and prescribe different requirements for different classes." Thus, the following text was added to the bill:

> The commissioner may from time to time make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of this law, including rules and forms governing applications and reports, and defining any terms, whether or not used in this law, insofar as the definitions are not inconsistent with the provisions of this law. For the purpose of rules and forms, the commissioner may classify securities, persons, and matters within his jurisdiction, and may prescribe different requirements for different classes.[166]

Section 25206.1 created a regulatory framework to govern the activities and accountability of finders, and it provided statutory and regulatory certainty for both finders and the businesses that rely upon them.[167]

The California legislature hoped that the bill would encourage persons who act as finders to comply with the bill's requirements by providing much-needed clarity regarding permissible and impermissible finder activities.[168] Those who operate within the bill's parameters have assurance that they do not need to obtain a broker-dealer license. However, those who do not meet the bill's definition may need to obtain licensing as broker-dealers.

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163. *Id.* at 6.
164. *Id.* at 7.
165. *Id.* at 6.
166. *Id.*
167. S. Comm. on Appropriations A.B. 667, at 1 (Cal. 2015). A simple framework is something that remains lacking in the Federal sphere and is likely to persist even in the event Release No. 34-90112 was to be adopted in its current form.
168. S. Comm. on Banking & Fin. Insts., A.B. 667, at 5 (Cal. 2015).

California is not the only state that has enacted legislation dealing with finders[169]; other states, including Texas, Michigan, and Minnesota, have done the same. Notably, both the Texas and Michigan finder statute are relatively similar to California's in that they place substantial limits upon the activities in which a finder can permissibly engage. This approach appears to have been adopted in SEC Release No. 34-90112. Michigan's position is somewhat different, requiring a person defined as a "finder" under Michigan law to register as an investment advisor and limiting the person's activities to ". . .locating, introducing, or referring potential purchasers or sellers."[170] Similarly, Texas limits finders to participating in the introduction of accredited investors.[171]

The California finder statute received mixed reviews.[172] Those who supported passage believed that the requirement that all parties must reside in California would cause the SEC to turn a blind eye to the exemption.[173] However, critics argue that it is just as cumbersome as the SEC's regime.[174] The Californian law imposes many conditions, including both reporting and filing obligations, upon finders,[175] and those who fail to follow the strict requirements are still subject to the same penalties as unregistered broker-dealers. Additionally, the ex-

169. Assemb. Comm. on Banking & Fin., A.B. 667, at 7 (Cal. 2015).

170. MICH. COMP. LAWS § 451.2102 (2002).

171. For a discussion of the history and practicalities of the Texas finder provisions, see generally John R. Fahy, *The New Texas "Finder" Securities Broker Registration*, TEX. J. BUS. L. 341, 341–42 (2005–2006).

172. *See, e.g.*, Amit Singh, *California Creates Finders Fee Exemption for Unregistered Persons*, STARTUPBLOG (Aug. 16, 2015), https://www.startupblog.com/blog/californiafinderrule; Christina Pearson, *A Limited Exception – California Enacts New Rules Governing Exemption for Finders in Securities Transactions*, JD SUPRA, (Aug. 10, 2017), https://www.jdsupra.com/legalnews/a-limited-exception-california-enacts-26316/; Will Marshall, *California Exemption of Little Help*, SAN DIEGO CNTY. BAR ASSOC. (2015), https://www.sdcba.org/index.cfm?pg=BusinessandCorporate201709.

173. The SEC has shown a tendency to defer to state law in purely intrastate transactions. *See Intrastate Offerings*, U.S. SEC. & EXCH. COMM'N (Sept. 6, 2022), https://www.sec.gov/smallbusiness/exemptofferings/intrastateofferings.

174. Marshall, *supra* note 172 ("The California finder exemption fails to align with the practical realities of how such finders operate and their tolerance for compliance burdens, thereby significantly reducing the usefulness of this exception.").

175. *See* CAL. CORP. CODE, § 25206.1.

emption seeks to prohibit the activities of a true finder.[176] Finders are not allowed to participate in the offering through "negotiating, advising or making any disclosures to the potential purchaser other than very limited information."[177] Because Section 25206.1 is so extensive, many critics doubted that it would solve the problems that it was enacted to fix.

C. *Goals of Section 25206.1*

Section 25206.1 was enacted to create "regulatory certainty for finders and business owners, by codifying a set of activities that will be legal when performed by persons without a broker-dealer's license, who meet the bill's definition of a finder."[178] Prior to the statute, there was much uncertainty at the State level regarding the activities a person without a broker-dealer's license could legally perform. As with the federal regime, most of the confusion stemmed from the law's lack of a definition for "finders" as a separate class of persons.[179]

Since finders are an "essential component of an efficient capital market,"[180] having a clear definition of what a finder is and what activities he or she may engage in provides "greater accountability, investor protection, and regulatory oversight."[181]

D. *Greater Accountability*

One of the primary purposes of Section 25206.1 was to clear up ambiguities surrounding finders, thus enabling the State to hold finders accountable.[182] Before, the lack of clear guidance regarding finders caused businesses to inadvertently put their businesses in jeopardy when seeking capital.[183] By providing the badly needed clarification, Section 25206.1 increases the accountability of both businesses and finders.

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176. Marshall, *supra* note 172.

177. Will Marshall, *California Finder Exemption of Little Help*, UBM LAW GROUP, LLP (Oct. 23, 2016), https://ubmlaw.com/california-finder-exemption-of-little-help/.

178. S. Comm. on Banking & Fin. Insts., A.B. 667, at 8 (Cal. 2015).

179. *See* Assemb. Comm. on Appropriations A.B. 667, at 2 (Cal. 2015).

180. S. Comm. on Banking & Fin. Insts., A.B. 667, at 9 (Cal. 2015).

181. *Id.*

182. Assemb. Comm. on Banking & Fin. Insts., A.B. 667, at 7 (Cal. 2015).

183. S. Comm. on Banking & Fin. Insts., A.B. 667, at 8 (Cal. 2015).

To start, Section 25206.1 defines a "finder"[184] as "a natural person who, for direct or indirect compensation, introduces or refers one or more accredited investors . . . to an issuer . . . solely for the purpose of a potential offer or sale."

It also establishes a framework of requirements for "finders" to legally receive transaction-based compensation in California.[185] First and foremost, in order for the exemption to apply, the issuer, the finder, and the investors must all be located in California.[186] Second, prior to engaging in any activities relating to securities transactions, the finder must file an initial statement of information and pay a $300 fee.[187] The statement of information must include:[188]

- The name and complete business or residential address of the finder; and
- The mailing address of the finder, if different from the business or residential address.

In addition, the finder must file a renewal statement with the Department of Business Oversight and pay a $275 fee.[189]

Finally, the finder must act within a strict subset of rules detailed in the statute. It is crucial for businesses to understand the legal limits of finders within California because they too can be penalized if the finder acts outside the permissible bounds. The following restrictions apply to finders in California:[190]

- Finders must only refer accredited investors to the issuer;
- Finders are unable to provide services to an issuer for the offer or sale of securities that exceed fifteen million dollars in aggregate;
- Finders cannot participate in negotiating the terms of the offer or sale;
- Finders may not offer advice regarding the advisability of investing in, purchasing, or selling the securities;

184. CAL. CORP. CODE, § 25206.1.
185. S. Comm. on Banking & Fin. Insts., A.B. 667, at 1, 7 (Cal. 2015).
186. CAL. CORP. CODE, § 25206.1.
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.*

- Finders may not conduct any due diligence (meaning the suitability of the investor or the condition of the issuer) for any party to the transaction;
- Finders cannot sell or offer for sale any securities that are owned, directly or indirectly, by the finder;
- Finders cannot receive, directly or indirectly, any funds in connection with the issuer transaction; and
- Finders cannot participate in the transaction or knowingly receive any compensation in connection with the sale, unless authorized by permit or exempt from qualification under California law.
- Finders must also adhere to strict rules when providing information to potential investors. Finders are only allowed to disclose the following information:[191]
- The name, address, and contact information of the issuer;
- The name, type, price, and aggregate amount of any securities being offered in the issuer transaction; and
- The issuer's industry, location, and years in business.

The finder must keep all records for transactions in which he participated as a finder for a period of five years.[192]

If the finder fails to follow any of these requirements or restrictions, he or she is no longer eligible for the exemption and will be subject to the same penalties imposed by the SEC upon those who are operating as unregistered-broker dealers.[193]

E. *Investor Protection*

Providing "clear guidance for finders and the businesses that rely on their services" is essential to ensuring that businesses are protected.[194] In the past, the lack of clarity has caused businesses and finders alike to become subject to penalties through inadvertent violations.[195] Small businesses often relied on finders engaged in technically illegal broker-dealer conduct which exposed them to a risk of severe conse-

191. *Id.*
192. *Id.*
193. *Id.*
194. Assemb. Comm. on Appropriations, A.B. 667, at 3 (Cal. 2015).
195. S. Comm. on Banking & Fin. Insts., A.B. 667, at 8 (Cal. 2015).

quences.[196] Yet, from both an economic and social perspective, finders are often the only option available for small business issuers to attain the capital they need to expand their businesses. Section 25206.1 seeks to provide the assurance and protection necessary for businesses to confidently utilize finders without fear of repercussion.

F. *Regulatory Oversight*

The sponsors of the Californian bill hoped that a new regulatory structure would incentivize unregistered persons to register as finders and thus bring previously unregulated activity within the government's control.[197] By creating a specific class of person and defining a subset of regulated activities for "finders," the Department of Business Oversight ("DBO") regulates finders who may previously have avoided oversight.[198]

G. *Federal Preemption and the New California Exemption*

Finders operating under the California exemption must be cautious of the fact that the SEC still has not changed its stance on unregistered persons receiving transaction-based compensation.[199] Thus, the exemption applies only to transactions in which the issuers, finders, and investors all reside and transact within California.[200] It does not provide relief from the SEC's strict policies nor does it exempt finders from adhering to every other state's broker-dealer requirements.[201]

In addition, it is possible that the SEC could take the position that the federal preemption doctrine applies and could prosecute a California finder paid lawfully under California state law.[202] Furthermore, the possibility remains that this state statute could be challenged and overturned in federal court. Outside of California, the finder is still considered an unregistered broker-dealer in violation of Section 15(a) of the Ex-

196. *See generally* Mark Hiraide, *Ready Capital,* L.A. Law, at 21, 24 (Feb. 2017).
197. Assembly Comm. on Appropriations, A.B. 667, at 4–5 (Cal. 2015).
198. *Id.* at 2.
199. *See* Guide to Broker-Dealer Registration, *supra* note 11.
200. *See* Cal. Corp. Code, § 25206.1.
201. Hiraide, *supra* note 196.
202. *See* U.S. Const. art. VI, § 2.

change Act.[203] As a result, both the finder and issuer could be subject to the significant penalties available to federal regulators.[204]

Until the SEC changes its current policy on finder's fees, both issuers and finders run the risk of being penalized by the SEC for any transactions that occur outside of California.

CONCLUSION

If the federal experience with unregistered finders tells us anything, it is that the current regime is clearly not working. The fact that no statutory definition of "finder" even exists under the Exchange Act speaks to an antiquated system which lags behind the rapidly changing investment market it purports to regulate. The amalgamation of smaller broker-dealers into larger operators means that servicing smaller businesses is less attractive for big-deal investors, while the need for new capital by growing companies remains. This leaves many cash-strapped smaller businesses with a simple, unenviable choice: engage with an unregistered broker-dealer and run the risk of dire consequences, or face bankruptcy. As commentators and the numerous cases referenced in this paper attest, many growing businesses continue to choose the former.

But it doesn't have to be this way. The SEC's tentative recognition of the finder versus broker-dealer distinction and of the need to exempt some finders from broker-dealer registration could pave the way for a more rational federal regime. That new federal regime should look to that of California. California's finder regulation has been operating successfully for half a decade, and the fact that Texas and Michigan finder statutes share such similar provisions to California's demonstrates that a California-based model could have successful nationwide application. Many commentators acknowledge that it is far less onerous and expensive compared to broker-dealer registration with the SEC.[205] The specificity of California's

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203. *See* U.S. SEC. & EXCH. COMM'N, BROKER-DEALERS (Mar. 10, 2016), https://www.sec.gov/divisions/marketreg/mrbdealers.shtml.

204. Daniel L. McAvoy et al., *Revenge of the Rat Pack; SEC Proposes Finders Exemption*, NAT'L L. REV. (Nov. 5, 2020), https://www.natlawreview.com/article/revenge-rat-pack-sec-proposes-finders-exemption.

205. Rick Randel, *Finders Keepers,* RANDEL L. BLOG (May 17, 2016), https://www.randellaw.com/finders-keepers; *see also* Chris Myers, *Reasons to Be Wary*

finder criteria is a major selling point; its clear guidelines free operators from the cost of residual uncertainty—the "worry cost" —that finders face within the federal regime.

While California's provisions are not perfect, they provide a working model which should serve as a template for the SEC. California balances the dual policy objectives of providing investor protection through oversight and facilitating capital investment in the small businesses and start-ups that help to make California the economic dynamo it is today: the number one state for venture capital investment in the nation.[206] Under a rationalized regime, free from broker-dealer restrictions, finders and the small businesses they support can thrive.

In short, finders, keepers.

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of California's Finder Exemption, HOLLAND & HART (Apr. 1, 2016), https://www.hollandhart.com/reasons-to-be-wary-of-californias-finder-exemption.

206. Andrew DePietro, *The Best and Worst States For Entrepreneurs In 2020*, FORBES (Nov. 13, 2019), https://www.forbes.com/sites/andrewdepietro/2019/11/13/best-worst-states-entrepreneurs-2020.