Is My Intermediary A "Finder" Or "Broker"?

Using An Unregistered Broker Is A Perilous Trap For The Unwary

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September 16, 2021

Companies seeking to raise capital from outside investors might turn to an intermediary to help them identify or connect with new investors. Before retaining an intermediary, however, it is imperative for the company to determine whether the intermediary is a finder or broker according to the United States Securities and Exchange Commission (the "SEC"). If the intermediary falls within the definition of a broker under the SEC Act of 1934 (the "Act"), they must be a registered broker or dealer. It can be a perilous trap for the unwary for a company to use an unregistered broker. Companies that use unregistered brokers expose themselves to significant legal liability, and could face penalties and fines, rescission of the offering, and may jeopardize the reputation and future of their company.

THE DEFINITION OF BROKER IS BROAD AND EXPANSIVE

Section 15 of the Act governs broker-dealer registration. The Act states that a broker is any person engaged in the business of effecting transactions in securities for the account of others, while a dealer is any person engaged in the business of effecting transactions in securities for their own account. The term "person" includes entities as well as individuals. The Act makes it unlawful for any entity or individual to effect transactions in securities without first registering as a broker or dealer. If an intermediary falls within the regulatory framework of the Act, such intermediary should register with the SEC as a broker-dealer, as well as with the Financial Industry Regulatory Authority (the "FINRA").

THE HALLMARK SIGN OF A BROKER IS TRANSACTION-BASED COMPENSATION

One way to tell if someone is a broker is if they are an agent who acts as an intermediary or negotiator, especially between prospective buyers and sellers. Perhaps the strongest indicator of a broker is if the intermediary is receiving transaction-based compensation or a success fee. In *Securities and Exchange Commission v. Bio Defense Corporation*, the Court looked at a commonly used multi-factor test to assess whether an entity or individual qualifies as a broker, indicating that a broker could consist of a combination of the following: "1) is an employee of the issuer; 2) received commissions as opposed to a salary; 3) is selling, or previously sold, the securities of other issuers; 4) is involved in negotiations between the issuer and the investor; 5) makes valuations as to the merits of the investment or gives advice; and 6) is an active rather than passive finder of investors." This case was one of many that went on to state that the hallmark sign of a broker is transaction-based compensation.

The SEC has provided similar guidance noting that a clear indicator is when an individual places himself squarely in the middle of each transaction in order to reap the profits.

THE LIMITED SCOPE OF WHO QUALIFIES AS A FINDER

The term "finder" is limited to an intermediary who brings together parties for a business opportunity. Massachusetts courts have narrowly interpreted a "finder" to consist of one who merely identifies a business opportunity for another. Anything that goes beyond the scope of these limited definitions would likely sweep the intermediary under the scope of a broker which would necessitate them to register with the SEC and FINRA.

The Jumpstart Our Business Startups Act (the "JOBS Act") in 2012 included a very limited exception from broker registration for intermediaries assisting in securities offerings exempting them under Rule 506 of Regulation D for intermediaries who maintain a platform that permits the offer, sale, purchase, and general solicitation of an offering. However, in order to meet the exemption, the intermediary must not receive compensation in connection with the purchase or sale of securities in the offering.

There are a few specific scenarios where an intermediary will not need to register with the Act. In *SEC No-Action Letter (issued July 24, 1991)*, Paul Anka was deemed to be a "finder" when he showed his contact list of potential investors to the Ottawa Senators. However, be forewarned that some courts have noted that if a similar case were to arise again, the outcome might not be the same. In fact, the SEC provided guidance of who would likely need to register as a broker, noting that if such entity was finding investors for issuers (entities issuing securities), even in a consultant capacity, that it would likely need to register as a broker.

On October 7, 2020, the SEC proposed a conditional exemption from broker registration requirements for "finders" who assist issuers with raising capital in private markets from accredited investors, by creating two tiers of "finders." While this exemption may provide some clarity to who would qualify as a "finder," until this exemption passes it should not be relied upon.

SCIENTER IS NOT A FACTOR IN ORDER TO BE FOUND IN VIOLATION OF THE ACT

Some intermediaries have tried to rely on certain ambiguities in the language under the Act in taking a position that they do not need to register as a broker-dealer with the SEC. The question then arises as to whether they can rely on that strategy. The short answer is no. Under the Act, scienter (or the knowledge of wrongdoing) is not a requisite factor for one to be held in violation of the Act. This means that if the Act does in fact cover the security dealings or other actions of an intermediary (meaning that they should therefore be registered with the SEC), if they are not registered and whether or not they knew they should have been, will unlikely serve as an effective defense.

COMPANIES WHO USE UNREGISTERED BROKERS COULD BE SUBJECT TO SEC ENFORCEMENT ACTIONS

While unregistered brokers could face SEC enforcement actions, monetary fines, and civil or criminal liability, the issuer companies and others who work with the unregistered brokers could also face aiding and abetting charges. Such enforcement actions and penalties for the companies could be as severe as to include rescission of the offering. "[A]ny person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of [the Act], or of any rule or regulation issued [thereunder], shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." 15 U.S. Code § 78t(e).

FINAL THOUGHT

If you are using an intermediary to raise capital for your company, there is a likely probability that the intermediary falls within the regulatory framework of needing to register as a broker-

dealer with the SEC and FINRA. It is in the best interests of your company and a fiduciary duty of the Board of Directors to act in its shareholders best interests and make sure that if you do use an intermediary that you use one who is registered. It is important to keep in mind that regardless of the title that the intermediary may go by, it is the actions (and pay structure) that determine whether an entity or individual should register under the Act.

For more information, please contact Elizabeth Resteghini.