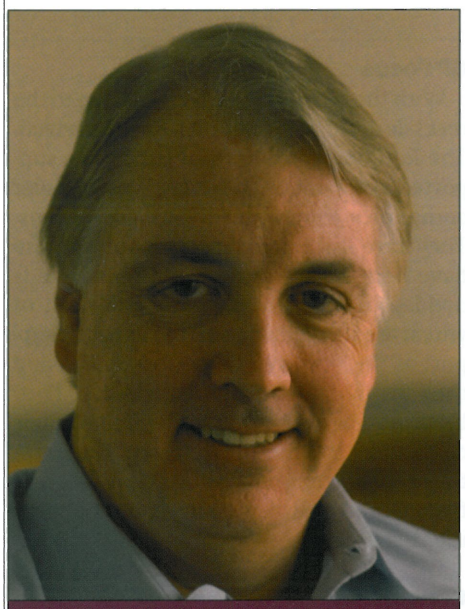
GUEST ARTICLE

BEWARE OF REGULATORY CRACKDOWN ON UNREGISTERED BROKERS



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For several years, two principals of a private company helped a number of businesses raise capital in private transactions. They found investors, a majority of which were hedge funds, and helped structure and negotiate the deal terms. They were paid a percentage of the money invested.

"So what?" you may be asking.

In mid-2009, the two principals, **Michael Fein** and **Stephen Saltzstein**, settled administrative and cease-and-desist proceedings, brought by the **Securities and Exchange Commission**, which had alleged they had willfully violated broker-dealer registration laws because they had acted as brokers without being registered as brokers.

Significantly, no fraud was alleged in connection with the securities offerings. Under the settlement, the principals paid penalties and interest in excess of $500,000 in addition to disgorging their fees.

Crackdown Underway

This enforcement action is a sign of a growing regulatory crackdown on unregistered persons assisting businesses in raising capital. While the broker registration requirement for persons playing more than a limited finder role has always existed under securities laws, past enforcement has often focused on situations either violating the antifraud provisions of securities laws or dealing with unsophisticated investors.

This enforcement trend can be attributed at least in part to greater information available to securities regulators as a result of the March 2009 change in Form D, the notice filed with the SEC by issuers to perfect the private placement exemption under Regulation D of the Securities Act of 1933. These changes required disclosure, identifying by name any person or entity receiving fees tied to the offering and whether such person or entity is a registered broker-dealer (and, if so, the broker-dealer registration number).

The number of these so-called "finders" is significant, and they have played an important role in assisting a large segment of the business community that cannot attract the interest of a registered broker-dealer to raise capital. These businesses include those in the early stage of development, those that are smaller in size or need relatively small amounts of capital, and those that are financially troubled.

In addition, these businesses typically do not have the balance sheet strength or operating history to attract bank financing, and have already exhausted capital from friends and family.

The persons who help these businesses raise capital generally enter into a consulting or finder agreement. Often their services extend beyond raising capital and include introductions to customers or suppliers, as well as offering general business advice. One common thread in their agreements is that at least part of their compensation is based on a percentage of the capital raised—a hallmark of broker-dealer activity.

These persons do not register as broker-dealers for various reasons. Perhaps they are unaware that they must register, as their capital-raising activities are limited to accredited investors where there would seem to be little regulatory concern. Broker-dealer registration and compliance involves significant expense. It's an expense that may not be justifiable on a cost-benefit basis given perhaps problematical and limited revenue.

Various securities regulators have considered proposals for no registration or a simplified registration process for unregistered persons who conduct limited broker-dealer activities solely to sophisticated investors. However, it does not appear that these proposals have the attention of the securities regulators or will be adopted in the near future.

Issuers that pay fees to an unregistered broker for raising capital may also suffer adversely. Under federal and some state securities laws, the investors may have rescission rights. The existence of rescission rights may adversely affect a company's future capital-raising efforts if investors identify this risk and either determine not to proceed or reduce their valuation of the company.

Broker-Dealer or Finder?

A broker is any person engaged in the busi-

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ness of effecting transactions in securities for the account of others. The reality is that registration is probably required for a person who more than once accepts a fee for helping businesses raise capital through a securities offering.

A finder "differs from a broker-dealer because the finder merely brings two parties together to make their own contract, while a broker-dealer participates in negotiations," according to "Black's Law Dictionary." Thus, a pure finder's conduct will not go beyond the introduction of issuers and investors.

Although regulators acknowledge a limited finder's exemption to the broker-dealer registration requirements, the exemption is limited. The boundary is vague between one's classification as a broker-dealer or finder. The SEC has made clear, however, that a person who undertakes any of the following activities without being registered as a broker-dealer or an associated person could be in violation of the law:

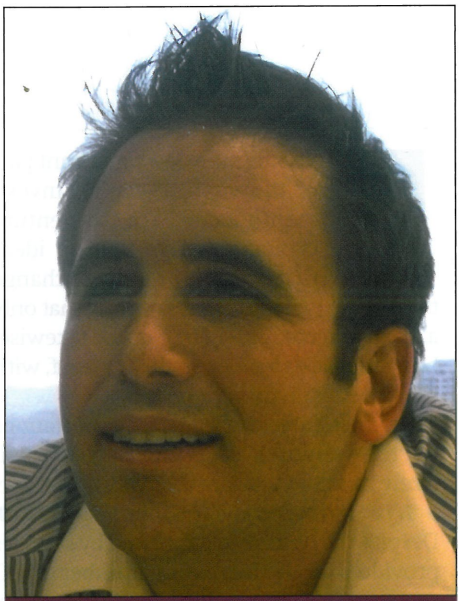
- Finds investors for registered broker-dealers.
- Participates in important aspects of securities transactions, including solicitation or negotiation.
- Receives transaction-based compensation (i.e., compensation as a percentage of funds raised).
- Regularly acts as a finder.
- And handles funds of others in connection with securities transactions.

Unregistered brokers are not entitled to any compensation for conducting broker-dealer activities. Because these activities and payments were frequently under the radar screen of securities regulators, enforcement has generally been in circumstances where the issuer refused to pay the fee and the unregistered broker subsequently sued.

However, with the changes in Form D filings, information pertaining to payment of finder's fees is now electronically available to the SEC and state securities regulators. As a result, one can expect an increasing number of direct regulatory enforcement actions seeking cease-and-desist orders and penalties.

What to Do

Individuals seeking to help companies raise capital should consider the following alternatives to avoid the severe penalties they may incur if acting as an unregistered broker-dealer:



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1. Act only as a finder. If a person simply introduces a company to prospective investors, does not regularly engage in such conduct, and is paid a fixed fee, then he may not need to register as a broker-dealer, at least under the federal securities laws. However, some states require finders to register. (These limitations make such arrangements unattractive and are precisely why unregistered finders conduct activities reserved solely for registered broker-dealers.)

2. Become an "associated person" of a registered broker-dealer. If one wishes to benefit from sharing his or her vast network of capital sources with companies in need of funding, he or she should work with a registered broker-dealer, thereby becoming an "associated person." In so doing, he or she may lawfully receive transaction-based compensation.

As arrangements with finders become more strictly scrutinized, the demand for finders will decrease. Accordingly, we will soon see an increase in "associated persons," especially since the process is not that burdensome.

To become an "associated person," one must be supervised by a registered broker-dealer, register with a self-regulatory organization, such as **Financial Industry Regulatory Authority Inc.** (FINRA), and pass a securities qualification examination. Many people take the Series 7 exam, which has no prerequisites and includes 250 multiple-choice questions.

3. Form or acquire a registered broker-dealer. Individuals with dormant assets and/or a substantial network of capital sources may reap the benefits that unregistered finders desire—without the accompanied risk of liability—by forming or obtaining a controlling interest in a broker-dealer firm.

In so doing, one can avoid registration altogether, while receiving through distributions transaction-based compensation (attributed to the efforts of "associated persons") that otherwise would have been illegal to receive. One could receive a salary for becoming a director of the broker-dealer firm and could potentially benefit from opening his or her contact list to the firm, subject to certain limitations.

To form a broker-dealer firm, one must, among other things, secure adequate capital to meet regulatory requirements, and submit an application to FINRA containing a business/supervisory plan that lists all principals and associated persons. The process takes about six months to complete.

Acquiring an existing broker-dealer firm is more straightforward. Once it is determined that an unregistered person will acquire at least 25% of the equity of a FINRA broker-dealer firm, the firm must submit an application to FINRA 30 days before the "change in control transaction." Subject to certain restrictions, the ownership change can be made after the 30-day period.

In conclusion, finders and the businesses they assist must be extremely cautious about the myths that have developed from the historically insignificant enforcement activity surrounding unregistered persons. If requirements for registration are not followed, the fate of Fein and Saltzstein will become increasingly more common.

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