

## Keeping Capital Finders In Step With SEC Broker Regulations

By **Eric Rubenfeld** (August 17, 2022, 6:16 PM EDT)

Capital finders — that is, persons who are not registered broker-dealers that connect potential investors with investment opportunities — are an integral part of the modern investment world.

Capital finders are particularly important in lower middle market transactions that are too large for traditional funding sources, such as funding from friends and family, but too small to attract institutional capital or support a registered securities offering.

Without other options, lower middle market issuers often seek to raise capital through limited Regulation D offerings to accredited investors. However, as the U.S. Securities and Exchange Commission has noted, "small businesses frequently encounter challenges connecting with investors in the exempt market, particularly in regions that lack robust capital raising networks."<sup>[1]</sup>

In particular, according to the SEC:

[f]or a small business seeking to raise capital, identifying and locating potential investors can be difficult. It becomes even more challenging if the amount sought (e.g., less than \$5 million) is below a level that would attract venture capital or a registered broker-dealer, but beyond the levels that can be provided by friends and family and personal financing. The number of registered broker-dealers has been falling, and few registered broker-dealers are willing to raise capital in small transactions.<sup>[2]</sup>

The SEC recognizes that capital finders play a critical role in filling this funding gap. According to the SEC:

In areas that lack robust venture capital ("VC") and angel investor networks, so-called "finders," who may identify and in certain circumstances solicit potential investors, often play an important and discrete role in bridging the gap between small businesses that need capital and investors who are interested in supporting emerging enterprises.<sup>[3]</sup>

However, the regulatory status of capital finders remains ad hoc and fraught with peril. Principally, capital finders who operate interstate and actively participate in the investment process in return for transaction-based compensation — i.e., commissions — may be acting as brokers and subject to the broker-dealer registration requirements of the Securities Exchange Act.



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Capital finders who operate as unregistered brokers can be sued by the SEC for disgorgement of compensation earned, plus interest, civil penalties and enjoined from committing further violations of the Exchange Act. Issuers who use unregistered brokers may face rescission by their investors.

Accordingly, both issuers and capital finders must carefully evaluate the services capital finders provide in the context of the Exchange Act to avoid legal jeopardy.

### **Recent SEC Complaints**

In July alone, the SEC brought five cases against persons for acting as unregistered brokers in connection with capital raising activities. On July 13, the SEC filed charges against four separate individuals for unlawfully selling securities of Sky Group USA LLC, a payday loan company.[4]

The SEC alleged, among other things, that the four individuals who were not registered as broker-dealers or associated with registered broker-dealers, collectively offered and sold more than \$25 million in Sky Group promissory notes to at least 346 investors for which the individuals were paid approximately \$5 million in commissions.

According to the SEC complaints, the individuals made sales pitches to investors, provided marketing documents and provided logistical help to investors to close their investments. The individuals were each charged with, among other things, acting as unregistered brokers in violation of the Exchange Act. The SEC is seeking an injunction, disgorgement with interest, and civil penalties against each defendant.

On July 15, in a separate and unrelated matter, the SEC filed charges against an individual for unlawfully acting as an unregistered broker in connection with multiple unregistered securities offerings.[5]

According to the SEC complaint, the charged individual initially operated as an opener who contacted prospective investors, described the investment opportunity and potential returns, and distributed printed materials, for which he was paid commissions of 7.5% or more of the investment made. Later, the individual also acted as a finder or closer in which, in addition to the foregoing, he attempted to close investments for which he was paid commissions of between 10% and 15% of the investments made.

In total, the SEC alleged the individual received \$351,250 in total commissions. The SEC is seeking an injunction, disgorgement with interest, and civil penalties.

### **Current Regulatory Framework**

Despite the recognized importance of capital finders, the SEC has yet to formally recognize and regulate capital finders as distinct from brokers.

Although the SEC initiated a rulemaking process in 2020 that would have recognized two tiers of capital finders and provided a nonexclusive safe harbor from registration as a broker for each tier, that rulemaking is in abeyance. Thus, capital finders must parse the law and limit their activities to avoid classification as a broker who must register under the Exchange Act.

Section 15(a)(1) of the Exchange Act[6] makes it unlawful for any broker to attempt to induce the purchase or sale of any security without registering with the SEC or associating with a registered broker-dealer. A broker is defined as "any person engaged in the business of effecting transactions in securities

for the account of others." [7]

The definition of security is extremely broad and includes, in addition to the usual investment products — notes, stocks, bond, debentures and options — any instrument commonly known as a security and any investment contract, [8] which encompasses any "contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party," as noted in the 1946 U.S. Supreme Court case, SEC v. W.J. Howey Co. [9]

Accordingly, most if not all, investment products that capital finders are involved with fall under the definition of security.

Brokers who operate exclusively intrastate and do not make use of any facility of a national securities exchange are not required to register with the SEC. However, such persons may be subject to state registration requirements.

For example, California Corporations Code, Section 25210, requires nonexempt broker-dealers to apply for and receive a certificate from the Commissioner of Business Oversight before engaging in securities transactions in California.

There is a limited exception to registration for employees of an issuer. Specifically, any natural person who is a partner, officer, director or employee of (1) the issuer; (2) a corporate general partner of a limited partnership that is the issuer; or (3) a company or partnership that controls, is controlled by or is under common control with the issuer, is not deemed to be a broker solely by reason of participation in the sale of the securities of such issuer under certain conditions.

Among other things, such person cannot be compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities and (1) the sales are made only to a limited set of specified institutions, (2) the person engaged in the sales primarily performs substantial duties for the issuer other than transactions in securities and does not participate in selling securities more than once every 12 months, or (3) the sales activities are primarily ministerial and clerical in nature. [10]

However, because this exemption is limited to associated persons of the issuer, it is inapplicable to persons who engage in capital finding as their primary business.

## **Analysis**

To determine whether a person is acting as a broker, courts apply a totality-of-the-circumstances approach, including weighing following nonexclusive factors:

- Is the capital finder an employee of the issuer?
- Does the capital finder receive commissions as opposed to a salary?
- Is the capital finder selling, or previously sold, the securities of other issuers?
- Is the capital finder involved in negotiations between the issuer and the investor?
- Does the capital finder make valuations as to the merits of the investment or gives advice?

- Is the capital finder an active, rather than passive, finder of investors?[11]

Not all the foregoing factors — the Hansen factors from the U.S. District Court for the Southern District of New York's 1989 decision in *SEC v. Hansen* — need to be present for a person to be characterized as a broker. Consequently, capital finders, who generally meet some but not all of them, are subject to significant uncertainty whether they are in fact brokers subject to registration under the Exchange Act.

In the absence of rulemaking, capital finders have been forced to rely on nonbinding SEC no-action letters, which are contradictory and highly fact specific.

For example, in reply to a request for no-action from the entertainer Paul Anka, the SEC stated in 1991 that it would not recommend enforcement if Anka, as an unregistered broker, acted as a capital finder in connection with the sale of certain securities in return for a 1% commission on the sales of all securities and a 10% commission on the sales of securities to investors found by him.[12]

The decision was predicated on a highly specific set of facts, some of which are inapplicable to a typical capital finder, to wit:

- Anka had not previously engaged in any private or public offering of securities, other than for his own account through a broker-dealer, and did not intend to participate in any future distribution of securities.
- Anka's activity was limited to furnishing the issuer with the names and telephone numbers of persons with whom he had a "bona fide, preexisting business or personal relationship" whom he believed might be interested in the investment.
- Anka would not participate in any negotiations between the issuer and potential investors.
- Anka would not solicit the investors, make any recommendations to them regarding the investment, or have any contact with them regarding the investment, either before or after the issuer contacted them.
- Anka would not participate in any advertisement, endorsement or general solicitation in the U.S. regarding the investment.
- Anka had not and would not participate in the preparation of any materials, including financial data or sales literature, relating to the investment or the distribution of such materials to potential investors.
- Anka would not perform any independent analysis of the investment, engage in any due diligence activities, assist in providing financing for the investment, provide any advice relating to the valuation of or the financial advisability of the investment or handle any funds or securities.
- The issuer alone determined the sales price of the securities and prepared all offering materials.
- The issuer agreed to disclose to each investor Anka's fees.

In contrast, the SEC refused no-action relief to Brumberg, Mackey & Wall PLC, a law firm that proposed to introduce an issuer to a limited number of its contacts, notwithstanding that Brumberg would not:

- Engage in any negotiations whatsoever on behalf of the issuer and the contact;
- Provide the contact with any information about the issuer which might be used as the basis for any negotiation regarding the investment;
- Have any responsibility for, not make any recommendations concerning the terms, conditions, or provisions of any agreement between the issuer and such contact regarding the investment; and
- Provide any assistance to any such contact or the issuer with respect to any transactions involving the financing of the investment. [13]

The SEC denied Brumberg's request because Brumberg would receive transaction-based compensation, which the SEC stated was a "hallmark of broker-dealer activity." The SEC disagreed that Brumberg's activity was sufficiently limited and stated that introducing "only those persons with a potential interest in investing" implied a prescreening of potential investors to determine eligibility and preselling of the investment to gauge investors' interest.

However, the SEC did not distinguish Brumberg's behavior from Anka's, who provided the names of investors that he believed were interested in investing in the issuer.

What is apparent in the Brumberg letter is the SEC's heightened concern over transaction-based compensation. In the Anka no-action letter, the SEC was silent on Anka's transaction-based compensation other than to note that it would be disclosed to investors.

In the Brumberg no-action letter, the SEC focused on the transaction-based compensation as a critical factor, stating that "the receipt of compensation directly tied to successful investments" in the issuer by investors introduced by Brumberg "would give [Brumberg] a 'salesman's stake' in the proposed transaction and would create heightened incentive for [Brumberg] to engage in sales efforts," requiring registration.

## **Conclusion**

Independent capital finders are necessarily in the business of actively finding potential investors for multiple issuers. Accordingly, half the Hansen factors militate in favor of requiring registration as a broker.

To avoid running afoul of the remainder of the Hansen factors, capital finders should limit their role in the investment decision-making process.

Specifically, capital finders should (1) avoid participating in negotiations between the issuer and the investor, (2) not make valuations of the merits of the investment, (3) not advise the investor on the investment, and (4) not handle investor's money or otherwise participate in closing mechanics.

Most importantly, and most challenging, capital finders should avoid the receipt of transaction-based

compensation, a hallmark of broker-dealer activity that compels registration.[14]

Capital finders who are committed to transaction-based compensation should strongly consider registration with the SEC if engaged in interstate activity, or the relevant state if engaged solely in intrastate activity.

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[1] 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, File No. S7-13-20, Securities and Exchange Commission Release No. 34-90112, October 7, 2020, 2020 SEC LEXIS 4555 at \*3-4 (internal citations omitted).

[2] Id. at \*4. (Internal citations omitted).

[3] Id. (Internal citations omitted).

[4] Litigation Release No. 25443 (July 13, 2022).

[5] Litigation Release No. 25444 (July 15, 2022).

[6] 15 USC §78o(a)(1).

[7] 15 U.S.C. §78c(a)(4)(A).

[8] 15 U.S.C. §78c(a)(10).

[9] SEC v. Howey Co., 328 U.S. 93, 298-99 (1946).

[10] 17 C.F.R. § 240.3a4-1.

[11] SEC v. Hansen, No. 83 Civ. 3692., 1984 U.S. Dist. LEXIS 17835, \*26 (S.D.N.Y. Apr. 6, 1984).

[12] Paul Anka, SEC Staff No-Action Letter (July 24, 1991).

[13] Brumberg, Mackey & Wall, P.L.C. Staff No-Action Letter (May 17, 2010).

[14] Brumberg No-Action Letter.