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CA: Private Offerings Using Non-Registered Broker/Dealers

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A new provision of the California Corporate Securities Law that became effective on January 1, 2005, raises the bar for companies raising money through equity offerings. This statute, Section 25501.5, provides that a person who purchases a security from or sells a security to an unlicensed broker/dealer may bring an action for rescission of the sale or purchase or, if the security is no longer owned by one of the parties, for damages. The statute further provides that the court in its discretion may award reasonable attorney's fees and costs to a prevailing plaintiff under the Section. The new law also provides for additional treble damages, up to a maximum of $10,000.

We anticipate that the new law, and the questions that it poses, will bring to fore an issue with which securities practitioners have long struggled " what is the exposure to the issuer of securities, if it engages a 'finder' or other financial intermediary that is not a registered broker/dealer"

I. Background

Most startups and early stage companies, in attempting to raise equity capital privately, do not have sufficient contacts themselves to find accredited or sophisticated investors, and accordingly seek the assistance of investment professionals or financial intermediaries to locate investors. These companies, however, which typically seek capital of less than $5 million, find it difficult to attract investment bankers who are registered broker/dealers, as such small

offerings are not economic for the broker/dealer. Consequently, early stage companies look to financial intermediaries who refer to themselves by a number of different titles (*e.g.*, investment bankers, merchant bankers, consultants, finders, etc.) that are not registered broker/dealers. This article addresses the risks faced by companies that use unregistered broker/dealers to access capital. [i]

II. The Finder's Exemption from Broker/Dealer Registration

Brokers and dealers in securities are required to register with the SEC. [ii] Similarly, each state has its own requirements for broker/dealer registration. Under federal law, a 'broker' is any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. [iii] A 'dealer' is a person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. [iv]

Section 15 of the Securities Exchange Act of 1934, as amended (the '34 Act) makes it unlawful for any broker or dealer to use the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of any security. [v]

Finders maintain they are not 'effecting' transactions in securities and are not therefore broker/dealers, because they merely, for a fee, 'find' and place in contact with one another buyers and sellers of securities. Although the exemption from broker/dealer registration of a finder has been recognized by Professor Louis Loss, [vi] it is generally a narrow exemption in light of SEC interpretations. [vii]

The SEC, in one no-action letter (Paul Anka, July 24, 1991), found an exemption from broker/dealer

registration for a finder who furnished, for a transaction-based fee, names of persons with whom he had had a preexisting relationship and whom he believed to be accredited investors. In finding the individual within the finder's exemption, the SEC noted that he had not previously been engaged in arranging financings and represented that he would not do so in the future.

The SEC's interpretation of the finder's exemption is predicated on the finder merely making available to the issuer, by introduction or otherwise, the identity of interested investors, and on the absence of the following factors, all of which tend to indicate broker/dealer activity:

Participation in negotiations

* Counseling investors of the merits of investing
* Recommending the investment to investors
* Receiving compensation based on a percentage of the offering proceeds
* Holding securities or cash
* Providing details of the financing to investors

[viii]

* Conducting sales efforts

Most finders' activities in raising money for the issuer include one or more of the above proscribed [ix] activities. Moreover, even under the Paul Anka interpretation, if the intermediary does not engage in any of these activities, he still may be engaged in the business of effecting transactions in securities, and therefore fall outside the 'finder's exemption,' if he receives transaction-based compensation more than once or twice in his career. More recent SEC no–action letters suggest that the staff is construing the 'engaged in the business' phrase even more narrowly than in the 1991 Paul Anka letter and may conclude that transaction-based compensation alone is sufficient to trigger the broker/dealer registration

[x]

requirement. In any case, it is difficult for small business issuers to be confident in obtaining private capital through the agency of non-registered finders without risk of being exposed to the consequences of using an unregistered broker/dealer. What then are the consequences to the company of using an unlicensed broker/dealer

III. Liability of Issuer for Compensating Unlicensed Broker/Dealer

Undoubtedly, under federal law, and now in California pursuant to Section 25501.5, an investor has a right of action against the unlicensed broker/dealer for violation of the broker/dealer registration requirement. An issuer may be liable on a theory of secondary liability, if the issuer knowingly assists or abets the violation of the broker/dealer registration requirement. We discuss below whether the investor may have a primary right of action for rescission or damages against the issuer for the unlicensed broker/dealer's violation of the broker/dealer registration requirements.

A. Right of Rescission: Voidability Statutes - Which Contracts May Be Rescinded

1. Federal Law Section 29(b) of the '34 Act

Section 29(b) of the '34 Act provides, in part:

> (b) Every contract made in violation of any provision of this title, and every contract heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title shall be void: (1)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, and (2)as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation.

Section 29(b) goes on to provide that any action brought 'by any person to or whom any broker or dealer sells or purchases, a security in violation of [the anti-fraud provisions] of Section 15(c)(1) or (2) must bring the action within one year of the discovery of such violation and within three years after the violation. Does 29 of the '34 Act invalidate a private offering arranged by a non-registered finder Section 29(b) has been interpreted to allow rescission by investors and by issuers of transactions [xi] in securities with unregistered broker/dealers. While the holding of these cases invalidated the agreement and transaction between the investor or the issuer and the non-registered finder, there is dicta in the Regional Properties case that the offering itself, as evidenced by the contract between the issuer and the investor, also could be invalidated by [xii] Section 29(b). On the other hand, it may be difficult to establish the requisite causal relationship between the injuries of the plaintiff purchaser of [xiii] securities to the finder's failure to register.

2. California Law Section 25501.5

Now, the addition of Section 25501.5 also raises the question of whether the investor who purchases a privately offered security from an issuer that pays a commission to an unregistered broker/dealer may seek rescission of his investment against the issuer under California law.

Section 25501.5 of the Corporate Securities Law of 1968 provides, in part:

> (a)(1) 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 the sale or purchase/secured from the commissioner a certificate authorizing that broker/dealer to act in that capacity, may bring an action for rescission of the sale or purchase or, if the plaintiff or the defendant no longer owns the security, for [xiv] damages.

Clearly, the statue provides a rescission remedy against the unregistered broker/dealer. What is not so clear is whether the investor can also seek rescission against the issuer. If the unlicensed broker/dealer acted as placement agent for the issuer, does this constitute a purchase of a security from an unlicensed broker/dealer?

In the typical corporate financing transaction, the unlicensed broker/dealer is a placement agent for the issuer, which is the principal in the sale transaction. Thus, the statute would seem ineffective, if it did not provide a remedy against the issuer. The situations in which the investor purchases securities directly from the unregistered broker/dealer acting as a principal in the transaction are few. For example, an underwriter in a public offering sells as a principal. A market maker of publicly traded securities also may sell securities as a principal from its own inventory. Lastly, there are certain securities in which the sponsor or promoter of the security is also a broker/dealer. It appears, however, that it is this last category of security that Section 25501.5 was intended to address specifically.

The Comments to the Assembly Floor Analysis to AB 2167 note that the bills sponsor, the Conference of Delegates of California Bar Associations, explained that the bill was designed to address the problem of 'bucket shops or boiler rooms' that engage in securities fraud and that, according to the Conference of Delegates, it specifically targets 'disreputable brokers who victimize consumers by operating illegally; unlicensed persons who sell products such as viaticals, mortgage pools, and pyramid or 'Ponzi' schemes; and persons licensed in a related field, like insurance, who sell securities to their existing clients without obtaining the proper securities licenses. However, except in the case of these unusual securities, where the seller of the security is the principal and falls within the definition [xv] of a broker-dealer and an issuer, most finders do not own the securities they sell they are acting as an agent of the issuer.

Nowhere in the legislative history is the issuer, or any other party other than the unregistered

broker/dealer mentioned. It thus appears from this legislative history, and the plain language of the statute, that the statute was intended to provide a rescission remedy in only those few instances where the unregistered broker/dealer acts as a principal. [xvi]

This interpretation is supported by the fact that in other states that have statutes with similar rescission remedies for violation of the broker-dealer registration requirements, the statutes identify very specifically other parties, including the issuer, that [xvii] are subject to rescission liability.

B. Right of Rescission '33 Act Registration/ Blue-Sky Qualification Provisions

Aside from the issue of invalidation of the offer under Section 29(b), another issue is whether the use of unregistered broker/dealers vitiates the issuer's exemption from the registration requirements under the Securities Act of 1933, as amended (the '33 Act) and the analogous state law qualification requirements for the issuer's sale of securities. If so, using an unlicensed broker/dealer will give rise to a statutory right of rescission for such registration/qualification violations.

1. General Solicitation

Most private offerings today are made pursuant to Rule 506 of Regulation D, as state blue-sky laws regulating the sales of securities sold in such offerings are pre-empted. Regulation D under the '33 Act provides a private offering exemption from registration under the '33 Act, provided the issuer does not use means of general solicitation or [xviii] advertising to find investors. In interpreting this requirement, the SEC's staff has stated that the existence of a pre-existing and substantive relationship is important in establishing an absence of general solicitation or advertising because it ensures that, prior to any offer by the issuer or persons acting on its behalf, the offeror can determine that the proposed investor has such

knowledge and experience in financial and business matters that he is capable of evaluating the merits [xix] and risks of the proposed investment.

If the issuer cannot develop 'pre-existing substantive' relationships with qualified investors, it may seek the assistance of broker/dealers whose business it is to build a customer base of qualified investors, with whom such pre-existing relationships may be [xx] attributed to the issuer.

[xxi] The SEC, in a series of no-action letters, has stated that the issuer, or persons acting on its behalf, must have established a substantive relationship with a potential investor before a private offering is commenced in order to avoid general solicitation. Thus, a selling agent must have, prior to commencement of any private offering, a coterie of qualified investors (either accredited investors or investors meeting the sophistication test of Rule 506 [xxii] (b)(ii)). But, with the exception of several matching services and networks, mostly non-profit [xxiii] [xxiv] entities, all of these no- *broker/dealers*.

Thus, if the issuer is relying on pre-existing relationships with potential investors established by the unregistered broker/dealer, the offering may not satisfy the requirements of Regulation D, giving rise [xxv] to a federal statutory right of rescission. Moreover, a private offering that does not satisfy the requirements of Rule 506 will be subject to state regulation, which similarly precludes general [xxvi] solicitation and may provide for longer statutes [xxvii] of limitation on rescission actions. In addition, many states' limited offering exemption expressly precludes the payment of commissions to persons who are not registered in the state as a broker/dealer.

2. Disclosure Requirements

Finally, if the issuer is deemed to have engaged in a general solicitation and violates the '33 Act registration provision, it can be subject to liability for failure to disclose the contingent liability resulting from the violation. Even if the issuer has not engaged in a general solicitation, the failure of an issuer to disclose that it is using an unregistered person might be considered a material fact that was required to be disclosed. [xxviii]

These questions may at best require embarrassing risk factor disclosures, and at worst cause delays or cancellation of the IPO. [xxix]

IV. Conclusion

Section 25501.5 does not appear to provide a rescission right against the issuer, and while it is relatively rare that an unlicensed broker/dealer sells its own security giving rise to a rescission right to its purchaser, the statute's ambiguity may discourage finders from helping small companies raise capital, and discourage issuers from using finders because of having to disclose that retaining a non–registered person as a finder may violate California law. Many small companies in Southern California raise equity capital through non-registered broker/dealers and finders, and such companies may now find that their private placement activities may subject them to substantial liability.

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[i] These risks and the impediments they pose to early stage capital formation recently have received increased attention by the Bar and small business community. A task force formed by the Business Law Section of the American Bar Association's Committee on Small Business recently recommended that the Securities and Exchange Commission (SEC), National Association of Securities Dealers (NASD) and North American Securities Administrators Association (NASAA) establish a simplified system of registration for unregistered financial intermediaries. See, Report and Recommendations of the Task Force on Private Placement Broker/dealers, ABA Section of Business Law (March 29, 2005) (ABA Task Force Report). Earlier, in 2003, the small business community made the same recommendation to the SEC at the SEC's 22nd Annual SEC Government-Business Forum on Small Business Capital Formation (December 2003).

[ii]
15 of the '34 Act.

[iii]
3(a)(4) of the '34 Act.

[iv]
3(a)(5) of the '34 Act.

[v]
15(c)(6) of the '34 Act.

[vi]
[A]lthough a *pure* finder may 'induce the purchase or sale of' a security within the meaning of 15(a), he is not normally a broker because he effects no transactions. *He merely brings buyer and seller together.* Louis Loss, *Fundamentals of Securities Regulation* at 609 (1988) (emphasis added).

[vii]
In numerical terms, perhaps more persons rely upon [the finder's] exception than on any other provision in the 1934 Act. It is the small businessman's exclusion and the basis upon which innumerable local consultants perform financial services for friends and associates without complying with the formal registration, record keeping [sic], and other requirements imposed upon brokers by 15 of the 1934 Act. The strict definition of a 'finder' is relatively narrow and would probably exclude, if tested, the majority who claim it as protection. Sheldon M. Jaffe, *Broker–Dealers and Securities Markets: A Guide to the Regulatory Process* 2.04, at 21 (1977).

[viii]
See, e.g., Richard S. Appel, SEC No-Action Letter, 1983 No-Act. LEXIS 2035 (Jan. 13, 1983); John DiMeno, SEC No-Action Letter, 1978 No-Act. LEXIS 2188 (Oct. 11, 1978).

[ix]
For an excellent discussion of the finders' exemption, see "The Finders" Exception from Federal Broker/dealer Registration, by John Polanin, Jr., Catholic University Law Review, Vol. 40, No. 4 (Summer, 1991).

[x]
See, Dominion Resources, Inc, SEC No-Action Letter, 2000 No-Act LEXIS 304 (March 7, 2000) (revoking its prior letter, Dominion Resources, Inc., SEC No-Action Letter, 1984 LEXIS 2511 (August 24, 1985)).

[xi]
See, e.g., Regional Properties, Inc. v. Financial & Real Estate Consulting Co., 678 F.2d 552, 558 (5th Cir. 1982); Eastside Church of Christ v. National Plan. Inc. 391 F.2d 357 (5th Cir.), *cert. denied sub nom.* Church of Christ v. National Plan, Inc., 393 U.S. 913 (1968). *See generally* Samuel H. Gruenbaum & Marc I. Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 Geo. Wash. L. Rev. 1 (1979).

[xii]
For example, in the Regional Properties case the court said: The statute does not in terms limit the class of persons who may invoke its contractual voidness provisions to investors. While the law was enacted to protect the public interest and the investor, [n17] its protection extends beyond those who buy securities. ***

Section 29(b) renders certain contracts void. It does not limit that invalidity to contracts between issuers and sellers or to those between issuers and investors. (678 F.2d at 561) (emphasis supplied); see, also, *Western Fed. Corp. v. Erickson, 739 F.2d 1439, 1443-44 n.5 (9th Cir. 1984).*

[xiii]
See, Sheldon M. Jaffe, *Broker/dealers and Securities Markets: A Guide to the Regulatory Process 2.05,* at 24 (1977) (citing Hayden v. Walston & Co., Inc, 528 F.2d 901 (9th Cir. 1975)).

[xiv]
Section 25501.5(b) provides that the court, in its discretion, may award reasonable attorney's fees and costs to a prevailing plaintiff under this section. Moreover, Assembly Bill 2167 stated that it extended the statute of limitations for actions under this section to within 5 years of the violation or within 2 years of the plaintiff's discovery of the violation, whichever comes first. However, Section 25506, which extended the statute of limitations for several other sections, did not include Section25501.5. Assembly Bill 2167 also extended the application of treble damages to an action under Section 25501.5 by amending Section 1029.8 of the Code of Civil Procedure to provide that any unlicensed person who causes injury or damage to another person as a result of performing services for which a license is required under, among other sections, Part 3 of Division 1 of Title 4 of the Corporations Code (Regulation and Notice Filing Requirements of Agents, Broker/dealers, Investment Adviser Representatives and Investment Advisers) shall be liable for treble the amount of damages assessed in a civil action, not to exceed $10,000.

[xv]
See, Corporations Code 25010 defining 'issuer.'

[xvi]
California's rescission statute (Civil Code 1691) provides that the party asserting rescission must promptly "[r]estore to the other party everything of value which he has received from him under the contract." But here the investor has not received anything from the unlicensed person, since the security purchased was from the issuer, not the unlicensed person.

[xvii]
See, Louis Loss and Joel Seligman, *Securities Regulation, Civil Liability*, 11-B-4, Voidability Provisions (3d, 2001).

[xviii]
Rule 502(c) of Regulation D provides in part: "Except as provided in Rule 504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

[xix]
J. William Hicks, Limited Offering Exemptions: Regulation D, 3.04 (West Group, 2000 2001 Edition).

[xx]
See no-action letters in footnote 21, below.

[xxi]
Arthur M. Borden (October 6, 1978); E.F. Hutton & Co., Inc. (December 3, 1985); Bateman, Eichler, Hill Richards, Inc. (December 3, 1985); and H. B. Shaine & Co., Inc. (May 1, 1987), in which the staff indicated tacit approval of use of an offeree questionnaire to establish a respondents sophistication and financial suitability.

[xxii]
Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) [must have] such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.

[xxiii]
Texas Capital Network, Inc. (Feb. 23, 1994); Colorado Capital Alliance, Inc. (May 4, 1995); Angel Capital Electronics Network (Oct. 25, 1996); Lamp Technologies, Inc. (May 29, 1997); Arizona Capital Network, Inc. (April 21, 1998); and IPONET (July 26, 1996), in which the SEC approved a procedure by a registered broker/dealer for private placements to accredited investors over the Internet whereby notice of a private offering in a password protected page of the broker/dealer's IPONET website would be accessible only to IPONET members who have previously qualified as accredited investors, where their solicitation was not linked to any pending or proposed offering and where a period of time has elapsed between member registration and participation in any private offering.

[xxiv]
In the SEC Interpretation: Use of Electronic and Internet Offerings, the SEC staff noted that internet private offerings by non-registered finders may pose regulatory concerns. SEC Release Nos. 33-7856, 34-42728 (May 4, 2000) (web site operators need to consider whether the activities that they are undertaking require them to register as broker/dealers.*** In other words, third-party service providers that act as brokers in connection with securities offerings are required to register as broker/dealers, even when the securities are exempt from registration under the Securities Act.). Presumably, the staff's position that registered broker/dealers can better perform this function than non-registered finders is predicated on the greater control of registered brokers, who have been trained to determine suitability of investors, are subject to fiduciary obligations, and are regulated by the NASD and the SEC.

[xxv]
See 12(a)(1) of the '33 Act.

[xxvi]
For example, California Corporations Code 25102(f).

[xxvii]
For example, California's 25506 which provides for a 5−year statute of limitations on violations of 25501, 25502 and 25504 after January 1, 2005.

[xxviii]
The ABA Task Force Report notes that the failure to accurately disclose compensation to an unregistered financial intermediary on Form D will almost certainly be found to be a material non-disclosure, and a fraud claim will lie for that omission. ABA Task Force Report at p. 42.

[xxix]
For example, Item 26 of the SEC registration form SB-2, and by cross reference Item 701 of Regulation SB, require disclosure of all securities sold privately by the issuer within the past three years, including the names of the

principal underwriters, total underwriting discounts and commissions and the section of the '33 Act or SEC rule under which the issuer claims an exemption from registration. It is here where the issue whether the underwriter or placement agent is a registered broker/dealer is likely to arise. State securities regulators also review Form Ds filed to determine whether commissions have been paid to unlicensed persons.