

Raising Capital or Facilitating Acquisitions?

Beware of Broker-Dealer Issues



By Jeffrey C. Hart

Do you help businesses raise debt or equity capital in exchange for fees? Are you compensated for matching buyers and sellers in business acquisitions? If so, you may need to register as a broker-dealer under applicable securities laws. Many individuals, consulting firms and small investment banks are unaware that engaging in capital raise and acquisition activities for third parties may require them to register as broker-dealers with the Securities and Exchange Commission (the “SEC”). The failure to register can result in the inability to enforce fee obligations, the imposition of government sanctions and fines and a prohibition on future securities and acquisition activities.

Section 15 of the Securities Exchange Act of 1934 (the “Exchange Act”) requires a person acting as a “broker” or a “dealer” in securities to register with the SEC. Both brokers and dealers are persons who are “engaged in the business” of buying and selling securities. Brokers arrange securities transactions for others, whereas dealers purchase and sell securities for their own accounts.

For purposes of the Exchange Act, persons are “engaged in the business” of buying and selling securities if they demonstrate a “regularity of participation” in such transactions. A person’s participation in a single, isolated transaction is insufficient to require registration. Nevertheless, the SEC and the courts interpret the phrase “engaged in the business” broadly. Generally, if a person engages in more than one broker-dealer transaction, this part of the broker-dealer definition is satisfied.

The courts and the SEC have identified a number of business practices that constitute broker-dealer activity. These so-called “badges” of broker-dealer activity include, but are not limited to: (1) actively soliciting buyers or investors for a business; (2) advising buyers or investors as to the merits of a securities transaction; and (3) actively participating in the negotiation or execution of a securities transaction. If a person engages in any of these activities (e.g., a private placement of securities or a business acquisition structured as a stock sale or merger) and receives transaction-based

compensation (e.g., a commission based on the size of the transaction or a success fee), the person likely must register with the SEC as a broker-dealer.

A person may attempt to refer to himself or herself as a “finder” and therefore claim an exemption from the broker-dealer registration requirements. The term “finder” is ambiguous and it is greatly misused in the private placement and investment banking industry. A finder’s activities simply fall outside scope of the broker-dealer definition, as there is not a recognized “finder” registration exemption. Typically, a finder merely locates a buyer or an investor for a business for a flat or hourly fee. After making an introduction, a finder does not conduct due diligence, perform a valuation, participate in structuring the transaction or in negotiations, provide advice to parties, or otherwise facilitate a closing. If a person’s activities fall within the broker-dealer definition described above, registration is required regardless of the label used.

The failure to comply with broker-dealer registration requirements may result in a variety of penalties. First, the SEC may take injunctive or disciplinary action against an unregistered person. Second, the SEC may deny future broker-dealer registration to an offending party. Third, a willful violation of the Exchange Act can lead to criminal prosecution and sanctions. Fourth, unlawful non-registration may give rise to private litigation. Finally, an unregistered broker-dealer may be subject to penalties under state securities laws. For example, California recently adopted a law that increases the risk to unregistered broker-dealers by, among other things, (1) providing an express right of rescission to investors purchasing from an unlicensed broker-dealer, and (2) permitting an investor to sue the unregistered seller for treble damages plus attorney fees and costs.

If you or your firm engage in activities that may trigger the Exchange Act’s broker-dealer registration requirements, you should seek legal advice as to your obligations under applicable law.

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