

LEGAL UPDATE

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By: Stephen M. Goodman

SEC SAYS AGAIN: TRANSACTION-BASED COMPENSATION TRIGGERS REGISTRATION REQUIREMENT

For many years, people who assist companies either in finding investors or a purchaser for the business have been advised that, if they only make introductions and do not otherwise participate actively in the transaction, they should be able to avoid registering as a broker under Section 15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Until a recent no-action letter, this was thought to be true even if the financial intermediary received a percentage of the amount raised as compensation, since the simple act of making introductions did not appear to involve being "in the business of effecting transactions in securities."¹

As noted in the 2005 Report of the American Bar Association's Task Force on Private Placement Broker-Dealers,

Although no single factor is dispositive of the question of whether a finder is engaged in the activities of a broker-dealer, SEC no-action letters reveal a variety of factors that are typically given some weight by the staff including: (1) whether the finder was involved in negotiations; (2) whether the finder engaged in solicitation of investors; (3) whether the finder discussed details of the nature of the securities or made recommendations to the prospective buyer or seller; (4) whether the finder was compensated on a transaction-related basis; and (5) whether the finder was previously involved in the sale of securities and/or was disciplined for prior securities activities.²

¹ Section 3(a)(4) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), defines "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others."

² Available at <http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf>.

Although all of these factors have played a role in the staff's interpretations of who is a broker, transaction-based compensation has frequently elicited special concern. The staff has frequently stated that such compensation gives the finder a "salesman's stake" in a securities transaction.³ However, in most instances where such compensation was present, other factors also seemed to contribute to the SEC's refusal to grant relief from the registration requirements.

Now the SEC has issued a no-action letter, *Brumberg, Mackey & Wall, P.L.C.*,⁴ in which it seems to reject in the strongest possible language the possibility that an unregistered finder can be compensated based on the amount raised, even when none of the other factors are present. In a fact scenario that could be considered very typical, the SEC refused to give assurance that it would not take action against the finder, basing its position almost exclusively on the fact that the firm was receiving transaction-based compensation.

According to the request for no-action, *Brumberg, Mackey & Wall* ("BMW") was a Virginia law firm which did not practice securities law and was not otherwise engaged in activities involving securities. The firm proposed to assist Electronic Magnetic Power Solutions, Inc., a Tennessee corporation ("EMPS"), in finding financing. Their role "would be limited to the introduction of EMPS to a limited number of its contacts who may have an interest in providing funds for financing the operations and development of EMPS." The letter recited that BMW would specifically not engage in negotiations

³ Herbruck, Alder & Co., SEC No-Action Letter (June 4, 2002), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/herbruckadler050302.htm>.

⁴ *Brumberg, Mackey & Wall, P.L.C.*, May 17, 2010, available at <http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf>

with contacts, would not provide them with information about EMPS and would not be involved in advising anyone regarding any agreement to provide funding.

Nevertheless, as noted, the staff refused to grant the no-action relief requested. The staff asserted that transaction-based compensation is “a hallmark of broker-dealer activity”.⁵ As to BMW’s description of its role as introducing EMPS to a limited number of its potential investors, the staff took the position that these activities implied that BMW was anticipating both “pre-screening” potential investors for eligibility and “pre-selling” the securities to gauge their interest. Therefore, although this fact situation was very different from the one in *Herbruck, Alder & Co.*,⁶ the staff repeated its assertion from *Herbruck* that the receipt of transaction-based compensation “would give BMW a ‘saleman’s stake’ in the proposed transactions and would create heightened incentive for BMW to engage in sales efforts.” Having earlier stated that “[a] person receiving transaction-based compensation in connection with another person’s purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer”, the staff concluded that BMW’s proposed activities would require broker-dealer registration.

This letter seems to undercut reliance by finders on the very narrow exemption allowed in the staff’s *Paul Anka* letter.⁷ There, Mr. Anka had invested in the Ottawa Senators Hockey Club Limited

⁵ The staff cited Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration, Securities Exchange Act Release No. 61884 (April 9, 2010) (“Indeed, the receipt of transaction-based compensation often indicates that such a person is engaged in the business of effecting transactions in securities.” (internal citation omitted)) and a letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Thomas D. Giachetti, Stark & Stark, regarding 1st Global, Inc. (May 7, 2001) (reiterating the staff’s position that “the receipt of securities commissions or other transaction related [sic] compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of ‘broker’ or ‘dealer’ ... generally is required to register as a broker-dealer.” (internal citations omitted)).

⁶ See note 3 above.

⁷ Paul Anka, SEC No-Action Letter (July 24, 1991).

Partnership and had also agreed to introduce potential “accredited investors” to the Senators. In the original request for no action, Mr. Anka was to contact the potential investor, give the issuer’s name and the price of the securities offered. He would also disclose his interest in the company and the fact that he would receive a finder’s fee. If the investor expressed interest, Mr. Anka would forward the name to the Senators, who would then conduct all further discussions with the investor.

The staff, however, apparently refused to confirm that even this limited activity would afford an exemption from registration, because a second request was submitted which indicated that, instead of Mr. Anka’s contacting the investors directly, he would submit to the Senators the names of potential investors “with whom he has a preexisting personal and/or business relationship and whom he thinks may be interested” in the investment. Someone from the Senators would then contact the investor, advising that the contact was at Mr. Anka’s suggestion. Apparently on the basis of this change, the staff agreed to grant no-action relief.⁸

If the specific facts of the *Paul Anka* letter do not fit, then *Brumberg, Mackey* seems to mandate that a finder avoid transaction-based compensation if it wants to avoid the risk that registration may be required. In at least one letter, *Colonial Equities Corp.*,⁹ the staff agreed to take no action after the compensation payable by a registered broker-dealer to multiple finders was changed from a percentage of the net brokerage commissions generated from sales. Instead, Colonial proposed to pay each finder a flat fee for each questionnaire it submitted from a prospective investor and, if the investor was found by Colonial to be suitable, an additional flat fee for arranging an introduction to the investor. In each case, the fee was

⁸ The staff also noted that Mr. Anka “has not previously engaged in any private or public offering of securities (other than buying and selling securities for his own account through a broker-dealer) and has not acted as a broker or finder for other private placements of securities. [Also,] he does not intend to participate in any distribution of securities after the completion of this proposed private placement.” BMW, although stating that it was not in the securities business, did not affirmatively state that their proposed engagement EMPS was expected to be unique.

⁹ *Colonial Equities Corp.*, SEC No-Action Letter, 1988 WL 234557 (June 28, 1988)

payable regardless of whether the investor actually made the investment.¹⁰

The very strong language used in the *Brumberg, Mackey & Wall* letter may be motivated in part by the increased scrutiny being given to the financial services industry across the board as a result of the recent industry crisis.¹¹ The staff may be trying to remind finders that the stakes have gotten higher in the current regulatory environment. In any event, it is clear is that the staff continues to view the receipt of transaction-based compensation as a strong indicator that the finder is acting as a broker within the meaning of the Exchange Act and therefore the finder should either affiliate with a registered broker or itself register as a broker.

Please feel free to contact the following members of our securities and corporate finance group if you have questions or wish to discuss the issues raised by this alert:

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The foregoing is intended to summarize the Healthcare Reform – Research Stimulus Provisions, and does not constitute legal advice. Please contact the Pryor Cashman attorney with whom you work with any questions you may have. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen M. Goodman at (212) 326-0146.

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¹⁰ Colonial’s proposal indicated that the fees would be uniform for all finders but might be adjusted up or down once every twelve months on a prospective basis, depending on its “cost-benefit analysis” of the services provided. The staff granted no-action relief based in part on “the fixed nature, uniform application and limitations on adjustment” of the proposed compensation arrangements.

¹¹ It is also noteworthy that in November, 2009, the SEC approved rule changes by the Financial Industry Regulatory Association (FINRA) allowing individuals whose activities are limited to investment banking to take a new Series 79 examination instead of the broader Series 7 examination. FINRA Regulatory Notice 09-41, effective November 2, 2009, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119461.pdf>.

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Mr. Goodman has been responsible for negotiating and documenting the following representative transactions:

- On behalf of a multi-national professional publishing company, acquisitions of the stock or assets of more than thirty targets, in transactions ranging in value up to \$1 billion, including acquisitions involving counsel in multiple jurisdictions, auction transactions and several involving friendly tender offers for the stock of publicly-traded companies
 - On behalf of a development stage biotechnology company, a private financing of \$8.4 million to advance a client's two lead drug programs and a "double-dummy" reverse merger a second biotechnology company, creating a single company with multiple drug programs which has been purchased by a public pharmaceutical company for more than \$100 million
 - On behalf of an early pioneer in internet music delivery, two private preferred equity financings, the second led by a major hedge fund
 - On behalf of a company developing compounds believed to have wound-healing and other regenerative properties, acquisition of a portfolio of patents for certain compounds together with clinical trial data filed with regulatory agencies related to these compounds
 - On behalf of a public company in the field of monoclonal antibody research, an initial and a secondary public offering
 - On behalf of a company in the field of RNAi therapeutics, acquisition of an entire division of a company engaged in RNAi research for influenza
 - On behalf of a warehousing logistics software company, a set of master documents for licensing and maintaining the company's software
 - On behalf of a company offering menu-driven iPod applications for foreign language translation, a license to utilize voice recognition software to enhance the utility of its programs
 - Multiple licenses for the use of university or research institute technology, including a license for exclusive worldwide rights to patents and patent applications covering a naturally occurring peptide and its derivatives in the fields of obesity, appetite suppression, reducing food intake, inducing weight loss and inducing satiety and another for a compound with potential for treating various conditions of the central nervous system, including addiction
 - A Feasibility Study, Option and License Agreement for the development of a client's lead drug candidate for moderate-to-severe pain
- Agreements with major textbook publishers for conversion of print or electronic textbooks into interactive formats utilizing client's proprietary software and coding

Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.