BUSINESS BROKERS ACTING AS BROKER-DEALERS OR UNDERWRITEERS

The United States Supreme Court has held that the sale of a controlling interest in a business affected by the sale of its stock constitutes a securities transaction. Accordingly, the transaction is entitled to the protection of the federal securities laws. This paper addresses broker-dealer registration requirements under the Exchange Act and the applicability of state blue sky laws to business brokers.

The recurring theme under federal and state law to determine if a business broker will be required to register as a broker-dealer or agent is whether he satisfies both the "engaged in business" and "effecting transactions" requirements of a securities broker-dealer or agent. The law which has emerged in this area has resulted primarily from pronouncements by the SEC staff.

The "engaged in business" requirement implies either holding oneself out as available to perform or actually performing repeated securities transactions. Although the definition of broker does not share the "regular business" language with the definition of a dealer, it appears that more than isolated transactions are required before one must register as a securities broker.

In applying the "recurrence test," the SEC in its no-action letters has uniformly held that registration is not mandated under section 15(a)(1) of the Exchange Act if a person has never participated in securities transactions and does not anticipate making any further securities offerings.

The SEC staff has stated that section 15(a) of the Exchange Act requires registration of a person who has had prior experience as a securities salesman and might become involved in future offerings.

The regularity and frequency of turnover is a decisive factor in the broker-dealer status determination. For example, a person who had repeatedly sold interests in real estate ventures to investors as part of a real estate business was held to be a "dealer" and, therefore, was required to register.

It is apparent that a person may be required to register as a broker-dealer although a person's securities activities neither constitute his principal business or principal source of income. In addition, advertising by a person or entity may evidence being "engaged in business." Holding oneself out as available or interested in trading through general advertising can bring one within the "engaged in business" test.

Typically, there are five activities conducted by business brokers which may bring one within the definition of a broker-dealer or agent: (1) acting as a finder; (2) consulting independently with an issuer; (3) channeling customers to broker-dealers; (4) sharing in broker-dealer compensation; or (5) maintaining custody or possession of customers' funds or securities.

Generally, a finder brings together two entities interested in forming a business combination. The services of finders may vary from case to case. If a finder merely brings the parties together with no involvement in negotiating the price or any of the other terms of the transaction, he will not be acting as a broker. On the other hand, **a business broker acting as a finder will be deemed to be a**

broker if he participates in negotiations by advising on questions of value or performs other acts to facilitate the transaction.

The SEC staff has taken the position that individuals who do nothing more than bring merger or acquisition-minded persons or entities together and do not participate in negotiations or settlements probably are not brokers or dealers. On the other hand, persons who play an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally are deemed to be either a broker or dealer .

The SEC staff has addressed whether a business broker was required to register as a broker under section 15(a) of the Exchange Act.

The staff did not recommend enforcement action against the business broker even though the broker entered into listing agreements with businesses to sell the assets of these companies, advertised the assets of these companies, provided information supplied by the seller to prospective buyers, assisted in negotiations by transmitting documents between parties, and collected a commission based on the selling price. In taking this position the staff noted that a business broker need not register because: (1) he had a limited role in negotiations between the seller and buyer; (2) the businesses involved were going concerns; (3) only assets were advertised; (4) transactions effected by sales of securities would involve the sale of all the equity to one buyer or a group formed without the business broker's assistance; (5) no advice was rendered by the business broker as to whether to issue securities nor did it assess the value of securities sold; (6) the compensation did not vary according to whether the form of the transaction was an asset or stock sale; and (7) the business broker did not assist the buyers in obtaining financing, except that it could, at the parties' request, provide a list of potential lenders.

To avoid broker-dealer status, an independent consultant must not assist or supervise the sales efforts . The consultant must limit his activities to advising the issuer on how to develop the offering.

In *Church Of Christ v. National Plan, Inc*., the court of appeals held that the evidence conclusively established that the defendant was a securities broker where the defendant: (1) assisted the issuer in doing all of the legal work concerning the offering; (2) completed all necessary printing; (3) handled all of the paper work in connection with the offering; (4) served as fiscal agent and trustee of the offering; (5) put on programs relating to the offering upon . The SEC staff held that a consultant retained to develop a proposed business plan of a new corporation, including the program for offering securities, need not register as a broker-dealer.

However the SEC staff concluded that registration would be required where a firm engaged in the following activities: (1) conducted a feasibility study to structure the issuance of securities; (2) prepared an outline for the issuer with recommendations relating to the issue; (3) searched out and obtained a registered broker-dealer to act as managing underwriter; (4) prepared the registration statement and handled its processing; (5) assisted broker-dealers and their representatives in analyzing and developing marketing techniques with respect to the offering; (6)

provided training programs for representatives of the broker-dealers upon request; and (7) received a commission based on the size of the offering.

In determining whether a person is a broker-dealer, the SEC staff has also examined whether the compensation is fixed as opposed to being transaction-based. The SEC has concluded that attorneys, accountants, insurance brokers, and financial service organizations "who for a fee assist promoters or other issuers in the sale of securities" are considered to be brokers if they have been "retained by an issuer specifically for the purpose of selling securities to the public and generally receive transaction-based compensation." However, the SEC staff held that registration was not required where a company received negotiated fees relating to "the overall size of the financing that the client wished to arrange, which generally would not be payable unless the financing clods successfully."

The conduct of a business broker may bring him within the definition of an "underwriter" if his services result in "participation in the undertaking rather than that of a mere interest in it."

Section 2(11) of the Securities Act of 1933 defines underwriter to include "any person who ... offers or sells for an issuer in connection with the distribution of any security, or participates or has a direct or indirect participation in any such undertaking .... Thus, a business broker may be deemed an underwriter if his services include effecting a public distribution of securities or the solicitation of indications of interest to purchase securities.

In a 1974 no-action letter, the SEC took a no-action position on a finder whose activities included introducing parties to negotiate acquisitions of businesses or assets. The finder did not become involved in the negotiations of parties or evaluation of the proposed transaction. However, the SEC indicated that if the finder's business included solicitation of investors' indications of interest in a security, the finder would be deemed an underwriter as defined in section 2(11) of the Securities Act.

The sale of a security by a unregistered broker-dealer or agent may result in both civil and criminal liability for the broker-dealer or agent and the issuer or seller.

The civil remedies available to a purchaser of securities from an unlicensed broker-dealer may be classified into three categories: remedies at common law; express or implied remedies under federal law; and express or implied remedies under state blue sky laws. In addition to the civil remedies, the Securities and Exchange Commission as well as the Commissioner of Securities for the relevant state is empowered to obtain injunctions against unregistered persons engaging in securities brokerage activity. Moreover, the Securities and Exchange Commission and the state Commissioner of Securities

The courts are divided about whether there is an implied right of recovery under the Exchange Act for buyers or sellers of securities when a broker or dealer fails to register under section 15(a) of the Act. Section 15(a), by its terms, does not mandate express liability for its violation.

Hence, courts have generally held that there is no private right of action for violations of section 15 of the Exchange Act.

If the commissioner has reason to believe that any security is being or has been offered or sold in this state by any unlicensed person in violation of this chapter or any rule or order hereunder, the commissioner may by order summarily prohibit such person from further offers or sales of securities in this state until licensed.

“It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.” 15 U.S.C. § 78a (l). By contrast, courts have held that a private cause of action can be founded upon section 29(b) of the Act. Section 29(b)provides: [e]very contract made in violation of any provision of [the Act] ... and every contract ... the performance of which involves the violation of ... any provision of [the Act] ...shall be void ... as regards the rights of any person who, in violation of any such provision ... shall have made or engaged in the performance of any such contract.”

Section 29(b) of the Exchange Act permits a party to a contract to seek rescission if he can show that "(1) the contract involved a 'prohibited transaction' [under the Exchange Act], (2) he is in contractual privity with the defendant, and (3) he is 'in the class of persons the Act was designed to protect.' Notwithstanding the courts' refusal to imply a private cause of action under section 15(a), courts have held that section 29(b) creates an implied private cause of action for rescission or similar equitable relief 135 Consequently, a section 29(b) claim can be based on an Exchange Act provision that does not contain private rights of action but the ordinary equitable defenses of estoppel, waiver, and laches are applicable. *In Regional Properties, Inc. v. Financial & Real Estate Consulting Co.,*

In determining whether injunctive relief is warranted under the federal securities laws, courts have examined whether "there is a reasonable likelihood of further violation in the future."

Addressing this issue in the context of a broker-dealer's failure to register, a district court examined the following factors: (1) the likelihood of future violations; (2) the degree of scienter involved; (3) the sincerity of defendant's assurances against future violations; (4) the isolated or recurrent nature of the infraction; (5) defendant's recognition of the wrongful nature of his conduct; and (6) the likelihood, because of defendant's professional occupation, that future violations might occur.1

Given the unregistered broker's history of securities law violations, the court granted a permanent injunction.

Although the degree of scienter may be a factor as to whether an injunction should be issued, it has been held in a case involving a claim for injunctive relief, that section 15(a)(1) contains no language from which a scienter requirement may be derived.

Courts have also enjoined a person from advertising when such conduct would cause the person to qualify as a broker-dealer. For example, a person who advertised in a newspaper with interstate circulation that he could save customers seventy percent on their brokerage commissions and that no commissions would be charged if the customer maintained a $500 balance in his account was enjoined for not registering as a broker-dealer.'

Section 15(b) (4) of the Exchange Act sets forth the Commission's authority to institute disciplinary proceedings against broker-dealers.

Under this section the Commission may order any of the following for a willful failure to register: (1) censure; (2) limitations on activities, functions or operations; (3) suspension of registration for a period not to exceed twelve months; and (4) revocation of registration. In addition, the Commission may order any of the above if one is permanently or temporarily enjoined from acting as a

As previously noted, a purchaser of securities may seek rescission under section 29(b) of the Exchange Act. Thus, a rescission action under section 29(b) based upon a section15(a) violation will have a greater impact on a seller or an issuer than the broker-dealer if it results in the business sale being voided. Although a purchaser of securities can obtain equitable relief against an issuer or seller, it is doubtful that money damages can be obtained.

Moreover, given the absence of an implied right of action under section15(a), it is unlikely that a purchaser of securities could rely on section 20(a) of the Exchange Act to impose liability on a seller of a business. Section 20(a) provides that a controlling person may be jointly and severally liable with the controlled person for securities violations under certain circumstances.

However, the common law action of respondent superior may be available to a purchaser of securities against a seller or issuer if an unlicensed broker-dealer was engaged to sell a business. The client needs to minimize the scope of activities in connection with the sale of a business. This may be accomplished by merely introducing the parties and not engaging in substantive business

If the business broker has passed the required NASD exams, he may be licensed in the state as an agent of the issuer and receive commissions without jeopardizing the applicable transactional exemption. In addition to the federal and state registration requirements, a broker-dealer is required to become a member of the appropriate self-regulating organization, such as the National Association of Securities (NASD). Broker-dealers that affiliate with the NASD are subject to NASD reporting and examination requirements.

The legislative history of the Exchange Act and state blue sky laws indicate an intent to regulate the competence and character of those effecting securities transactions. However, the characterization of those who engage in controlling interest business sales as securities brokers creates untoward

results, in that, *a purchaser of a business who is able to pursue a claim against a business broker for failure to register will also benefit by the strict liability imposed upon the seller or issuer of the business. Consequently, the purchaser of the business has effectively been granted a "put"* in the stock of the company during the civil statute of limitations.

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