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Family Office Insights
Broker-Dealer Registration and the Finder's Exception

As we have discussed in prior installments of our Family Office Insights, family offices are increasingly being presented with co-investment opportunities for a wide range of transactions, including private equity, real estate and debt finance. As transaction sponsors increasingly tap into the family office community for co-investment funding, we have seen circumstances in which they have sought to also tap into the family office connections of a "lead" family office to find additional co-investors, in exchange for a fee or some other financial consideration. In the context of a co-investment transaction that involves the sale of "securities," for US law purposes, family offices need to be mindful of the broad scope of US securities law as it relates to securities brokers and dealers. Specifically, in a transaction involving the sale of securities (whether an acquisition transaction in the form of a stock purchase, the acquisition of certain debt securities or otherwise), a family office that receives financial consideration by a transaction sponsor for identifying other co-investors should be mindful of the distinction drawn under US securities law between finders, whose activities do not require registration, and broker-dealers, whose activities can trigger registration requirements under federal and state law.

The Securities Exchange Act of 1934 (Act) requires a person or entity who acts as a broker or dealer of securities to register as a "broker-dealer." Registering as a broker-dealer can be an expensive and time-consuming process and subjects the registrant to a panoply of federal and state securities regulation.

Most people can easily determine whether they are acting as a broker or dealer of securities. The Act, however, provides little specific guidance for those who engage in activities where there is uncertainty. The Act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others," and a dealer as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." The term "person" includes entities as well as individuals. Whether a person is acting as a "dealer" or "broker" generally turns on whether the person is acting as a principal or agent in a securities transaction. Because parties who act as principals typically do so knowingly and intentionally, there are far fewer instances of persons inadvertently acting as unregistered dealers than persons inadvertently acting as unregistered brokers.

The wide purview of the phrase "business of effecting transactions in securities" makes it easy for parties who have tangential relationships to securities transactions to unknowingly fall within the definition of broker. Further, courts and the SEC interpret the definition broadly. The definition encompasses activities such as "providing advice regarding the value of securities, locating issuers, soliciting new clients, assisting in the structuring and negotiation of securities transactions, and disseminating quotes for securities."[1] Courts and the SEC have distinguished certain activities that do not require broker-dealer registration through court cases and SEC no-action letters. The cases most often turn on a party's level of involvement in the transaction and the form of compensation the party receives. Some frequently cited factors are "whether a person: (1) works as an employee of the issuer, (2) receives a commission rather than a salary, (3) sells or earlier sold the securities of another issuer, (4) participates in negotiations between the issuer and an investor, (5) provides either advice or a valuation as to the merit of an investment, and (6) actively (rather than passively) finds investors."[2] These factors do not make up a mechanical test, but merely provide guidelines for determining whether someone needs to register as a broker-dealer. One particularly difficult factual determination is whether a person involved in a securities transaction is merely acting as a finder and is, therefore, exempt from broker-dealer registration requirements.

Because of the nuances of securities transactions and the relationships of parties, courts and the SEC have not been able to clearly articulate what scope of activities or degree of participation in a transaction allows parties to fall within the "finder's exception" and avoid broker-dealer registration. Courts and the SEC have provided some guidance through case law and SEC no-action letters. In general, this guidance turns on whether a person merely brings the parties to a securities transaction together or whether the person takes a more active role in the transaction. Cases examine whether parties are involved in "key points in the chain of distribution" such as negotiations, financial analysis, discussing details of the transaction and recommending an investment. A typical scenario where the finder exception applies is when a person introduces investors to issuers or their promoters without further involvement in discussions between the issuer and the investor(s) and without giving any advice to investors about the investment. Despite the guidance available, the "finder" exception remains highly fact dependent.

1 InTouch Global, LLC, SEC No-Action Letter (November 14, 1995).

2 *S.E.C. v. Hansen*, 1984 WL 2413, *10 (S.D.N.Y.1984).

Something in particular that family offices should keep in mind is whether the office receives compensation for bringing parties to a transaction together. The form of compensation a party receives is often highly influential in the determination of potential broker-dealer status. Regulators look to whether the compensation paid to a transaction participant is tied to the success of the raising of capital. In other words, regulators are less likely to excuse a person receiving sales commissions, or "transaction-based compensation," from broker-dealer registration as a finder. In fact, the SEC has stated that "any 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."[3] The SEC's underlying concern is that "transaction-based compensation represents a potential incentive for abusive sales practices that registration is intended to regulate and prevent."[4] Although a common rule of thumb is that only percentage-based compensation, and not a flat advisory fee, is problematic, the SEC has found parties receiving a flat fee to be acting as broker-dealers and has found parties receiving a commission to be acting as finders. Additional factors the SEC considers include the frequency with which the party performs the services at issue and how frequently the party receives compensation for its services. If the party performs a service on a regular basis and receives consistent payments for that service, the SEC will be more inclined to find that party to be "engaged in the business of effecting transactions in securities." The SEC also looks at the relationship between the parties to the transaction and the circumstances that brought about the transaction.

Family offices should be mindful when structuring incentive arrangements with transaction sponsors to identify other potential co-investors, not to inadvertently enter into arrangements that could lead the SEC to believe they are acting like broker-dealers. Family offices can avoid the burdens of broker-dealer registration and regulatory scrutiny by taking a minimal role in the transaction and structuring the incentive arrangement in a way that does not resemble "transaction-based compensation." Good practice necessitates ensuring that any incentive arrangements are independent of the success of the transaction.

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3 See *S.E.C. v. Kramer*, 778 F. Supp. 2d 1320, 1336 (M.D. Fla. 2011) (quoting Brumberg, Mackey & Wall, P.L.C., SEC No–Action Letter, 2010 WL 1976174 (May 17, 2010)).

4 *S.E.C. v. Kramer*, 778 F. Supp. 2d 1320, 1336 (M.D. Fla. 2011).