PRYOR CASHMAN LLP

LEGAL UPDATE

April 2013 *By: Stephen M. Goodman, Bertrand C. Fry and Michael T. Campoli*

IS AN ISSUER RESPONSIBLE FOR THE ACTS OF ITS UNREGISTERED FINDER?

When a company seeks to raise capital, it may consider retaining "finders" that are not registered with the Securities and Exchange Commission (the "SEC") as broker-dealers.[1] Frequently, the proposed compensation arrangements involve paying the finder a percentage of the funds raised. The SEC has long taken the position that percentage-based compensation of this type almost invariably causes the recipient to be a "person engaged in the business of effecting transactions in securities for the account of others" and therefore a "broker" as defined under Section 3(a)(4) of the Securities Exchange Act of 1934 (the "1934 Act").[2] However, the courts have not been so quick to make this assumption. Instead the courts have looked at the actual activities engaged in by the individual or firm to determine if the recipient fits the definition or not, with the form of compensation considered merely one determinant.[3]

Because the SEC has refused to adopt the court's more nuanced approach to distinguishing between a "finder" and a "broker", almost any finder who is receiving a percentage-based commission runs the risk that the SEC may regard its activities as requiring broker-dealer registration under the 1934 Act. In a recent cease and desist order (the "Ranieri Order")[4], the SEC has now raised the threat that, at least in certain circumstances, if the finder is found to be a broker and has failed to register, as required by Section 15(a) of the 1934 Act, the finder's violation may form the basis for regulatory action against the company which engages the finder (the "Employer"), the issuer, and executives of the Employer to whom the finder reports.

In short, based on the Ranieri Order and a companion cease-and-desist order[5] (the "Stephens Order", and, together with the Ranieri Order, the "Orders"), if an issuer hires an unregistered finder, it appears that an Employer can no longer take a hands-off approach to the finder's activities, assuming that the finder will limit its activities to those not requiring broker-dealer registration -- even where the finder agrees in writing to such a restriction. Instead, the Employer and its affiliates and principals may now be forced to take affirmative steps to prevent and/or supervise the finder's contacts with prospective investors -- or risk liability as an "aider and abettor" of violations of federal securities laws.

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[1] This is frequently the case with those private investment funds, such as the ones involved in the SEC orders discussed in this Legal Update, which rely on the exclusions from registration as investment companies under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended.

[2] *See* Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf. For an extensive discussion of the issues raised by this no-action letter, see Stephen M. Goodman, *Vanishing Breed: The Narrowing Opportunities for Unregistered Finders*, 42 SEC. REG. & L. REP. 1911, Oct. 11, 2010.

[3] See, *SEC v. Kramer*, 778 F. Supp. 2d 1320 (M.D. Fla. 2011), *app. dismissed* (11th Cir., Dec. 2, 2011); *Maiden Lane Partners, LLC v. Perseus Realty Partners*, G.P., II, LLC, 28 Mass. L. Rep 380 (Mass. Super. Ct. 2011). See also, Stephen M. Goodman, *Still Room for Finders? Court Questions SEC View of Broker Activity,* 43 SEC. REG. & L. REP. 2312, Nov. 14, 2011.

[4] *In the Matter of Ranieri Partners LLC & Donald W. Phillips*, Release No. 34-69091 (March 8, 2013).

[5] *In the Matter of William M. Stephens,* Release No. 34-69090 (March 8, 2013).

BACKGROUND FACTS

According to the Orders, William M. Stephens (the "Consultant") was retained by Ranieri Partners LLC ("Ranieri Partners"), the holding company of an investment advisory firm, to assist Ranieri Partners in finding investors for two funds (the "Selene Funds").[6] Prior to this engagement, due to previous violations of federal securities laws in connection with the investment of pension fund assets, the Consultant had been barred from associating with any investment adviser. Furthermore, he was not registered a broker or dealer.

One of Ranieri Partners' senior managing partners, Donald W. Philips (the "Managing Partner"), was in charge of raising capital for the Ranieri Funds. A "long-time friend" of the Consultant, the Managing Partner twice arranged for an affiliate of Ranieri Partners to retain the Consultant as an "independent consultant" to find potential investors for the Selene Funds, first in February 2008, and again in 2010. These engagements, which apparently were memorialized in contracts prepared by Ranieri Partners' outside counsel, were offered to the Consultant despite the fact that the Managing Partner was (according to the SEC) "generally aware" of the ban on the Consultant's associating with investment advisers.

Terms of the Consultant's Engagement

In each instance, Ranieri Partners agreed to pay the Consultant a fee equal to 1% of all capital commitments made to the Selene Funds by investors introduced by the Consultant and apparently agreed to reimburse certain expenses incurred in connection with the Consultant's activities on behalf of the Selene Funds. Perhaps because he was aware of the risks in hiring a finder who was not a registered broker, the Managing Partner (and probably the contract) instructed the Consultant of the following limitations:

- His activities on behalf of Ranieri Partners were limited to contacting potential investors to arrange meetings for the principals of Ranieri Partners.
- He was not permitted to provide private placement memoranda ("PPMs") directly to potential investors. (He was told that Ranieri Partners controlled the distribution of PPMs for the Selene Funds.)
- He was not permitted to contact investors directly to discuss his views of the merits and strategies of the Selene Funds.

Notwithstanding the terms of their own restrictions, Ranieri Partners and the Managing Partner provided the Consultant with copies of executive summaries relating to the Selene Funds, including Ranieri Partners' investment strategy and its view of the distressed mortgage market and of its competitive advantages in its investment space. The Consultant was also supplied with PPMs, subscription documents, presentation materials, and Ranieri Partners' overall business plan.

The Managing Partner met weekly with the Consultant and others to discuss their progress in raising capital for the Selene Funds. Ranieri Partners also received the Consultant's requests for expense reimbursements, which included expenses for trips to meet potential investors that the Consultant took both with and without the Managing Partner or any other Ranieri Partners personnel.

Details of the Consultant's Activities

The SEC found that the Consultant's activities on behalf of the Selene Funds included the following:

- arranging and attending preliminary meetings between the Managing Partner and potential investors;
- providing several prospective investors with additional due diligence material, PPMs, and subscription documents relating to the Selene Funds;
- having direct contact with potential investors without the presence of personnel from Ranieri Partners, including via email, through which the Consultant provided additional marketing

[6] Ranieri Partners had established the Selene Funds with general partners which were also affiliated entities of Ranieri Partners.

glosses on potential investments in the Selene Funds[7];

- providing at least one prospective investor with a list of current and expected investors in the relevant Selene Fund, including the expected dates and amounts of the investors' respective capital commitments, together with an indication that this Selene Fund would impose a cap on the amount of capital commitments it would accept;
- hiring a subagent to solicit a state retirement system, and agreeing to share his percentage-based fee with the subagent;
- drafting correspondence for the Managing Partner's signature addressing key questions about the potential investment raised by an executive of a potential investor; and
- purporting to negotiate fee terms with respect to a potential investor's investment in a Selene Fund.[8]

SCOPE OF LIABILITY; PENALTIES

In the Stephens Order, the SEC had no difficulty finding that the Consultant's conduct constituted a willful violation of the 1934 Act. As noted above, the courts and the SEC diverge somewhat on the question of whether the receipt of percentage-based compensation of the type that the Consultant negotiated for itself (and for its subagent) is virtually dispositive of the question of whether the recipient is acting as an unregistered broker in violation of Section 15(a).[9] Normally, if a finder only makes introductions (i.e., does not participate in negotiations or otherwise do anything to "sell" a deal), the courts (although not necessarily the SEC) are reluctant to determine that the finder was acting as a broker, even if the finder's compensation is percentage-based. In this situation, however, it seems likely that the combination of the Consultant's "selling" activities and percentage-based compensation would cause the courts to reach the same conclusion as the SEC.

The SEC, however, went further. In the Ranieri Order the SEC found that Ranieri Partners caused, and that the Managing Partner willfully aided and abetted and caused, the Consultant's violations of Section 15(a). In arriving at these conclusions, the SEC pointed to the fact that the Managing Partner effectively enabled the Consultant in his solicitation activities by ignoring the stated restrictions on those activities, first by providing him with "key fund documents and information" which the Consultant then recirculated, and second by failing to limit the Consultant's extensive contacts and substantive communications with potential investors.

The penalty imposed on the Consultant was disgorgement of over $2.4 million plus interest. A $375,000 fine was imposed on Ranieri Partners[10] and it was barred from committing "or causing" any violations or any future violations of Section 15(a). The Managing Partner was likewise ordered to cease and desist from committing or causing such violations and was suspended for nine months from association in a supervisory capacity with any broker, dealer, investment adviser or the like. He also was required to pay a $75,000 fine.

[7] For example, the Consultant followed up after one meeting with a potential investor with an email that described participating in the relevant Selene Fund as "a rare opportunity to earn above market returns" and encouraged adjusting the prospective investor's asset allocation plan to take advantage of the opportunity. In another instance, the Consultant emailed the chief investment officer and another staff member of an endowment fund that was considering an investment in the later-offered Selene Fund that "returns to [the predecessor Selene Fund] have been strong and the outlook for [the current Selene Fund] looks real positive with Ranieri Partners taking on the role of market leader in the space."

[8] In the same email referred to in note 7 above to an endowment's chief investment officer and another staff member, the Consultant told the CIO that the endowment would pay a lower management fee if it made a commitment before the first closing date for the relevant Selene Fund.

[9] See text at notes 2 and 3 above.

[10] After the conduct in question, Ranieri Partners modified its policies and procedures to provide that it would not retain a third party, including a finder or marketer, that was not a broker or dealer or registered representative of a broker or dealer to market or place any security or investment in any security of any affiliate of Ranieri Partners. The Commission stated that it had considered the remedial efforts undertaken by Ranieri Partners in determining to accept Ranieri Partners' settlement offer.

ANALYSIS AND PRACTICE POINTS

The noteworthy aspect of these Orders is the SEC's decision to seek penalties for a finder's activities from the firm retaining the finder and that firm's senior executive officer. While it is possible that Ranieri Partners was held to a higher standard regarding supervision of its "independent consultant" due to its status as a regulated entity,[11] there is nothing in the Orders that specifically indicates that an unregulated firm, including an unregulated issuer, might not find itself similarly subject to substantial fines.

Where previously it appeared that the risk of acting as an unregistered finder was primarily the finder's, with the Ranieri Order the SEC seems to be saying that that risk is now shared by the issuer and any other person responsible for the offering. Thus, the issuer must now concern itself to a much greater extent with exactly how the finder behaves in the engagement. This task is complicated by the uncertainty of where exactly to draw the line between finders and brokers, forcing issuers to adopt a very conservative position if they wish to avoid trouble.

Consider, for example, if XYZ Corporation were to hire Joe Smith, an unregistered finder, to find investors to participate in a $5,000,000 private offering of XYZ's preferred stock. XYZ has prepared, in consultation with Mr. Smith, an offering memorandum and other documents describing the offering and the company. Mr. Smith, with a mandate to find potential investors for XYZ Corporation, naturally asks for substantial background information about XYZ – including, besides the offering memorandum, XYZ's business plans, marketing material, and financial statements. Mr. Smith arranges introductions to a number of investors and sits in on the initial meetings. Where investors have requested that he do so, Mr. Smith forwards XYZ's offering memorandum and some of XYZ's other materials to them.

At least two courts have felt that simply sitting in meetings and forwarding issuer material to potential investors does not automatically cause a finder to be acting as a broker (even with percentage-based compensation in the picture).[12] Nevertheless, in the Orders the SEC clearly views these activities as contributing to their findings of violations of the 1934 Act. Consequently, although Mr. Smith may have a good basis for taking the view that his activities are permitted for an unregistered finder, the SEC appears to have imposed a duty on XYZ to inquire about the extent of Mr. Smith's activities and to insist that they be limited only to those that the SEC regards as appropriate for persons who have not registered as a broker.

Thus, despite contrary court decisions and without a rulemaking procedure, the SEC has now raised the distinct possibility that an issuer's mere provision of its offering memorandum, business plans, and other due diligence material to an unregistered finder, with the concomitant risk that the unregistered finder will provide it to prospective investors, may constitute the basis for an aiding and abetting claim against the issuer. Again, taking the view of the courts which have addressed this issue, merely having contact with investors and forwarding them information from the issuer does not necessarily rise to the level of acting as a broker. Thus, in the situation that Ranieri Partners faced with the Consultant, the fact that the Managing Partner made the placement memoranda available to the Consultant and the Consultant distributed them to potential investors is arguably defensible, despite the fact the Managing Partner first told the Consultant that he could not distribute placement memoranda or contact investors directly and then ignored his own instructions.

Nonetheless, in light of the Ranieri Order, the mere fact that XYZ provides its offering memorandum or other marketing material to Mr. Smith and allows Mr. Smith to redistribute them seems to put XYZ at risk. The

[11] According to its Form ADV, Ranieri Residential Investment Advisors LLC, an investment adviser registered with the SEC, is more than 75% owned by Ranieri Partners, and is under common control with RREP Recovery Partners Manager LLC and WP Global Partners, Inc. (each of which is also an investment adviser registered with the SEC), Signature Bank (a bank); and Signature Securities Group Corporation (a registered broker-dealer).

[12] See *Kramer* and *Maiden Lane Partners*, supra note 5.

Ranieri Order appears to expand the list of activities that can be used to allege that one is acting as a "broker", and thus reduces the tasks for which XYZ can utilize Mr. Smith without risking a claim that it "caused" him to breach Section 15(a). Despite the fact that the SEC makes much of the Managing Partner's failure to supervise the Consultant, the Ranieri Order implies an SEC position that merely giving the Consultant access to the PPM and other materials and permitting him to forward them to investors constitutes "causing" a Section 15(a) violation. If this correctly states the SEC's view, even aggressive monitoring of the Consultant's use of those materials would not have prevented this accusation from being made against the Managing Partner and Ranieri Partners.[13]

However, whether access to and distribution of an issuer's offering materials would itself be sufficient to support a claimed Section 15(a) violation cannot be determined from the Ranieri Order because of other facts. Specifically, the Consultant had continuing personal and email contacts with the investors after the initial meetings (including meetings at which no representative of Ranieri Partners was present) and sent emails to various investors characterizing the investment as "a rare opportunity to earn above market returns", purporting to negotiate special fees for one particular prospective investor, and pressuring another investor by suggesting the offered fund would soon be closed to new investment. These are the type of selling activities that the courts, as well as the SEC, view as clearly crossing the line beyond which one is "in the business of effecting transactions in securities".

Nonetheless, if these are the activities which made the Consultant a statutory "broker", the SEC introduces a concerning precedent in finding that these activities were "caused" by the Managing Partner and Ranieri Partners. Here, the SEC relied primarily on the fact that the Managing Partner and Ranieri Partners had received the Consultant's expense requests reflecting his contacts with the investors.[14] According the SEC, those requests were sufficient to impute knowledge of the Consultant's broker-like activities to the Managing Partner and Ranieri Partners, and thus supported the conclusion that they contributed to the Consultant' bad behavior by looking the other way.

Thus, if an issuer decides to use an unregistered finder, it must confront two issues: first, will it make its offering materials available to the finder for redistribution and, second, how will it supervise the finder's contacts with potential investors. It may be that the difficulties inherent in managing those contacts make it too risky to make offering materials available to the finder, as the combination has now been shown to be fairly toxic. No issuer wants to find itself in the position of having to explain to the SEC why it did not prevent a finder's inappropriate contacts with prospective investors.

Thus, the Ranieri Order makes it difficult for an issuer to accept an unregistered finder's services without also accepting additional risk which may be challenging to manage. Allowing a finder to redistribute offering materials and not supervising the finder's other activities may now constitute new justifications for SEC enforcement actions against issuers who use such services. This result represents a significant change in the relationship between finders and those that retain them, or at least in the way that the SEC views this relationship. As the SEC has probably anticipated, this view will increase the pressure on issuers and others involved in launching and growing a company to retain only registered broker-dealers to assist in their marketing efforts.[15] Despite the courts' unwillingness to follow its lead, the SEC's efforts to eradicate unregistered finders continue.

[13] This approach may be intended to put teeth into the position taken by the SEC in its *Paul Anka* no-action letter (*Paul Anka*, SEC No-Action Letter, LEXIS 925 (July 24, 1991), where the finder was not even permitted to contact the investors, but could only turn over their names to the issuer for its own solicitation activities.

[14] There is no indication in the Ranieri Order that the Managing Partner and Ranieri Partners were aware of the content of the Consultant's emails. However, the SEC may have concluded that because they were aware that the extent of the Consultant's contact with the investors, they should have taken steps to determine whether in fact he was trying to influence their investment decisions.

[15] See, e.g., supra, note 10.

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The foregoing is merely a discussion of the SEC orders described. 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, Bertrand C. Fry at 212-326-0134 or Michael T. Campoli 212-326-0468.

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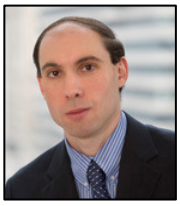

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