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How Well Do You Know Your Finder? ''Bad Actor'' Rules Add Further Risk

BY STEPHEN M. GOODMAN

Much has been written about the risks of using unregistered brokers or ''finders'' to raise capital. See, e.g., Stephen M. Goodman, *Vanishing Breed: The Narrowing Opportunities for Unregistered Finders*, 42 Sec. Reg. & L. Rep. 1911, Oct. 11, 2010; see also Richard B. Hadlow, *Capital Raising using Unregistered Finders and Financial Consultant*, Bloomberg Law Reports – Securities Law, Vol. 5, No. 30 (2011). Recent amendments to the Rule 504 and the Rule 506 exemptions from registration have created a further hurdle for issuers using brokers, whether registered or not. As a result of the amendments, an issuer's failure to determine whether the finder/broker is a ''bad actor'' may result in losing the exemption from registration for the offering. See *Exemptions to Facilitate Intrastate and Regional Securities Offerings*, SEC Release 33-10238 (October 26, 2016) and *Disqualification of Felons and Other ''Bad Actors'' from Rule 506 Offerings*, SEC Release 33-9414 (July 10, 2013) (''Adopting Release'').

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As noted in more detail below, the ''bad actor'' disqualification provisions (sometimes called ''bad boy'' rules) prohibit the directors, officers and significant shareholders of the issuer and others (such as underwriters and placement agents) from participating in exempt securities offerings if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or violations of other specified laws. The SEC had originally adopted ''bad actor'' disqualifications for Regulation A offerings (before the recent adoption of Regulation A+, which retained them), but only Rule 505 under Regulation D (17 CFR 230.505(b)(2)(iii) incorporated them by reference in Rule 505 to Rule 262 under Regulation A (17 CFR 230.262).

Before the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290) (''NSMIA''), only state disqualification provisions prevented violators from participating in Rule 506 offerings. However, when NSMIA was passed, states were preempted from enforcing those provisions against Rule 506 offerings. This raised the question whether federal disqualification provisions should be adopted to replace the state rules. The recent changes to Rules 504 and 506 provide the answer.

These changes raise a significant new risk for issuers that wish to engage in a private placement but that also

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wish to use finders. Many issuers have no interest in filing a registration statement covering the offering with the Securities and Exchange Commission (''SEC'') and incurring the ongoing costs of being a public company. According to a report by the SEC's Division of Economic and Risk Analysis at https://www.sec.gov/info/smallbus/acsec/private-securities-offerings-post-jobs-act-bauguess-022516.pdf, from 2010 to 2015 more capital was raised in offerings under an available exemption under the Securities Act of 1933, as amended (the ''Securities Act'') than in registered offerings.

Nevertheless, raising capital privately is frequently a frustrating experience for many small to mid-size businesses. Many do not have connections to high net worth individuals or institutions that would be likely to invest in their business, nor do they have the bandwidth to research who potential investors might be. Although there are registered broker dealers who will work on smaller transactions with such companies, many entrepreneurs find themselves dealing with unregistered brokers, commonly known as ''finders'', who offer to raise capital for the business in exchange for a percentage of the amount raised or other compensation similar to what a company would pay to a registered broker.

However, finders may be brokers even if that is not what they call themselves. Section 3(a)(4) of the Securities Exchange Act of 1934 (the ''Exchange Act'') defines ''broker'' to mean ''any person engaged in the business of effecting transactions in securities for the account of others.'' 15 U.S.C. § 78c(a)(4). Contacting investors, distributing material about a company or its securities offering or participating in negotiations of the terms of an offering, among other things, are all activities which have been considered as ''effecting transactions'' in securities, meaning that a finder who does these things is a broker for purposes of this statute. Furthermore, the SEC has stated that introductions of investors to an issuer may constitute broker-like activity, because it implies '' 'pre-screening' potential investors to determine their eligibility to purchase the securities, and 'pre-selling' [an issuer's] securities to gauge the investors' interest.'' SEC No-Action Letter to *Brumberg, Mackey & Wall, P.L.C.*, May 17, 2010, available at http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf. This same no-action letter stated, ''A person's receipt of transaction-based compensation in connection with [securities offerings] is a hallmark of broker-dealer activity.''

If a finder fits the definition of a broker but is not registered as a broker with the SEC and the Financial Industry Regulatory Association (''FINRA''), then the finder is in violation of Section 15(a)(1) of the Exchange Act which prohibits anyone from ''effect[ing] any transactions in, or . . . induc[ing] or attempt[ing] to induce the purchase or sale of, any security'' unless that person is registered. Much has been written about how such a violation may have consequences for the broker, the issuer and the particular offering. The broker may be subject to regulatory sanctions and fines and also risks the refusal by the issuer to pay the fees bargained for, because the enforceability of an ''illegal'' contract may be in question. See In re Thomas R. Stanley, SEC Release No. 33-10307 (February 13, 2017). The issuer who hired the finder may risk liability as an ''aider and abettor'' of violations of federal securities laws if the issuer fails to actively supervise the finder's contacts with prospective investors. See *In the Matter of Ranieri Partners LLC & Donald W. Phillips*, Release No. 34-69091 (March 8, 2013) and *In the Matter of William M. Stephens*, Release No. 34-69090 (March 8, 2013).

In addition, it has been argued that the presence of an unregistered broker in an offering could render the investor's purchase agreement voidable and that therefore investors may have the right to rescind the transaction and seek return of their funds. It should be noted that the author is unaware of any case or SEC pronouncement that has actually held that the use of an unregistered broker gives rise to such a rescission right. There is, however, certain case law which takes the view that an otherwise valid securities purchase agreement is not necessarily voidable solely because an unregistered broker was involved in the transaction. See *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 201 (3d Cir. 2001). But see *In re Neogenix Oncology, Inc.*, Case No. 12-23557 (TJC), United States Bankruptcy Court, District of Maryland (filed July 23, 2012) and *Neogenix Oncology, Inc. v. Peter Gordon, Mintz Levin Cohn Ferris Glovsky & Popeo P.C.* (CV 14-4427 JFB, AKT) (EDNY, 2017) (company files for bankruptcy when unable to raise funds because of accountant's ''going concern'' opinion based on contingent liabilities for rescission).

With the recent changes to Rule 504 and particularly Rule 506, an issuer has a much more specific, tangible risk to worry about. If there is a ''covered person'' involved in an issuer's securities offering and that person is the subject of a ''disqualifying event'', the issuer can no longer rely on the relevant exemption from registration. ''Disqualifying events'' include:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- Certain SEC cease-and-desist orders;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization;
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

Criminal conviction must have occurred within five years before the proposed sale of securities in the case of the issuer, its predecessors, and affiliated issuers, and within 10 years before the proposed sale of securities in the case of other covered persons. An injunction or restraining order must have occurred within five years before the proposed sale of securities. Other events must have occurred within the previous five years. Final regulatory orders must be based on a violation of law or regulation prohibiting fraudulent, manipulative, or deceptive conduct and issued within 10 years of the proposed sale of securities.

''Covered Persons'' include the issuer, any predecessor, and any affiliated issuer; any director, executive officer or other officer ''participating'' in the offering, general partner or managing member of the issuer; and any beneficial owner of 20% or more of the issuer's outstanding voting equity securities. In addition, any placement agent and other compensated solicitor, and each

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of its respective directors, executive officers or other officers involved in the private placement are subject to the rule. The disqualification also covers the investment managers (including sub-advisors), general partners or managing members of a fund, and their principals and officers.

Note that while ''finders'' are not specifically mentioned in the definition of ''covered persons'', the definition does include anyone who is a ''compensated solicitor'', defined as ''any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities.'' This would include a paid finder even if the finder's compensation is not calculated as a percentage of the amount being raised. The SEC has stated, ''All persons who have been or will be paid, directly or indirectly, remuneration for solicitation of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be, registered under Exchange Act Section 15(a)(1) or are associated persons of registered broker-dealers.'' Compliance and Disclosure Interpretations (Securities Act) (Last Update: April 19, 2017) (''CD&I''), Question 260.17. Therefore, if anyone is paid by the issuer to find investors and that person turns out to be a bad actor, the issuer will have lost the exemption from registration for that offering.

Rule 506(d) does provide one way in which an issuer can avoid such a loss even if the ''compensated solicitor'' is a bad actor. If the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that the finder's participation raised a question, then the exemption may be preserved. However, the SEC specifically refused to prescribe specific steps as being necessary or sufficient to establish reasonable care. Instead they indicated that ''the steps an issuer should take to exercise reasonable care will vary according to the particular facts and circumstances.'' Adopting Release p. 66. In any event, ''reasonable care'' requires that an issuer make a bona fide inquiry into the ''relevant facts''.

An issuer will have more difficulty doing an investigation of an unregistered finder than a registered broker, since FINRA maintains the BrokerCheck database recording various violations by registered brokers. See Adopting Release, n. 202 and associated text. And the Adopting Release acknowledges the challenges for issuers in establishing whether finders and other covered persons are the subject of disqualifying events, given that there is no central repository that aggregates information from all the federal and state courts and regulatory authorities that would be relevant in determining whether a finder has a disqualifying event in his or her past.

The Adopting Release suggests that ''factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicator suggesting bad actor involvement.'' Adopting Release p. 66 (emphasis added). In addition, the SEC has stated, ''An issuer may reasonably rely on a covered person's agreement to provide notice of a potential or actual bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification.'' CD&I, Question 260.14. However, if the circumstances give an issuer reason to question the truth or completeness of the responses to its inquiries, then the SEC indicates that reasonable care would require the issuer to take further steps to provide a reasonable level of assurance that no disqualifications apply.

Thus, an issuer that does not do a meaningful investigation of a finder may discover that it has lost the ability to rely on the Rule 506 exemption (or Rules 504, 505 or Regulation A if those were relied upon). In practical terms, at the very least, an issuer now needs to get a finder to represent that the finder (as well as each of its directors, executive officers or other officers involved in the offering) has not committed one of the disqualifying acts listed in the bad actor rules. Although in rare cases an issuer might argue that someone being compensated is not ''soliciting'' within the meaning of the rule (e.g., because the person's activities are limited exclusively to providing the issuer with names of potential investors without ''pre-screening'' them), an issuer that wants to ensure that it can rely on a registration exemption will obtain assurance from any finder being compensated in connection with the offering that he or she has not been the subject of any disqualifying event referred to in Section 506(d).