by Liam O'Brien

Are You a Finder or an Unregistered Broker?

It is an issue that comes up with regularity—can you compensate the person that is facilitating a particular transaction as a finder, or is the person acting as an unregistered broker? If it is the latter, then you risk litigation, regulatory exposure, fines, and penalties.

As a finder, a person is permitted to engage in a narrow scope of activities without triggering the broker-dealer registration requirement. However, because of the nature of the activities, a potential finder's involvement in a securities transaction may fall under the duties of a registered broker. Accordingly, it is important to know how the courts distinguish finders from unregistered brokers. It may surpise you to learn that the courts have been more liberal in their interpretation than the Securities and Exchange Commission (SEC).

In *SEC v. Kramer* (2011), the U.S. District Court for the Middle District of Florida questioned the SEC's opinions regarding finders set forth in various fact-specific no-action letters.

In this case, Kenneth Kramer entered into an agreement with Skyway Communications Holding Corp. that authorized it to pay Kramer for every introduction of a potential investor that Kramer made to Skyway, conditioned upon the investor actually investing. Kramer introduced multiple investors and received periodic checks from Skyway totaling nearly $200,000. He also received 20 percent of the number of shares that each investor bought from his long-time business associate, who was also an independent contractor for Skyway.

The SEC argued that this compensation structure indicated that Kramer was acting as an unregistered broker-dealer. However, the court disagreed. The court stated that there was no evidence of Kramer's "involvement in key points in the chain of distribution such as negotiation, analyzing the issuer's financial needs, and discussing details of the transaction." Absent this evidence, Kramer's receipt of transaction-based compensation for an introduction of an investor "cannot, without additional evidence," qualify him as a broker.

The court further commented that the SEC's transaction-based compensation test did not accurately reflect the law and that, in the absence of a statutory definition stating otherwise, the Exchange Act controlled the test for broker activity.

Historically, the SEC has utilized various factors, with none being determinative, to ascertain whether a finder exceeds the scope of his activities, thereby triggering the broker-dealer registration requirement. These factors include an analysis of the finder's compensation, the finder's participation in any negotiations between the issuer and the purchaser, the finder's history of involvement in securities transactions, and the finder's role in handling the securities of other parties in connection with securities transactions.

For example, in 2006, the SEC issued a no-action letter in response to Country Business Inc.'s (CBI) request for guidance. As a business broker for small business, CBI's role as a potential finder would be limited to transmitting documents between the parties, valuing the assets of the business as a growing concern, and providing the seller with administrative support. CBI would also receive a predetermined fixed fee for its services. The SEC stated that it would not recommend enforcement if CBI did not register as a broker-dealer.

However, in a no-action letter addressed to Hallmark Capital Corporation in 2007, the SEC stated that Hallmark would have to register as a broker-dealer. Hallmark sought to engage in similar activities as CBI, by identifying parties interested in working with small businesses. Here, Hallmark would be compensated with an upfront retainer and fee based on the outcome of the transaction, rather than a predetermined fee like CBI would have received. This difference suggests that the SEC's analysis for enforcement heavily focused on the manner of compensation.

In 2010, the SEC's no-action letter to the Investment Archive, LLC, solidified its tendency to focus on compensation as the breadth of its analysis. Here, the Investment Archive sought to provide a website that allowed investors to calculate the cost-basis of their securities with the Investment Archive receiving a predetermined flat usage fee. The SEC stated that based on its activities, the Investment Archive did not need to register as a broker-dealer.

In March 2010, the SEC issued a no-action letter to the law firm of Brumberg, Mackey, & Wall P.L.C. (Brumberg). This opinion later served as the basis for the *Kramer* lawsuit. Brumberg sought to introduce potential investors to a corporation, and in return, would

Finder or Broker continued on page 45

Liam O'Brien has 20 years of broad-based experience trying cases as lead counsel in federal and state courts and before arbitration panels. He has successfully argued appeals before the U.S. Court of Appeals Second Circuit and the New York State Appellate Division and has represented clients in a number of other jurisdictions. O'Brien is a member of the Federal Bar Association (Government Relations Committee and the Chairman of the Securities Law Committee for the Southern District of New York Chapter), American Bar Association, and the New York County Bar Association, where he is a member of the Arbitration and ADR committee. He is admitted to practice in New York State and before the U.S. District Court for the Southern and Eastern Districts and the U.S. Court of Appeals for the Second Circuit.

DEPOSE THE SEC continued from page 36

SEC failed to identify him as an expert witness. The pretrial order directed that if Kramer wished to depose the witness (even though discovery was closed), the SEC should cooperate fully in scheduling the deposition prior to trial. Thereafter, the SEC's staff accountant was deposed, and he testified on the SEC's behalf at trial, in an individual capacity.

[8]*SEC v. Kramer*, 778 F. Supp. 2d 1320, 1326-28 (M.D. Fla. 2011).

[9]*Id.* at 1327 (quoting *SEC v. Collins & Aikman Corp.*, 256 F.R.D. 403, 414 (S.D. N.Y. 2009)); *United States ex rel. Fry v. Health Alliance of Greater Cincinnati*, No. 1:03-cv-167, 2009 WL 5227661, at *2 (S.D. Ohio Nov. 20, 2009) (citing *Yousuf v. Samantar*, 451 F.3d 248, 255 (D.C. Cir. 2006)).

[10]*Kramer*, F. Supp. 2d at 1327, citing Charles Alan Wright, Arthur R. Miller, Mary Kay Kane, Richard L. Marcus, 8A Fed. Prac. & Proc. § 2037 (3d ed.); *SEC v. Dowdell*, No. 3:01-CIV-00116, 2002 WL 1969664, at *2 (W.D. Va. Aug. 21, 2002).

[11]*SEC v. Kramer*, appeal dismissed Dec. 2, 2011, 11th Cir. No. 11-12510 (DE 22).

[12]*SEC v. Merkin*, Case No. 1:11-cv-23585-Graham/Goodman (S.D. Fla.).

[13]The SEC submitted the following authorities in support of its request that the Rule 30(b)(6) deposition notice be quashed: *SEC v. Morelli*, 143 F.R.D. 42, 47 (S.D.N.Y. 1992) (quashing 30(b)(6) deposition of SEC on ground that it "constitutes an impermissible attempt by defendant to inquire into the mental processes and strategies of the SEC."); *SEC v. Nacchio*, No. 05-cv-00480-MSK-CBS, 2009 WL 211511 (D. Colo. Jan. 29, 2009) (magistrate judge upholds SEC's refusal on deliberative process grounds to answer questions during 30(b)(6) deposition of division of corporation finance and office of chief accountant); *SEC v. Nacchio*, 614 F. Supp. 2d 1164, 1175-79 (D. Colo. 2009) (affirming magistrate judge's decision to quash 30(b)(6) deposition regarding he allegations in the complaint as "unduly burdensome" and because "most of the areas of inquiry . . . would repeatedly tread upon arguably privileged grounds.").

[14]*Merkin*, 283 F.R.D. at 693 and n.2 (S.D. Fla. 2012) (footnote 2 states, "*Contra* George Orwell, Animal Farm ch. X (1945) ('All animals are equal, but some animals are more equal than others.')").

[15]*Id.* at 694 n.4 (citing *United States v. Sanchez,* 520 F. Supp. 1038, 1040 (S.D. Fla. 1981)); *see also SEC v. Snyder*, No. H-03-04658, 2006 WL 6508273, at *1 (S.D.Tex. Aug. 22, 2006).

[16]*Merkin*, 283 F.R.D. at 694-95 and n.5 (citing 8A Charles Alan Wright, Arthur R. Miller and Richard L. Marcus, Fed. Prac. & Proc. § 2103 n. 37). The magistrate court also noted, in footnote 5 of its order, "In their April 2012 supplement, the authors also added the comment that 'permitting a party to invoke work product as a blanket obstacle to a 30(b)(6) deposition seems to undermine the important utility of that device.'"

[17]*Id.* at 696.

[18]*Id.* at 697 (quoting *Dongguk Univ. v. Yale Univ.*, 270 F.R.D. 70, 74 (D. Conn. 2010)).

[19]*Id.* at 696.

[20]*SEC v. Merkin*, No. 11-23585-CIV, 2012 WL 2504003, at *3 (S.D. Fla. June 27, 2012).

[21]*SEC v. Merkin*, 283 F.R.D. 699 (S.D. Fla. 2012).

FINDER OR BROKER continued from page 37

receive a success-based compensation in the form of a percentage of the funds raised by those investors. Brumberg agreed not to engage in negotiations on either party's behalf, make recommendations about financing agreements, or assist with any financing transactions. Nevertheless, the SEC stated that Brumberg should register as a broker-dealer because of the success-based compensation and because its involvement in prescreening investors to determine eligibility and interest exceeded the scope of a finder's role.

An analysis of the SEC's recent no-action letters suggests that the SEC was focusing heavily on the method of compensation received by the potential finder. The *Kramer* court's critique of that approach suggests that the SEC's analysis is too narrow.

So which analysis should one follow? The SEC has not issued any no-action letters since the *Kramer* decision and, to the great surprise of industry watchers, has decided not to appeal the decision. However, it would be imprudent to rely upon a single decision from a Florida district court. It would be best to act in accordance with the SEC's pre-Kramer no-action letters until the SEC clarifies its approach or the problem is resolved by additional litigation. ⊙