

Date of Hearing: April 20, 2015

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Matthew Dababneh, Chair

AB 667 Wagner – As Amended April 6, 2015

SUBJECT: Broker-dealers: finders

SUMMARY: Creates an exemption for "finders" under the Corporate Securities Law of 1968. Specifically, **this bill:**

- 1) Defines a "finder" as an individual who introduces or refers one or more accredited investors to an issuer or an issuer to one or more accredited investors, solely for the purpose of a potential sale of securities of the issuer.
- 2) Prohibits a "finder" from:
 - a) Providing services to an issuer for a transaction or a series of related transactions for the offer or sale of securities exceeding a securities purchase price of \$15,000,000 in the aggregate;
 - b) Negotiating any of the terms of the securities transaction;
 - c) Advising any party to the securities transaction regarding the value of the securities or the advisability of investing in, purchasing, or selling the securities;
 - d) Conducting any due diligence on the part of any party to the transaction;
 - e) Selling or offering to sell in connection with the issuer transaction any securities of the issuer that are owned, directly or indirectly, by the finder;
 - f) Receiving directly or indirectly, possession or custody of any funds in connection with the issuer transaction;
 - g) Knowingly receive compensation in connection with any offer or sale of securities unless the sale is qualified or unless the security or the transaction is exempt or not otherwise subject to qualification; and,
 - h) Making any disclosure to a potential purchaser other than:
 - i) The name, address, and contact information of the issuer;
 - ii) The name, type, price, and aggregate amount of any securities being offered in the issuer transaction; and,
 - iii) The issuer's industry, location, and years in business.
- 3) Requires the "finder" to file an initial statement of information (SOI) (created by the Department of Business Oversight (DBO)) with the DBO prior to engaging in any activities

that includes the following:

- a) The name and complete business or residential address of the finder; and,
 - b) The mailing address of the finder, if different from the business or residential address.
- 4) Requires the "finder" to pay a filing fee of \$300 to DBO with the SOI.
- 5) Requires the "finder" to file within 30 days of the anniversary of the finder's initial SOI and annually thereafter a renewal SOI with the DBO that includes all of the following:
- a) Representations that:
 - i) The finder has complied and will continue to comply with (2, a-h) listed above;
 - ii) The finder has not performed any acts or satisfied any circumstances prohibited by Corporations Code Section 25212 or been sanctioned by the commissioner; and,
 - iii) The finder has obtained the written agreement with respect to each transaction in which the finder has participated in the prior 12 months.
 - b) An indication by the finder as to whether the finder has received transaction-based compensation that is subject to the actual sale of securities by the issuer in any transaction in which the finder participated in the prior 12 months.
- 6) Requires a filing fee of \$275 with the renewal SOI.
- 7) Requires the finder with each introduction to obtain the informed written consent of each person introduced or referred by the finder to an issuer. The written agreement must be signed by the finder, the issuer, and the person introduced or referred disclosing the following:
- a) The type and amount of compensation that has been or will be paid to the finder and the conditions for the payment of that compensation;
 - b) That the finder is not providing advice to the issuer or any person introduced or referred by the finder to an issuer as to the value of the securities;
 - c) Whether the finder is also an owner, directly or indirectly of the securities being offered or sold;
 - d) Any actual and potential conflict of interest in connection with the finder's activities related to the issuer transaction;
 - e) That the parties to the agreement shall have the right to pursue any available remedies at law or otherwise for any breach of the agreement; and,
 - f) Requires representation that the person introduced is an accredited investor.

- 8) Requires the "finder" to maintain and preserve for 5 years from the date of the filing of the notice, a copy of the notice, the written consent and all other records relating to any securities transaction in connection with which the finder receives compensation.
- 9) Provides that if a natural person does not meet the definition of finder, any person introduced or referred by that natural person to an issue shall have the right to pursue any applicable remedy afforded under state law.

EXISTING FEDERAL LAW:

- 1) Establishes the federal Securities Exchange Act of 1934 which prohibits any broker or dealer from effecting, inducing, or attempting to induce the purchase or sale of any security unless such person is registered with the Securities and Exchange Commission (SEC). (Section 15 (a) (1))
- 2) Defines "accredited investor," as:(17 C.F.R 230.501 (a))
 - a) Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds \$1 million at the time of their purchase of securities, exclusive of their primary residence; or,
 - b) Any natural person with an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person's spouse in excess of \$300,000 in each of those years, together with a reasonable expectation of reaching the same income level in the current year.

EXISTING STATE LAW:

- 1) Provides a broker licensed by the Real Estate Commissioner is exempt from the provisions of Section 25210 when engaged in transactions in any interest in any general or limited partnership, joint venture, unincorporated association, or similar organization (but not a corporation) owned beneficially by no more than 100 persons and formed for the sole purpose of, and engaged solely in, investment in or gain from an interest in real property, including, but not limited to, a sale, exchange, trade, or development. An interest held by a husband and wife shall be considered held by one person for the purposes of this section. [Corporations Code, Section 25206]
- 2) Defines a "broker-dealer" as any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account. A broker-dealer also includes a person engaged in the regular business of issuing or guaranteeing options with regard to securities not of his own issue. [Corporations Code, Section 25004]
- 3) Requires a broker-dealer to apply and obtain a certificate from the DBO to as a broker-dealer in California. [Corporations Code, Section 25210]
- 4) Defines "issuer" as any person who issues or proposes to issue any security, with exceptions. [Corporations Code, Section 25010]

- 5) Provides that “broker-dealer” does not include several persons, including, among others, banks; trust companies; savings and loan companies; real estate brokers; options exchanges certified by DBO; individuals who trade for their own accounts or in some fiduciary capacity, but not as part of a regular business; issuers; and agents, when they are employees of broker-dealers or issuers. [Corporations Code, Section 25004]
- 6) Authorizes DBO to pursue the following types of enforcement actions against persons who are not licensed as broker-dealers, but who are acting in a manner that requires such licensure. DBO may:
 - a) Issue an order to desist and refrain from the activity or activities that warrant licensure, until the required license is obtained. [Corporations Code, Section 25532]
 - b) Levy an administrative penalty of up to \$5,000 for a first violation, up to \$10,000 for a second violation, and up to \$15,000 for a third and subsequent violation (Section 25252), and include in the administrative action imposing such penalty a claim for ancillary relief, including but not limited to a claim for restitution or disgorgement or damages on behalf of persons injured by the act or practice giving rise to the action. [Corporations Code, Section 25254]
 - c) Take possession of the property, business, and assets of such person. [Corporations Code, Section 25253]
 - d) Bring an action in the name of the people of the State of California in Superior Court to enjoin the acts or practices of the person violating the law and enforce compliance, and, if the commissioner determines it is in the public interest, to include in that action a claim for ancillary relief, including but not limited to a claim for restitution or disgorgement or damages on behalf of persons injured by the act or practice constituting the subject matter of the action. [Corporations Code, Section 25530]
- 7) Provides that a person who purchases a security from or sells a security to a broker-dealer that is required to be licensed and who has not, at the time of the sale or purchase, applied for and secured from the commissioner a certificate in effect at the time of sale or purchase, may bring an action for rescission of the sale or purchase, or, if the plaintiff or the defendant no longer owns the security, for damages, as specified. [Corporations Code, Section 25501.5]

FISCAL EFFECT: Unknown.

COMMENTS:

Currently, California does not have a clear statutory regime surrounding finders. About the only protection a purchaser has against an unregistered broker-dealer is Corporations Code, Section 25501.5, stated above. AB 667 puts in statute, regulations regarding finders whom lurk in a grey area of securities law. AB 667 will exempt from certain broker-dealer requirements those persons who satisfy the statutory definition of finder and act in compliance with certain requirements. The requirements consist of: filing initial and subsequent statements of information and paying related filing fees as set by DBO, obtaining the informed written consent of each investor; and, maintaining certain records. AB 667 defines a finder, in order to meet the definition of finder, investors introduced by the finder must be accredited investors, and the

finder must not participate in negotiating any terms of the investment, advise any party regarding the investment, or sell any securities owned by the finder.

Need for the bill:

According to the sponsor, the Corporations Committee of the Business Law Section of the State Bar of California, "Finders are often critical to the success of capital-raising efforts by start-up companies and other small to mid-sized companies that would otherwise be unable to engage a broker-dealer or access needed capital. Indeed, it is widely acknowledged that many individuals act as finders in the State of California and that this is the method by which a vast majority of capital is raised to fund early stage businesses. Under current law, however, the scope of permitted activities for a finder is poorly defined, often resulting in inadvertent violations of broker-dealer registration requirements. In fact, there is no statutory definition of finder, nor is there any regulation of finders. This lack of clear guidance puts finders and the businesses that rely upon them for crucial funding in jeopardy. It also impedes the State's ability to regulate finders and to hold them accountable. "

Finders

Currently, both federally and at the state level, the law is vague on the issue of "finders." Finders do not fall within the definition of broker-dealer because they are limited to certain activities. "Finders" is a common term used in the securities environment as an unlicensed individual who introduces an accredited investor to an issuer. In exchange for bringing in a potential accredited investor, the finder receives compensation. The only role of a finder in a securities transaction is the introduction; therefore, finders are not required to register as a broker-dealer. Questions that should be considered when determining whether or not a finder should register as a broker-dealer include:

- Is the finder planning on being involved in the negotiations for the sale of securities? The more involved the finder, the more likely the finder should register as a broker-dealer.
- Is the finder intending to discuss with potential accredited investors the details of the securities sold, or otherwise make any recommendations? If yes, the finder should register as a broker-dealer.
- Will the finder be compensated by a transaction-based compensation with the respect to a securities transaction? If yes, the finder should register as a broker-dealer.
- Has the finder previously been involved with effecting securities transactions? Any previous compensation or other evidence of previous involvement in effecting securities transaction increases the likelihood that a finder should register as a broker-dealer.

Finders fall in a gray area of the law, which increases the liability of using one and potentially unnecessary litigation. A finder, if found to act as an unregistered broker-dealer could come with grave consequences such as: investor rescission right, the issuer could be found as an aider and abettor, negative publicity, as well as, be subject to criminal penalties, fines, suspension and disbarment.

Federal Regulations

Section 15(a) of the Securities Exchange Act (The Act) of 1934 requires that persons engaged in broker or dealer activity must register with the SEC pursuant to Section 15(b) of the Act unless an applicable exemption is available. In general, federally, a “broker” is any person “engaged in the business of effecting transactions in securities for the account of others” and a “dealer” is any person “engaged in the business of buying and selling securities for such person’s own account.” Although the Act and the rules promulgated thereunder do not specifically define “effecting transactions” or “engaged in the business,” the SEC has taken a very expansive view of the scope of those terms. Based on no-action guidance from the SEC, activities that may be deemed (alone or in combination) to confer “broker” status include, among other things:

- Soliciting investors to enter into securities transactions;
- Assisting issuers in structuring prospective securities transactions or helping issuers to identify potential purchasers of securities;
- Participating in the negotiating process or otherwise bringing buyers and sellers of securities together; and;
- Receiving compensation contingent on the success of a securities transaction or based on the amount or value of a securities transaction.

Activities that have been identified (alone or in combination) by the SEC as indicators of “dealer” status include, among other things:

- Participating in a selling group, underwriting securities or purchasing or selling securities as principal from or to customers rather than from or to only brokers or dealers;
- Carrying a dealer inventory (positions intended to be used directly or indirectly to trade with customers) or holding oneself out as a dealer or market-maker or as otherwise willing to buy or sell particular securities on a continuous basis;
- Obtaining a regular clientele of customers, issuing or originating securities or rendering incidental investment advice to others; and,
- Engaging in trading transactions for the benefit of others (including for an affiliate or for an affiliate’s customers), rather than consistently with one’s own judgment and investment and liquidity objectives.

On April 5, 2013, the SEC addressed the potential application of the broker-dealer registration requirements under Section 15(a) of the Act in the context of fundraising activities and other services for private funds. The SEC has observed that certain private fund advisers are paying transaction-based compensation to their personnel for selling interests in a fund and private fund advisers, their personnel and/or their affiliates are receiving transaction-based compensation “for purported investment banking or other broker activities relating to one or more of the fund’s portfolio companies.” The SEC has consistently viewed transaction-based compensation as broker-dealer activity. The SEC cautioned that the receipt of transaction-based compensation

coupled with the types of activities being performed may trigger the requirement to register with the SEC as broker-dealers.

In the early 1990s, the SEC granted no-action relief to an individual whose involvement in securities transactions was limited to one instance of providing a list of names and telephone numbers of potential investors and receiving a success fee for doing so. This no-action position gave rise to the notion that a so-called “finder’s exemption” exists in the law. Nonetheless, despite this very limited fact pattern, the SEC has subsequently indicated its disapproval of this no-action position, and has in fact stated that even one instance of transaction-based compensation may be enough for a finding that a person was “engaged in the business” of broker activity, and thus subject to registration. Notably, while the SEC has taken an extremely expansive view of the concept of being “engaged in the business,” some courts have been more lenient in this regard, finding that something more than just transaction-based compensation is necessary to require broker registration.

Other States

Three other states have enacted finder legislation, Texas, Michigan and Minnesota.

Michigan requires a “finder” (as defined under Michigan law) to register as an investment adviser and finder activities are limited to “locating, introducing, or referring potential purchasers or sellers.”

The Texas State Securities Board adopted regulations to provide for a restricted registration system for finders (as defined by regulation). A finder would be limited to introducing only accredited investors and would not be permitted to negotiate the terms of any investment or give any advice about entering the investment. Securities examination requirements would be waived for finders.

In adopting the Uniform Securities Act of 2002, Minnesota included a non-standard provision, which exempted private placement broker-dealers representing issuers in connection with any exempt transaction from registering as agents. Minnesota conditioned the availability on the absence of any disciplinary history, prohibited the handling or possession of funds and securities, and required a notice filing and consent to service of process. Minnesota’s provision permits a private placement broker-dealer to register only once with the state securities regulator but allows the private placement broker-dealer to represent multiple issuers.

Previous Legislation:

AB 713 (Wagner) 2013-2014 Legislative Year. Would have provided that any person who meets the definition of a finder, and who satisfies all of the conditions established for finders, is deemed to be a finder and not a broker-dealer. Died in Senate Appropriations Committee.

REGISTERED SUPPORT / OPPOSITION:

Support

California State Bar (Sponsor)

Opposition

None on file.

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