

Date of Hearing: January 6, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
AB 713 (Wagner) – As Amended: January 6, 2014

SUBJECT: Broker-dealers.

SUMMARY: Exempts "finders" from the definition of broker-dealers if he or she only acts as a "finder." 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) Negotiating any of the terms of the securities transaction;
 - b) Advising any party to the securities transaction regarding the merits of, or the advantages or disadvantages of entering into the securities transaction; or,
 - c) Selling or intending to sell any securities of the issuer, which securities are owned, directly or indirectly, by the finder as a part of the securities transaction.
- 3) Requires the "finder" to file a form (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 no more than \$25 if determined by the DBO with the form described above.
- 5) Requires the "finder" to timely file an annual report of activity with the DBO and pay any requisite filing fee if determined by the Commissioner of DBO.
- 6) Requires a "finder" for each transaction or series of transactions to file with the DBO on a form set forth by the Commissioner of DBO a notice that includes the following representations:
 - a) The finder acts only to introduce the issuer and the potential purchaser of an issuer's securities and will not effect any transaction in, advise or consult on, or induce or attempt to induce the purchase or sale of, any securities in this state;
 - b) The finder has not done any of the acts, satisfied any of the circumstances, or is subject to any order specified in Corporations Code 25212;

- c) The finder will not receive, directly or indirectly, possession or custody of any funds related to the purchase and sale of the subject securities transactions;
 - d) The finder has not acted in violation of any provision of this bill; and,
 - e) The finder has fully disclosed and obtained the informed written consent of the issuer and each potential purchaser introduced by the finder to the issuer regarding the material terms of the compensation arrangement between the issuer and the finder relating to the finder's services provided for the subject securities transaction.
- 7) Requires a "finder" to separately file a notice for each new transaction or series of transactions no later than 20 business days following the first sale of securities in the offering. Allows the commissioner of DBO to require a filing fee of not more than \$25.
- 8) Requires the "finder" to obtain the written consent of each potential purchaser introduced by the finder to an issuer for the purchase and sale of securities of the issuer, in an agreement signed by the finder, the issuer and the potential purchaser. The agreement must disclose the following:
- a) The amount of compensation that will be paid to the finder in connection with the subject securities transactions and the conditions for payment of that compensation;
 - b) That the finder shall neither recommend nor advise the potential purchaser with respect to the subject securities transaction;
 - c) Whether the finder is also an owner of the securities of the issuer; and,
 - d) Any actual and potential conflict of interest in connection with the finder's activities related to the subject securities transaction.
- 9) Requires the potential purchaser to represent in the written consent that the potential purchaser is an accredited investor; as well as, consents to the payment of the compensation.
- 10) 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.
- 11) Prohibits a "finder" from:
- a) Directly or indirectly taking possession or custody of funds related to the purchase and sale of any subject securities transaction;
 - b) Knowingly participating in any unregistered offering not otherwise exempt from registration or qualification;
 - c) Failing to make the disclosures required by the measure;

- d) Conducting due diligence on behalf of the issuer or the potential purchaser related to any subject securities transaction; and,
- e) Making any disclosures to potential purchasers other than disclosures expressly permitted or required under the measure.

12) Specifies permitted disclosures shall be limited to the name, address, and telephone number of the issuer; the name, type and price of any securities to be issued, issuer's industry, location, and years in business; the type of number, aggregate amount of securities being offered; and contact information regarding the potential purchaser.

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." (17 C.F.R 230.501 (a))

EXISTING STATE LAW

- 1) 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)
- 2) Requires a broker-dealer to apply and obtain a certificate from the DBO to as a broker-dealer in California. (Corporations Code, Section 25210)
- 3) Defines "issuer" as any person who issues or proposes to issue any security, with exceptions. (Corporations Code, Section 25010)

FISCAL EFFECT: Unknown.

COMMENTS:

NEED FOR THE BILL:

According to the sponsor, the Corporations Committee of the State Bar of California Business Law Section, "A determination that a finder has engaged in unlicensed broker-dealer with State of California can be the basis for subjecting an issuer (including its directors and officers) and the unlicensed person to substantial liability, as California law provides investors with the right of rescission and an extended statute of limitations arising from unlicensed broker-dealer activity. Whether a person is acting as a broker-dealer or finder is a fact-specific inquiry, and the proposal will promote market transparency among issuers, finders and investors."

In addition, the sponsor states, "the enactment of the proposal adds a modicum of certainty in connection with the engagement of finders in securities transactions. This added certainty will

benefit (a) the State of California via increased income tax revenues, (b) startup companies, and small to mid-sized business entities seeking access to the capital markets, and (c) individuals who have the capability"

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 e 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 fund raising 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.

QUESTIONS

- 1) Does this area of law need more transparency? Currently, finders lurk in the shadows. This measure would bring finders to the forefront and provide guidelines but this measure could also eliminate a profession and push more individuals to apply to become a broker-dealer.
- 2) The issue of finders has been a controversial topic for decades. Why has the SEC not created federal guidelines or regulations on this matter? The DBO considered the issue in 2006, why hasn't the DBO moved forward with regulating finders? Why do the regulators seem content keeping finders in the gray area and looking at each securities transaction on a case by case basis? Does it make sense to have a California based finder system?
- 3) Considering the rigorous requirements of this measure with all the filings and fees, why wouldn't a finder just apply for a certificate as a broker-dealer? When the purpose of a finder is the simple task of making an introduction, are such strict regulations needed?
- 4) This measure would only apply on an intrastate basis in California, if enacted, could "finders" go around the regulations by working under federal regulations, where no explicit finder regulations exist?
- 5) How would the Financial Industry Regulatory Authority (FINRA) work with this legislation?

RECOMMENDED AMENDMENTS

- 1) Page 2 line 5, add "or her" after his
- 2) Page 2 line 7, add "or her" after his
- 3) Page 2 Line 12, add "or she" after he
- 4) Page 2 Line 12 add "or her" after his
- 5) Page 2 Line 15 add "or she" after he
- 6) Page 2 Line 29 add "or she" after he
- 7) Page 2, line 33 add "in this state" after "finder"
- 8) Page 3, line 9, delete "a"
- 9) Page 3 line 13, delete "have filed" and add file
- 10) Page 3 line 32 delete "have filed" and add file
- 11) Page 3, line 33 delete "as"
- 12) Page 3 line 37 delete purchaser, add accredited investor
- 13) Page 3, delete lines 26-30
- 14) Page 3, line 31, add "securities" before transaction, and "securities" before transactions
- 15) Page 3, line 38, add "securities" before transaction
- 16) Page 4, line 10 delete "purchaser", add accredited investor
- 17) Page 4, line 15, add "securities" before transaction and securities before transactions
- 18) Page 4, line 24, add "or referral" after introduction
- 19) Page 4 line 24 delete " have"
- 20) Page 4, line 25 delete "obtained", add obtain
- 21) Page 4, line 26 delete purchaser add accredited investor
- 22) Page 4, line 26 add, or referred after introduced
- 23) Page 4, line 28, delete purchaser, add accredited investor

- 24) Page 4, line 33 delete purchaser, add accredited investor
- 25) Page 4, line 38, delete purchaser, add accredited investor
- 26) Page 4, line 39, delete purchaser, add accredited investor
- 27) Page 5, line 2 delete purchaser, add accredited investor
- 28) Page 5, line 27 delete purchaser, add accredited investor
- 29) Page 5, line 28, delete purchasers, add accredited investors
- 30) Page 5, line 34 delete purchaser, add accredited investor

REGISTERED SUPPORT / OPPOSITION:

Support

California State Bar (Sponsor)
Fortis General Counsel, LLP
Fox Rothschild LLP
Law offices of Joseph W. Carroll, P.C.
Russ August & Kabat
Townsend & Styer Maintenance CO., LLC

Opposition

None on file.

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