

Why should a company use a broker-dealer that is registered?

Whether in the mergers and acquisitions (“M&A”) or in the capital raising context, there are many financial intermediaries operating without registering as a broker-dealer. Issuers of securities that use unregistered brokers face risks which may not be borne out immediately. For example:

<i>Rescission rights</i>	<p>Purchasers, whether in a capital raising transaction or the M&A context, may be later able to require the issuer to repurchase the securities sold, plus interest (and attorneys fees in some states).</p> <p>Regulators are focusing more on these problems. For example, the realization that a large number of potential rescission right holders existed, which began with SEC questions concerning financial statements, recently lead a publicly traded company to go out of business.</p>
<i>Voiding the sale</i>	<p>Section 29(b) of the Securities Exchange Act of 1934 provides that any contract made in violation of the 1934 Act, and the performance of any contract which involves the violation of the 1934 Act, “shall be void.”</p> <p>These claims have been difficult to make, but providing such a claim to deal participants can only harm the issuer.</p>
<i>Compromise future financings</i>	<p>An issuer of securities that uses an unregistered broker may later need to provide an opinion of counsel to an underwriter or other deal participant respecting past securities offerings. The fact that the issuer used an unregistered broker in the issuance of securities in the past could impair the ability of the issuer’s law firm to opine that the prior issuance complied with applicable law.</p>
<i>Identification of the unregistered broker</i>	<p>Issuers/sellers must usually disclose their employment of a broker, and their failure to disclose can cause a number of problems:</p> <ul style="list-style-type: none"> ▶ In the M&A context, most purchase agreements contain a representation regarding the participation by and payments to brokers in the transaction. ▶ Issuers relying on Regulation D must file a Form D with the SEC and generally with each state in which sales are made. Item 12 of Form D requires the issuer to identify recipients of sales compensation, as well as the recipient’s broker-dealer registration number. Issuers utilizing an unregistered broker must therefore either admit they used the unregistered broker (and therefore subject themselves to the potential pitfalls) or file a false Form D (which can subject principals of the issuer to substantial penalties under Section 24 of the Securities Act of 1933). ▶ If an unregistered broker is used in a securities transaction and that fact is not disclosed to purchasers, it may provide a claim of an omission of a material fact to purchasers. ▶ <i>Tarini</i>: In 2010, the Connecticut Department of Banking imposed a

\$25,000 fine and other penalties on the president of an issuer for misleading the Department regarding the role of an unregistered broker in the issuer's offerings.

► *Walsh*: In 2002, the SEC sued a former Tyco director for failure to disclose his receipt of a finder's fee he received in connection with a merger.

Void exemptions

Each securities transaction needs to be registered under federal and state law unless exempted. Using an unregistered broker can increase the probability that the transaction will not be exempt.

► Many states' exemptions from the registration requirement are conditioned on the issuer not using an unregistered broker. If Rule 506 is not used or becomes unavailable (because it later turns out all of the rule's conditions are not met), the use of an unregistered broker in the transaction may render the transaction in violation of state securities offering registration requirements.

► Brokers who shun registration requirements may be more likely to ignore other legal requirements, such as not conducting securities offerings in a manner that is deemed to be a public solicitation, and therefore eliminate the seller's ability to rely on exemptions.

Direct violation of state law

Independent of what exemption is used at the state level for sale of a security, many states' laws specifically prohibit the use of an unregistered broker by an issuer of securities. Further, issuers of securities can face liability under both federal and state law for knowingly aiding and abetting violations by unregistered brokers.

Lose the supervision of the registered broker

Running your M&A transaction or capital raise through a registered broker provides many benefits:

► Provides comfort to purchasers and other deal participants that the deal does not have the taint of an unregistered participant, and that the selling broker is adequately capitalized (and thus less likely to use high pressure or inappropriate methods to close the deal)

► May add to the issuer/seller's legitimacy, as deal participants and purchasers know that the registered broker has vetted the issuer and the offering

► The registered broker's supervision of its representatives' activities in selling the securities adds a layer of protection to all parties, including the seller/issuer

Common myths

Many financial intermediaries operate without registering as a broker-dealer for a number of reasons, and sometimes those reasons are based upon myths or erroneous advice, such as:

There is no-action relief

No-action letters released by the SEC staff, in some cases many years ago, provided relief in very limited circumstances which some unregistered brokers erroneously believe provide them with relief. Additionally, many unregistered brokers do not understand that in order to rely on previous no-action requests, one must not deviate from the

fact pattern contained in the request in any way, and SEC staff no-action letters bind few. Last, it is unlikely that most clients seeking the services of a broker would pay for services that are as limited as those proposed by prior recipients of no-action relief.

An M&A deal is not the sale of “securities”

Prior to 1985, many attorneys correctly advised that the “sale of a business” doctrine provided that if a business was sold, that the federal securities laws may not apply, even if the transaction vehicle was the sale of stock. However, the Supreme Court rejected the “sale of a business” doctrine in the 1985 *Landreth Timber* case, and therefore the securities laws do apply to any securities transaction—in the M&A context or otherwise.

Everyone does it

Despite estimates that many thousands of brokers operate without registration, there is no defense to any regulatory violation or private right of action for failure to register as a broker based on the assertion that others violate the same law.

The “issuer’s agent” exemption

Rule 3a-4 adopted under the 1934 Act does exempt certain persons associated with issuers from registering as brokers. However, a key condition of that rule is that the broker cannot get paid based upon whether securities are sold. Since issuers/sellers are not going to want to pay unless a deal is closed (among other reasons), third party intermediaries will rarely be able to rely on this rule.