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Broker-Dealer Law Reform: Financial Intermediaries in a State of Limbo

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Cover Page Footnote

The current state of federal securities law poses many issues for small businesses aspiring to raise capital through the assistance of a broker. A literal reading of section 15(a)(1) would seem to require all brokers to register as broker-dealers, even if they only engage in a single transaction. Recognizing that the burdens imposed on registered broker-dealers make this regulatory framework highly undesirable, the SEC and the courts have diverged from a literal reading of the act. Courts apply a multifactor test to determine if brokers must register as broker-dealers, and the SEC tends to focus on specific factors, often declaring that the receipt of transaction-based compensation is in itself sufficient to require registration. Recognizing that the regulatory framework in place prevents the capital financing of many small businesses, the SEC revised its enforcement policy by stating in a no-action letter that it would not recommend enforcement against an M&A broker who transferred control of a business in a private transaction, subject to many limiting conditions. While providing some relief, this no-action letter is insufficient to ameliorate the tension between the actual practices of brokers and the law as it stands. As a result, a significant portion of the private equity market is still in flux. The legislative solution proposed by this note is a viable path to ensuring the continued growth of American small businesses while maintaining the integrity of markets and protection of investors.

Broker-Dealer Law Reform

FINANCIAL INTERMEDIARIES IN A STATE OF LIMBO

INTRODUCTION

Prior to 2012, Neogenix Oncology, Inc. was a prospering biotechnology company with more than 500 shareholders and significant clinical developments in the field of cancer treatment. In order to boost share prices, the company's CFO paid unregistered financial intermediaries to sell Neogenix stock to investors.[1] Following the stock sales, the Securities and Exchange Commission (SEC) launched an inquiry into the legality of the transactions that hinged on whether the financial intermediaries who pushed the stock were in fact required to be registered as broker-dealers.[2] Pursuant to section 78*o*(a)(1) of the 1934 Securities Exchange Act, which requires financial intermediaries who sell securities to register with the SEC, the SEC found that the sales by the unregistered intermediaries were illegal and voidable.[3] Since the securities transactions were voidable, Neogenix was unable to complete its financial statements to the satisfaction of its outside auditors.[4] Consequently, Neogenix was unable to continue raising capital.[5] The company entered bankruptcy in July 2012 and was forced to sell all of its assets to a single bidder.[6] The story of Neogenix's rise and fall exemplifies a recurring trend in the murky field of small-issuer finance. When unregistered financial intermediaries facilitate the sale of securities to investors, companies face potential rescission of transactions, loss

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1 *See* Amy Natterson Kroll et al., *Neogenix—A Cautionary Tale,* LAW360 (Sept. 13, 2012, 7:19 PM), http://www.law360.com/articles/378306/neogenix-a-cautionary-tale?article_related_content=1 [http://perma.cc/W59M-WENZ].

2 *See* Letter from Philip M. Arlen, President and CEO, Neogenix Oncology, to Neogenix Oncology Shareholders (Jan. 11, 2012), http://www.sec.gov/Archives/edgar/data/1341293/000114420412001993/v245246_ex99-1.htm [http://perma.cc/52Z2-3FPK] [hereinafter Neogenix Letter].

3 *See id.*

4 *See id.*

5 *See id.*

6 *See In re* Neogenix Oncology, Inc., No. 12-23557-TJC, 2015 WL 5786345, at *2 (Bankr. D. Md. Oct. 1, 2015).

of securities offering exemptions, and criminal liability.[7] These consequences may deal a death blow to companies, like Neogenix, that are seeking investment to grow and succeed.

Raising capital is critical for startup companies and established corporations alike.[8] It is an essential aspect of starting a business, because "[c]apital is the lifeblood of a growing business."[9] Small businesses account for 99.7% of all employer firms; thus, if startups cannot grow, the economy of the United States cannot grow.[10] Raising capital is an important prerequisite for talent acquisition, manufacturing, marketing, and expanding operations. Funding for early-stage companies is often sought in relatively small amounts and is typically supplied by angel investors.[11] Successful fundraising requires a skill set that many entrepreneurs do not possess; thus, when entrepreneurs need early-stage financing, they will often hire a "finder"—an individual who does possess such skills.[12] The purpose of the 1934 Securities Exchange Act was predominantly to protect investors by imposing registration requirements on securities and the financial intermediaries that market those securities to investors.[13] To this end, the SEC obliges financial intermediaries, which help to locate investors and facilitate transactions, to register as broker-dealers.[14] Under current SEC regulations, many of the

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[7] *See infra* Section II.B.

[8] Daniel H. Peters, *Finders Can Put the Brakes on Capital Raising*, LAW 360 (July 15, 2014), http://www.law360.com/articles/557676/finders-can-put-the-brakes-on-capital-raising?article_related_content=1 [http://perma.cc/WL28-YRUB].

[9] ANDREW J. SHERMAN, RAISING CAPITAL 1 (3d ed. 2012).

[10] *Id.* at 2.

[11] An "angel investor" is generally an affluent individual who provides startup equity for a business, typically in return for convertible debt or equity. GREGORY C. YADLEY, ADVISORY COMM. ON SMALL AND EMERGING BUS., SEC, "NOTABLE BY THEIR ABSENCE: FINDERS AND OTHER FINANCIAL INTERMEDIARIES IN SMALL BUSINESS CAPITAL FORMATION" 1 (2015), http://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf [http://perma.cc/G3HA-PG2Z].

[12] *See* Jim Casparie, *Choosing a Finder When Raising Capital*, ENTREPRENEUR (May 16, 2015), http://www.entrepreneur.com/article/77838 [http://perma.cc/H3YF-QUYG]; *see also* Peters, *supra* note 8 (explaining that founders of companies often enlist intermediaries to find investors, frequently by providing compensation in proportion to the amount of equity transferred in the transaction).

[13] *See* S. REP. No. 792, at 1-5 (1934).

[14] *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC (June 1, 2013), http://www.sec.gov/about/whatwedo.shtml [http://perma.cc/QC4H-UAP5]; *see also* Securities Exchange Act of 1934, 15 U.S.C. § 78c (2012). Section 78c(a)(4)(A) of the Securities Exchange Act defines a "broker" broadly as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A). Section 78c(a)(5)(A) of the Securities Exchange Act defines a "dealer" as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." *Id.* § 78c(a)(5)(A). The definition of "dealer" does not include a "trader," that is, a person who

individuals who introduce entrepreneurs to investors run the risk of civil or even criminal liability if they do not register as broker-dealers with the SEC.[15] Despite the risk of such consequences, many individuals continue to act as unlicensed broker-dealers due to market demand.[16]

Few registered broker-dealers are willing to facilitate transactions worth less than $25 million.[17] The costs of transacting for smaller issuers are potentially even higher than they are for larger issuers because larger issuers are more experienced with such transactions.[18] The financial information and internal recordkeeping systems for larger issuers are often more sophisticated than for smaller issuers.[19] Thus, smaller issuers turn to unregistered brokers and risk serious consequences if the SEC later determines that the broker should have been registered.[20]

The consequences for unregistered financial intermediaries and issuers include purchasers' legal rights to rescind transactions, the loss of a registration exemption from the Securities Act of 1933, the loss of the legal ability to engage in private placement offerings,[21] and in some cases, criminal prosecution.[22] The SEC changes its interpretation of the broker-dealer rules quite frequently, with the most recent iteration in the form of a no-action letter purporting to allow unregistered financial intermediaries to engage in transactions limited to transferring control of a closely held corporation, as long as they do not possess securities during the consummation of the

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buys and sells securities for his or her own account, either individually or in a fiduciary capacity, but not as part of a regular business. Individuals who buy and sell securities for themselves are generally considered traders and not dealers. Any financial intermediary classified as a "broker" or "dealer" under the aforementioned provisions must register as a broker-dealer with the SEC.

15 *See Compliance Guide to the Registration and Regulation of Brokers and Dealers: Guide to Broker-Dealer Registration*, SEC (July 29, 2014), http://www.sec.gov/divisions/marketreg/bdguide.htm [http://perma.cc/3A37-9NLD] [hereinafter *Compliance Guide*].

16 *See* Task Force on Private Placement Broker-Dealers, ABA Section of Bus. & Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 968-69 (2005) [hereinafter ABA Report].

17 *See id.* at 968.

18 Larger issuers are more experienced with preparing private placement memorandums for their offerings and are more likely to have complete and accurate financial information. *See id.* at 968-69.

19 *See* YADLEY, *supra* note 11, at 3.

20 *See infra* Section III.B.

21 A private placement is an offering to a relatively small group of investors in reliance on an SEC exemption from securities registration. *See, e.g.*, *Offering*, BLACK'S LAW DICTIONARY (10th ed. 2014).

22 Securities Exchange Act of 1934, 15 U.S.C. § 78*o* (2012); *see supra* note 15; *see also infra* Section II.B (explaining the consequences of violating broker-dealer registration requirements).

transaction.[23] Regardless of SEC interpretations of the Securities Exchange Act, the market continues to provide incentives for unregistered broker-dealers to operate because small-scale issuers need them to raise capital.[24]

This note proposes a legislative solution that would align the law with the reality of current early-stage business financing practices while advancing the core purposes of the broker-dealer registration requirements and the Securities Exchange Act. This note argues that a new class of broker-dealers should be created in order to facilitate transactions with smaller issuers in limited circumstances. Intermediary brokers for smaller transactions should have a streamlined registration process, less onerous SEC and Financial Industry Regulatory Authority (FINRA) requirements, and exemption from registration under state law. In order to maintain investor protection against fraud and market manipulation, intermediary brokers registered under this proposed framework should not be permitted to handle funds or securities exchanged in the transaction. This legislative solution would permit transaction-based compensation, as well as the initiation of negotiations between potential investors and issuers. Since the functions that many small-issuer broker-dealers perform are limited to introductions, buyer formation, and facilitation of negotiations, the current regulations imposing stringent recordkeeping and financial responsibilities are unnecessary to ensure that investors are protected.[25] This innovative solution would provide for a secondary marketplace of financial intermediaries for smaller issuers that cannot yet afford to hire registered broker-dealers.

Part I of this note explains the ambiguities created by the broker-dealer rules in the Securities and Exchange Act of 1934, federal courts' limited input on the subject, and the SEC's problematic interpretation of the law. Part II explains why the current framework for broker-dealer registration is an obstacle to capital acquisition. Part III provides a legislative solution to the problem. This solution would strike a balance between protecting investors and issuers and providing a regulatory framework that would provide a proposed new class of broker-dealers with sufficient incentives to facilitate smaller transactions.

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[23] *See infra* Section III.A.

[24] *See* ABA Report, *supra* note 16, at 960.

[25] *See* 17 C.F.R. §§ 240.17a-3 to -5, -11 (2013).

I. THE SECURITIES EXCHANGE ACT OF 1934: AMBIGUITIES AND INTERPRETATIONS

Corporate promoters often solicit individuals to help locate and persuade investors to contribute capital.[26] In contemporary capital markets, an increasing number of companies and funds are seeking the assistance of intermediaries for the purpose of raising capital or selling their business.[27] A broker is a person who acts as an intermediary in securities transactions for entrepreneurs.[28] A dealer is any person who buys and sells securities for his or her own account.[29] Broker-dealers may trade securities on their own account and effect securities transactions for business owners. When smaller companies desire capital, they often seek out broker-dealers to assist them in finding investors. Generally, broker-dealers seek out investors for larger transactions for which the broker-dealer is well compensated. Concomitantly, "many broker-dealers will not work with smaller issuers offering a securities tranche less than twenty-five million dollars in value, because there is insufficient transaction-based compensation for the broker-dealer."[30] Therefore, when smaller issuers need capital, they often seek out unregistered intermediaries for the purpose of finding investors.[31] These unregistered intermediaries are known as "finders," and they act as financial intermediaries in transactions that are not valuable enough to warrant registered broker-dealer attention. A finder is typically defined as a person, who brings together buyers and sellers for a fee, but who has no active role in negotiations, does not hold securities or cash, and may not bind either party to the transaction.[32]

In order to become a registered broker-dealer, one must comply with many comprehensive requirements. The broker-dealer must pass licensing tests administered by the SEC and

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[26] *See* Kenneth G.M. Mason & Sharon Obialo, *Fog May Be Lifting Around Finders*, LAW360 (Apr. 16, 2014, 11:25 AM), http://www.law360.com/articles/521047/fog-may-be-lifting-around-finders [http://perma.cc/MNE7-D3B7].

[27] *See* Dario de Martino & Jason Canales, *Finders Agreements in a State of Flux*, LAW360 (July 13, 2011, 12:54 PM), http://www.law360.com/articles/257427/finders-agreements-in-a-state-of-flux?article_related_content=1 [http://perma.cc/G859-AUFQ].

[28] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4)(A) (2012).

[29] *Id.* § 78c(a)(5)(A).

[30] *See* ABA Report, *supra* note 16, at 969.

[31] *See* Robert Connolly, *Legitimizing Private Placement Broker-Dealers Who Deal with Private Investment Funds: A Proposal for a New Regulatory Regime and a Limited Exception to Registration*, 40 J. MARSHALL L. REV. 703, 704 (2007).

[32] *See* Alan J. Berkeley & Alissa J Altongy, *Regulation D Offerings and Private Placements* 51 (ALI-ABA Continuing Legal Education, 2001). For purposes of this note, the terms "finders" and "unregistered brokers" will be used interchangeably.

FINRA.[33] Section 78*o*(a)(1) of the 1934 Securities Exchange Act states, in pertinent part,

> It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered in accordance with subsection (b) of this section.[34]

The purpose of the Securities Exchange Act is predominantly to protect investors against market manipulation by imposing regular reporting requirements upon securities issuers.[35] Registered broker-dealers are required to follow a set of rules promulgated with the purpose of protecting investors, including standards of professional conduct, minimum net-capital requirements, recordkeeping requirements, and supervisory obligations over broker-dealer employees.[36] The registration requirement aims to guarantee that securities are only sold by an intermediary who understands and appreciates both the financial instrument the broker-dealer sells and the broker-dealer's responsibilities to investors.[37] Registration triggers many other sections of the Securities Exchange Act, and consequentially, provides investors with full disclosure regarding securities offerings, ensures that broker-dealers are competent and financially able to conduct transactions,[38] and subjects broker-dealers to the oversight of self-regulatory organizations.[39]

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[33] F. Alec Orudjev, *The State of Unregistered Intermediary Regulation*, LAW360 (Nov. 17, 2008, 12:00 AM), http://www.law360.com/articles/77199/the-state-of-unregistered-intermediary-regulation?article_related_content=1 [http://perma.cc/MTE6-NLLB].

[34] Securities Exchange Act of 1934, 15 U.S.C. § 78*o*(a)(1) (2012).

[35] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (citing S. Rep. NO.792, at 1-5 (1934)).

[36] *See* Roth v. SEC, 22 F.3d 1108, 1109 (D.C. Cir. 1994) (citing David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899 (1987)).

[37] *See id.*

[38] Financial ability is ensured by net capital requirements, which call for a minimum of net capital and equitable solvency. See 17 C.F.R. § 240.15c3-1, which states,

> For the purposes of this section, a broker or dealer is insolvent if the broker or dealer: (i) Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker or dealer or its property or is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer or its property; (ii) Has made a general assignment for the benefit of creditors; (iii) Is insolvent within the meaning of section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or (iv) Is unable to make such

Certain classes of broker-dealers are exempt from the registration requirement imposed by section 78*o*(a)(1). Specifically, broker-dealers who deal only in "exempted securit[ies] or commercial paper, bankers' acceptances, or commercial bills" are not required to register.[40] Further, broker-dealers who deal exclusively in intrastate transactions are not required to register under the Act, but they may still be subject to state regulation.[41] The intrastate exception is interpreted narrowly, in that a transaction involving the use of interstate communication, whether by telephone, electronic mail, or another means of interstate communication, qualifies the transaction as an interstate one requiring registration with the SEC.[42]

A. *Determining the Legal Status of Financial Intermediaries*

In specific instances, the SEC and the federal courts will determine whether an unregistered financial intermediary is in fact acting as a broker-dealer and thus falls under the purview and registration requirements of the Securities Exchange Act. Section 78*o*(a)(1) specifies that a person "effecting securities transactions" using the instrumentalities of interstate commerce must register as a broker-dealer.[43] The Act does not, however, define the meaning of "effecting securities transactions."[44] In order to determine if a finder must register as a broker-dealer,

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> computations as may be necessary to establish compliance with this section or with § 240.15c3-3.

17 C.F.R. § 240.15c3-1(16) (2014).

[39] *See* David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899, 907 (1987).

[40] Securities Exchange Act of 1934, 15 U.S.C. § 78*o*(a)(1) (2012).

[41] *See, e.g.*, N.Y. GEN. BUS. LAW § 352(2) (McKinney 2015) ("No dealer or broker shall sell or offer for sale to or purchase or offer to purchase from the public within or from this state, as principal, or broker, any securities issued or to be issued unless and until a notice, to be known as the 'state notice,' containing the name, business or post office address of such dealer or broker and if a corporation the state or country of incorporation thereof, and if a partnership the names of the partners, shall have been filed in the department of state."); *see* 15 U.S.C. § 78*o*(c)(1)(A) (making it unlawful for a broker-dealer to "make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security"); *see also* N. Sec. Co., SEC No-Action Letter, 1974 WL 8442, at *5 (Mar. 13, 1974) ("We would like to emphasize that the thrust of the broker dealer registration provisions of Section 15 of the '34 Act are to regulate interstate broker dealers, while the '33 Act regulates the interstate offering of securities. . . . The activities of the issuer in this instance are interstate and rightly come within the provisions of the '33 Act.").

[42] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(17).

[43] *Id.* § 78*o*(a)(1).

[44] *See* DeHuff v. Digital Ally, Inc., No. 3:08CV327TSL-JCS, 2009 WL 4908581, at *3 (S.D. Miss. 2009).

the SEC and federal courts typically apply a multifactor analysis that considers

> whether a person (1) works as an employee of the issuer, (2) receives a commission rather than a salary, (3) sells or earlier sold the securities of another issuer, (4) participates in negotiations between the issuer and an investor, (5) provides either advice or a valuation as to the merit of an investment, and (6) actively (rather than passively) finds investors.[45]

Some courts have postulated that the most important factor in determining whether an individual is a broker-dealer is the "regularity of participation in securities transactions at key points in the chain [of] distribution."[46] For example, in *SEC v. Martino*, the court found that a financial intermediary, Martino, regularly participated in transactions "at key points in the chain of distribution" when Martino was involved in every aspect of the securities transactions at issue and was "at all times aware" of the status of the transactions.[47] Consequently, the court found that Martino was acting as an unlicensed broker-dealer and ordered him to disgorge illegal brokerage revenues.

The SEC asserts that "[t]ransaction-based compensation, or commissions[,] are one of the hallmarks of being a broker-dealer" because transaction-based compensation provides "a potential incentive for abusive sales practices that registration is intended to regulate and prevent."[48] For example, in the partial denial of no-action relief[49] by the SEC, the issuer, 1st Global, asked the Division of Market Regulation whether it would recommend enforcement "if a registered broker-dealer subsidiary

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[45] SEC v. Kramer, 778 F. Supp. 2d 1320, 1334 (M.D. Fla. 2011); *see also* Cornhusker Energy Lexington, LLC v. Prospect St. Ventures, No. 8:04CV586, 2006 WL 2620985, at *6 (D. Neb. Sept. 12, 2006) (identifying activities such as "analyzing the financial needs of an issuer, recommending or designing financing methods," discussing "details of securities transactions," and recommending an investment as evidence of broker activity for purposes of triggering the registration requirements); SEC v. Margolin, No. 92 Civ. 6307 (PKL), 1992 WL 279735, at *5 (S.D.N.Y. Sept. 30, 1992) (finding evidence of "brokerage activity" in the defendant's "receiving transaction-based compensation, advertising for clients, and possessing client funds and securities").

[46] *See* SEC v. Bravata, No. 09-12950, 2009 WL 2245649, at *2 (E.D. Mich. July 27, 2009) (quoting SEC v. Martino, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003)); *see also* Landegger v. Cohen, No. 11-cv-01760-WJM-CBS, 2013 WL 5444052, at *5 (D. Colo. Sept. 30, 2013) (finding that two of the factors should be afforded heightened weight: transaction-based compensation and regularity of participation).

[47] *Martino*, 255 F. Supp. 2d at 283; *see also* SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 12-13 (D.D.C. 1998) (describing "regularity of participation" as one of the primary indicia of "engag[ing] in the business").

[48] *Cornhusker Energy Lexington*, 2006 WL 2620985, at *6.

[49] See *infra* notes 81-84 and accompanying text for an explanation of the precedential value of a no-action letter.

of 1st Global, Inc. enter[ed] into arrangements with certified public accountants and CPA firms to pay securities-based commissions."[50] The Division partially denied no-action relief to 1st Global under the arrangement proposed, because

> an unregistered CPA firm would indirectly receive securities commissions earned by a CPA registered representative, thereby giving it a financial stake in the revenues generated by the registered representative's securities transactions, at the same time that the CPA firm is in a position to influence the registered representative's actions and to direct customers to the registered representative.[51]

The SEC reasoned that intermediaries who receive transaction-based compensation generally have to register as broker-dealers because "registration helps to ensure that persons with a 'salesman's stake' in a securities transaction operate in a manner consistent with customer protection standards governing broker-dealers and their associated persons, such as sales practice rules."[52] Broker-dealer sales-practice rules require registered brokers to maintain voluminous records of customer information.[53] In addition, broker-dealers must reasonably believe that an investment strategy is suitable for a specific investor based on the strategic goals and risk tolerance of the investor.[54] The SEC's hardline approach to transaction-based compensation should be contrasted with the approach of the federal courts, which frequently hold that none of the factors taken individually are intended to be dispositive of whether an individual is acting as a broker-dealer.[55]

Courts and the SEC have disagreed regarding the number of transactions necessary to establish broker-dealer status. Moreover, calculating the number of transactions in which a finder participates becomes an uncertain part of the analysis because of the ambiguous definition of "participation" in a transaction.[56] The SEC has stated that participation in a transaction "includes, among other activities, assisting an issuer to structure prospective securities transactions, helping an issuer

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[50] 1st Glob., Inc., SEC No-Action Letter, 2001 WL 499080, at *13 (May 7, 2001).

[51] *Id.* at *16.

[52] *See id.* at *14.

[53] *See* Books & Records Requirements for Brokers & Dealers Under the Sec. Exch. Act of 1934, Exchange Act Release No. 44992, 2001 WL 1327088 (Oct. 26, 2001).

[54] *See* OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, JOINT SEC/NASD STAFF REPORT ON EXAMINATION FINDINGS REGARDING BROKER-DEALER SALES OF VARIABLE INSURANCE PRODUCTS 2 (2004), https://www.sec.gov/news/studies/secnasdvip.pdf [http://perma.cc/8NXJ-VMYN].

[55] *See, e.g.*, SEC v. Benger, 697 F. Supp. 2d 932, 945 (N.D. Ill. 2010); SEC v. Kramer, 778 F. Supp. 2d 1320, 1334 (M.D. Fla. 2011).

[56] *See* Mason & Obialo, *supra* note 26.

to identify potential purchasers of securities, soliciting securities transactions (including advertising), and participating in the order-taking or order-routing process (for example, by taking transaction orders from customers)."[57] For instance, in *SEC v. Margolin*, the Court held that the SEC succeeded in demonstrating "regularity of business activity" because Margolin, a financial intermediary, had participated "in dozens of transactions for various clients."[58] Thus, the regularity of business activity factor is influential but not dispositive in the federal broker-dealer registration analysis.

B. Changes in Enforcement Policy by Congress and the SEC

Recognizing that ambiguities in statutory intent and market realities were making it difficult for smaller issuers to find investors, and thus to raise capital, Congress and the SEC shifted their policies to facilitate smaller-issuer capital acquisition. The Jumpstart Our Business Startups Act of 2012 (JOBS Act) presented a policy change for financial intermediaries assisting issuers with transactions under Rule 506 of Regulation D.[59] Rule 506 permits issuers to sell securities to investors without registration, provided that issuers comply with conditions designed to maintain the private nature of the offering.[60] The JOBS Act permits a financial intermediary assisting with a Rule 506 offering not integrated with offerings under any other exemption to facilitate the transaction, as long as the financial intermediary does not receive transaction-based compensation.[61] Although a step in the right direction, the exemption for Rule 506 transactions is not broad enough to provide a suitable framework for small-business capital acquisition, especially in light of the growing use of Title III and Regulation A+ offerings to market unregistered securities to the investing public.[62]

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[57] MuniAuction, Inc., SEC No-Action Letter, 2000 WL 291007, at *1 (Mar. 13, 2000).

[58] SEC v. Margolin, No. 92 Civ. 6307 (PKL), 1992 WL 279735, at *5 (S.D.N.Y. Sept. 30, 1992).

[59] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[60] *See id.*

[61] *See id.* § 201(c)(2), 126 Stat. at 314.

[62] Press Release, SEC, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), http://www.sec.gov/news/pressrelease/2015-49.html [http://perma.cc/SF6F-DUTY]; Press Release, SEC, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), https://www.sec.gov/news/pressrelease/2015-249.html [http://perma.cc/F3ET-4S8X]. Title III and Regulation A+ permit issuers to market securities to regular investors, frequently through the use of Internet portals.

On January 31, 2014, the SEC issued a no-action letter[63] stipulating that the SEC would not take enforcement action against a mergers and acquisitions broker (M&A broker) in connection with the transfer of a privately held company.[64] This action solidified the notion that financial intermediaries should not be required to register to engage in the sale of control of a small issuer. In the no-action letter, the SEC defined an "M&A broker" as a financial intermediary engaged in the business of effecting securities transactions solely with the purpose of transferring ownership and control of a privately-held company through the sale of securities.[65] The SEC emphasized that the buyer must actually control the company after the sale, and control may be found through the power to elect executive officers or the power to approve the annual budget.[66] Although it is risky to treat a no-action letter as legal precedent,[67] presumably, the SEC "would not recommend enforcement under Section 15(a) of the Exchange Act if an M&A broker were to effect securities transactions in connection with the transfer of ownership of a privately-held company."[68] There are many limits on the scope of the protection afforded to M&A brokers by this letter. Specifically, M&A brokers are prohibited from binding parties to an M&A transaction, providing financing for a transaction, handling funds or securities exchanged in connection with the transaction, organizing the groups involved in the M&A transaction, or transferring interests to a passive buyer, among other restrictions.[69]

The effect of the no-action letter is presumably that the SEC will not file suit against an M&A broker who engages in one or more of the following activities[70]:

> 1. Represent[ing] the buyer or seller [of securities] . . . as long as both receive disclosure and give written consent. 2. Facilitat[ing] a transaction with a buyer or buyer group that, upon completion of the transaction, will control the business. 3. Facilitat[ing] a transaction involving the purchase or sale of a privately-held company no matter its size. 4. Advertis[ing] a company for sale with information such as the description of the business, general location, and price range. 5. Advis[ing]

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63 *See infra* notes 81-84 and accompanying text.
64 M&A Brokers, SEC No-Action Letter, 2014 WL 356983, at *1 (Jan. 31, 2014).
65 *Id.*
66 *Id.*
67 *See infra* notes 81-84 and accompanying text.
68 *M&A Brokers*, 2014 WL 356983, at *1.
69 *See id.* at *2-3.
70 *See infra* notes 81-84 and accompanying text.

the parties to issue securities or accomplish the transaction by means of securities, and assess the value of any securities sold.[71]

Control of the business is presumed to exist if the purchaser has the power to direct or influence the management of the acquired company.[72] Other conditions sufficient to find control include ownership of 25% or more of a class of voting securities, the power to sell 25% or more of a class of voting securities, or in the case of a partnership or limited liability company, the right to receive upon dissolution or contribution 25% or more of the capital.[73] Finally, the provisions of the letter prohibit mere figureheads; the buyer "must actively operate the . . . business with the assets of the company."[74] Although the M&A broker no-action letter granted some latitude to unregistered financial intermediaries, many uncertainties remain that threaten to diminish investment in early-stage companies.

In sum, the currently uncertain regulatory landscape leaves many gray areas for financial intermediaries and issuers and threatens to hinder future business investment. It is unclear how many transactions a broker may engage in without restraint before broker-dealer registration is required. There is no clear doctrine regarding the effect of a flat fee that simulates transaction-based compensation. The M&A no-action letter, by its plain language, does not apply to transactions in which a large stake of a company is sold but control is retained, leading to dissimilar outcomes in nearly identical cases. Regardless of an uncertain legal landscape, due to market demand and erratic enforcement policies from the SEC, unregistered brokers continue to facilitate smaller transactions.[75]

II. CURRENT REGISTRATION REQUIREMENTS STIFLE CAPITAL ACQUISITION

In light of the varying interpretations of section 78*o*(a)(1) of the 1934 Securities Exchange Act by the SEC and various federal courts, many unregistered brokers are exposed to liability, and their issuer-principals are exposed to recsissionary liability.

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[71] Alexander Davie, *SEC Provides Exemption from Broker-Dealer Registration Requirements for M&A Brokers*, LEXISNEXIS LEGAL NEWSROOM: SEC. (Mar. 11, 2014, 2:22 PM), http://www.lexisnexis.com/legalnewsroom/securities/b/securities/archive/2014/03/11/sec-provides-exemption-from-broker-dealer-registration-requirements-for-m-amp-a-brokers.aspx [http://perma.cc/3Z26-KR79].

[72] *See M&A Brokers*, 2014 WL 356983, at *2.

[73] *See id.*

[74] *See id.*

[75] *See* ABA Report, *supra* note 16, at 959.

The M&A broker no-action letter only applies to transactions in which the buyer is obtaining control of the business.[76] Thus, smaller businesses that want to raise capital without relinquishing control to an outsider remain dependent on unregistered brokers, which are in the gray zone of current regulations. Further, even if a company is willing to cede control to an outside buyer, the M&A no-action letter is insufficient to ensure that the SEC will not bring suit, because no-action letters have no binding precedential effect, and the SEC has a history of revising its interpretation of the Securities Exchange Act.[77] Violation of the registration requirements of the Exchange Act may bring deleterious consequences for brokers and issuers, including voiding the transaction at issue, losing registration exemption privileges, and even criminal sanctions. In addition, state securities laws[78] are unnecessarily duplicative and impose additional burdens on unregistered brokers who attempt to facilitate transactions for smaller businesses.[79]

A. The Implications of the M&A No-Action Letter

The SEC's position that M&A brokers do not need to register to conduct a broad range of M&A activities or receive transaction-based compensation would seem to open up new opportunities for small-issuer financing.[80] The SEC letter, however, has no precedential effect, and the SEC can revoke it at any time.[81] No-action letters are opinions issued by the staff of the SEC, not the commissioners.[82] As such, no-action letters are not reviewable "orders" of an agency under the Administrative Procedure Act.[83] The no-action letter is nothing more than a declaration stating "we won't sue you this time for this possible infraction of the law." It has no binding effect on other parties or on the same party in subsequent transactions. In practice, many

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[76] *See M&A Brokers*, 2014 WL 356983, at *2-3.

[77] *See infra* notes 81-84 and accompanying text.

[78] State blue sky laws are usually modeled after the Uniform Securities Act of 2002. *See* MUTUAL FUNDS GUIDE (CCH) ¶ 2565, 2009 WL 2319599 (2009).

[79] *See* Rutheford B. Campbell Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553, 553 (1985).

[80] *See* Davie, *supra* note 71.

[81] *See* Amalgamated Clothing & Textile Workers Union v. SEC, 15 F.3d 254, 257 (2d Cir. 1994).

[82] *See* Bd. of Trade of the City of Chi. v. SEC, 883 F.2d 525, 530 (7th Cir. 1989).

[83] *See id.* at 529-30.

attorneys do rely on no-action letters, possibly to the detriment of their clients.[84]

The SEC has revised its regulations with regards to broker-dealers many times in the recent past, resulting in the hindrance of small-issuer capital acquisition. The SEC held a hardline position against unregistered finders from 1993 to 2007, requiring registration if the broker was actively involved in the transaction and received transaction-based compensation.[85] The SEC expanded its views in subsequent no-action letters. For example, a 2008 no-action letter stated that

> an intermediary who did nothing more than bring merger or acquisition-minded people or entities together and did not participate in negotiations or settlements between them probably would not be a broker in securities and not subject to the registration requirements of Section 15 of the Exchange Act; on the other hand, an intermediary who plays an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally would be deemed to be a broker and required to register with the Commission.[86]

In this letter, the SEC recognized that certain financial intermediaries may facilitate negotiations for issuers without registration, as long as they do not engage in activities that pose a significant risk to investors or issuers.

In 2009, the SEC enhanced its scrutiny of transaction-based compensation by bringing an administrative proceeding against RAM Capital Resources, LLC and its two principals.[87] RAM Capital and its principals had identified and solicited investors to participate in private investments in public companies without registering with the SEC as a broker-dealer.[88] RAM was compensated in proportion to the size of the deals and had a hand in the structure of the offerings.[89] The SEC imposed sanctions on

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[84] *See* Informal Guidance Program for Small Entities, Exchange Act Release Nos. 33-7407, 34-38446, 35-26695, 39-2349, IC-22587, IA-1624, 17 C.F.R. Part 202, at n.20, 1997 WL 138947 (Mar. 27, 1997) ("The Divisions of Corporation Finance and Market Regulation specify when others may rely upon the advice in a no-action letter. The Division of Investment Management generally permits third parties to rely on no-action or interpretive letters to the extent that the third party's facts and circumstances are substantially similar to those described in the underlying request for a no-action or interpretive letter."); Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 946-47 (1998).

[85] Mason & Obialo, *supra* note 26 (citing Hallmark Capital Corp., SEC No-Action Letter (June 11, 2007); Wirthlin, John R., SEC No-Action Letter, 1999 WL 34898 (Jan. 19, 1999); Davenport Mgmt. Inc. et al., SEC No-Action Letter (Apr. 13, 1993)).

[86] *See* Goppelt, Henry C., [1973-1974 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 79,814 (May 14, 1974).

[87] Ram Capital Res., LLC, Exchange Act Release No. 60149, 2009 WL 1723950 (June 19, 2009).

[88] *Id.*

[89] *Id.*

RAM and its principals pursuant to section 15(a) of the Securities Exchange Act, finding that they "knew or were reckless in not knowing that Ram's compensation structure for its services required RAM to register as a broker-dealer."[90] By "compensation structure," the SEC was referring to the fact that RAM was paid in proportion to the monetary size of the transaction.

Similarly, in 2010, the SEC denied no-action relief to Nemzoff & Company, LLC, even though the company arguably fell within a limited exception to broker-dealer registration under section 3(e) of the Securities Exchange Act, and Nemzoff, in its role as a consultant, would not possess securities at any point during the transaction.[91] Section 3(e) provides that charitable organizations are exempt from broker-dealer registration.[92] The SEC determined that "Nemzoff, as a consultant, would not be a [q]ualifying [p]erson under Section 3(e)" because Nemzoff did not preclude the possibility of receiving transaction-based compensation.[93] Therefore, Nemzoff's 3(e) exemption from registration was voided on the basis of transaction-based compensation. Under the provisions outlined in the 2014 M&A brokers no-action letter,[94] Nemzoff would likely be exempt from the registration requirement, because in its role as a consultant to the transacting parties, it would not bind the parties to the transaction, provide financing to a transaction, handle funds or securities exchanged in connection with the transaction, organize the groups involved in the M&A transaction, or transfer interests to a passive buyer.[95] The preceding temporal evolution of SEC policy demonstrates that the SEC does not possess a static view with regard to interpretation of the broker-dealer registration provisions. Furthermore, the M&A no-action letter is less valuable to broker-dealers than it may appear at first glance, because the SEC may revoke it at any time.

The SEC may change its policies for many reasons. The commissioners are politically appointed officials;[96] thus, their policies may shift as the legislative and executive branches change. Different political ideologies may favor investor

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[90] *Id.*

[91] Nemzoff & Co., LLC, Denial of SEC No-Action Letter Request, 2010 WL 4914519 (Nov. 30, 2010).

[92] Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4) (2012).

[93] *Id.*

[94] M&A Brokers, SEC No-Action Letter, 2014 WL 356983 (Jan. 31, 2014).

[95] *See id.* at *2-3.

[96] *Current SEC Commissioners*, SEC, http://www.sec.gov/about/commissioner.shtml#.VK2zASvF_g0 [http://perma.cc/VRW2-WXJU] (last visited May 30, 2016).

protection over the regulation of brokerage activities.[97] But stability and growth in the economy require definitive capital acquisition regulations that persevere through political changeover. This can be achieved more effectively through a comprehensive legislative solution.

Although the M&A no-action letter represents a favorable change in SEC enforcement policy towards unregistered brokers who transfer control of a company, it has no impact on brokers who effect transfers of less than full control. It is not in the business plan of many small businesses to cede control, especially early in the venture. Many entrepreneurs would rather sell their business concept instead of accepting loss of control over the evolution of the company.[98] If the owner sells the idea, the owner will realize a definite economic return; however, if the owner sells control of the company, the owner cannot be sure that new management will successfully market and develop the idea or product.[99] Thus, although the M&A no-action letter shows that the SEC is cognizant of the realities of the private equity market, the current broker-dealer rules are insufficient to ameliorate the difficulties presented to small businesses seeking capital. More robust changes in regulation are necessary in order to allow unregistered financial intermediaries to effect transactions without transferring control of the business.

B. Consequences of Violating Broker-Dealer Registration Requirements

If the SEC chooses to categorize an unregistered broker as a broker-dealer under the 1934 Act, the unregistered broker will be unable to legally collect unpaid fees from principals.[100] Section 78cc(b) of the Exchange Act renders void sales of securities made in violation of the Exchange Act. Therefore, any investor that purchases securities from an unregistered financial intermediary acting as a broker-dealer may have the right to void the transaction and claim that the funds used to purchase the securities must be returned.[101] Furthermore, if a company uses an

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[97] *See generally* Lucian A. Bebchuk & Zvika Neeman, *Investor Protection and Interest Group Politics*, 23 REV. FIN. STUD. 939 (2010) (arguing that political forces directly affect levels of investor protection).

[98] James S. Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 282 (1969).

[99] *See id.*

[100] Securities Exchange Act of 1934, 15 U.S.C. § 78cc(b) (2012); Martino & Canales, *supra* note 27.

[101] *See* 15 U.S.C. § 78cc; Martino & Canales, *supra* note 27.

unregistered broker, the company stands to lose its exemption from the registration requirements of the Securities Act of 1933.[102] It may lose an important avenue for raising capital because the SEC may restrict the company from engaging in private placement offerings.[103] This consequence is significant because most small-issuer offerings rely on SEC exemptions, as smaller issuers cannot yet afford a fully registered offering. The SEC can seek an injunction against "the finder activities, issue a cease-and-desist order following notice and a hearing," and in an unlikely state of affairs, "refer the matter to the government for criminal prosecution."[104] The SEC can also impose civil penalties and require accounting and disgorgement.[105]

One of the consequences for small businesses that engage unregistered brokers is the possibility that transactions may be rescinded if the SEC determines that the broker should have been registered prior to facilitating the transaction.[106] The rescission of a securities transaction can lead to the financial ruin of small businesses. In 2012, Neogenix Oncology, Inc. filed for Chapter 11 Bankruptcy because the SEC found that securities transactions assisted by unregistered financial intermediaries were voidable, and the company was unable to continue raising capital.[107] As a

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[102] For example, in a Regulation D transaction, an issuer may be liable for the general solicitation conducted by an unregistered broker, leading to loss of the exemption and liability for the sale of unregistered securities. *See* 15 U.S.C. § 77d(a)(2) (exempting offerings by an issuer "not involving any public offering"); SEC Regulation D, 17 C.F.R. § 230.502(c) (2013) (prohibiting public advertising and general solicitation to investors in all Regulation D transactions, except for transactions under Rule 504 or 506(c)).

[103] *See, e.g.*, 17 C.F.R. § 230.506(d) (2013) (prohibiting "bad actor[s]" from engaging in Regulation D exempt offerings); Martino & Canales, *supra* note 27.

[104] Martino & Canales, *supra* note 27; Securities Exchange Act of 1934, 15 U.S.C. § 78u-3 (2012).

[105] 15 U.S.C. § 78u-2(a)-(e).

[106] The Securities Exchange Act provides in pertinent part that

> [e]very contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation . . . .

Id. § 78cc(b).

[107] *See* Neogenix Letter, *supra* note 2; *see also* Alexander J. Davie, *Neogenix Oncology: A Good Case Study on Securities Law (Non)Compliance by a High Growth Company—Part 1: How It All Happened*, STRICTLY BUS. (Oct. 5, 2012), http://www.strictlybusinesslawblog.com/2012/10/05/neogenix-oncology-a-good-case-study-on-securities-law-noncompliance-by-a-high-growth-company-part-1-how-it-all-happened/

result, Neogenix was forced to sell all of its assets to a single bidder, effectively dissolving the company. A legislative solution is necessary to remedy this defect in the rules governing financial intermediaries in order to allow small businesses to efficiently and effectively raise capital.

C. *State Blue Sky Laws*

Even though the M&A brokers no-action letter provides limited relief to M&A brokers from federal enforcement of registration laws, states continue to impose registration requirements on unregistered financial intermediaries.[108] State securities laws, often coined "blue sky laws,"[109] impose expensive and cumbersome registration requirements on intermediaries who are not registered with the federal government. Blue sky laws are not preempted by federal law as it now stands.[110] Blue sky laws have been enacted in virtually every state, and while they differ in their details, their overriding purpose is to protect investors from fraud and market manipulation.[111]

State blue sky laws are modeled on the Uniform Securities Act of 2002, the goal of which was to standardize state securities laws.[112] Blue sky laws generally require registration of securities offerings and financial intermediaries for the purpose of protecting investors.[113] One advantage of having a uniform act is that courts can defer to the interpretations of courts in other states on unresolved questions of law.[114] The California Act, for

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[http://perma.cc/Q83A-Z6W6] ("These 'finders' fees' were payments Neogenix made to third parties for their role in raising over $30 million in capital for Neogenix.").

108 *See* B. Rogers, *Blue Sky Laws*, 87 A.L.R. 42 (1933).

109 While the exact origin of the name is unclear, the first known use was by Justice McKenna in *Hall vs. Geiger-Jones Co.*, 242 U.S. 539, 550-51 (1917) ("The name that is given to the law indicates the evil at which it is aimed; that is, to use the language of a cited case, 'speculative schemes which have no more basis than so many feet of "blue sky"'; or, as stated by counsel in another case, 'to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines and other like fraudulent exploitations.' Even if the descriptions be regarded as rhetorical, the existence of evil is indicated, and a belief of its detriment; and we shall not pause to do more than state that the prevention of deception is within the competency of government and that the appreciation of the consequences of it is not open for our review." (quoting Trading Stamp Cases, 240 U.S. 342, 391 (1916))).

110 *See* Campbell, *supra* note 79, at 567.

111 *See* Rogers, *supra* note 108.

112 *See* CCH MUTUAL FUNDS GUIDE, *supra* note 78; *see also* Adam J. Gana & Michael Villacres, *Blue Skies for America in the Securities Industry . . . Except for New York: New York's Martin Act and the Private Right of Action*, 19 FORDHAM J. CORP. & FIN. L. 587, 590-91 (2014).

113 *See, e.g.*, Gill Printing Co. v. Goodman, 139 So. 250, 254 (1932) ("The registration of stock for sale under the Blue Sky Law is not a revenue measure, but is a regulation to protect the investing public.").

114 Gana & Villacres, *supra* note 112, at 591.

instance, defines a "broker" as any person who effects "transactions in securities . . . for the account of others or for his own account."[115] Blue sky laws require most sellers of securities to obtain a license.[116] A license is granted pursuant to an inquiry into the applicant and the nature of the securities that the applicant plans to sell.[117] Since state blue sky laws share with federal law a common purpose of full disclosure and investor protection, there are overlapping regulations. Such regulations are unnecessary and detrimental to the efficient functioning of securities markets because registrants must pay registration fees and comply with separate disclosure requirements at both the federal and state levels, thereby dissuading registered broker-dealers from participating in smaller transactions. Although many assert that state securities laws are an outgrowth of efforts to prevent fraud and manipulation, others argue that the statutes were passed in large part due to special interest lobbying.[118]

In recognition of the significant impediment that blue sky laws pose to early-stage capital acquisition, the North American Securities Administrators Association (NASAA)[119] has submitted for comment a uniform state model rule regarding the exemption of certain M&A brokers from registration as broker-dealers.[120] The model rule mirrors the provisions of the M&A brokers no-action letter[121] and exempts financial intermediaries from state registration as long as they limit their activities to the transfer of control of a privately held company without possessing securities or funds at any point in the process.[122]

Like the SEC, most states currently do not recognize the difference between a finder and a broker-dealer. Michigan is the only state that allows separate registration for finders.[123] Michigan requires unregistered broker-dealers to register as

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115 CAL. CORP. CODE § 25004 (West 2005).

116 Rogers, *supra* note 108.

117 *Id.*

118 Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348-51 (1991).

119 The NASAA is an organization dedicated to promulgating uniform securities laws, protecting investors, and guiding SEC and SRO rulemaking processes. *See About Us*, NASAA, http://www.nasaa.org/about-us/ [http://perma.cc/T337-V63Y] (last visited May 30, 2016).

120 *See* NASAA, NASAA MODEL RULE EXEMPTING CERTAIN MERGER AND ACQUISITION BROKERS FROM STATE REGISTRATION (2015), http://www.nasaa.org/wp-content/uploads/2015/04/Second-Request-for-Comments-MA-Broker-Model-Rule-FINAL.pdf [http://perma.cc/GSM6-GYHY] [hereinafter NASAA MODEL RULE].

121 *See* M&A Brokers, SEC No-Action Letter, 2014 WL 356983, at *2-3 (Jan. 31, 2014).

122 *See* NASAA MODEL RULE, *supra* note 120, at 2.

123 *See* Michigan Uniform Securities Act, 2008 Mich. Pub. Acts 247.

investment advisers.[124] The statute allows these finders, registered as investment advisers, to perform tasks typical of intermediary brokers, including the introduction of issuers to investors and the delivery of offering materials.[125]

Blue sky laws can prohibitively restrict entrepreneurial activities, resulting in the sale or abandonment of existing small businesses, rather than development and growth.[126]

> Six state statutes contain voidability provisions, all of which specifically give a right of rescission to the buyer. Four states make any sale made in violation of any provision of the Blue Sky statutes voidable. "Arizona limits its voidability provision to the sale of unregistered securities, transactions by unregistered dealers, or specified fraudulent practices; Florida and Illinois extend rescission to violation of the securities dealer, associated person, and investment adviser registration provisions."[127]

California provides rescission rights, attorneys' fees, and damages to persons who transact with an unregistered broker-dealer.[128] Although individual states' blue sky laws vary widely, generally the registration requirements are redundant against the backdrop of federal securities regulation, and they inhibit small business growth while simultaneously affording minimum additional protections to investors.

D. *Consequences of the Current Regulatory Framework*

Brokerage firms are willing to provide registered broker-dealers for larger transactions but are wary of smaller deals because of "self-imposed thresholds."[129] Registered broker-dealers are averse to dealing with smaller issuers for many reasons, including the fact that compliance costs for small and large transactions are often the same, and the cost of transacting for smaller issuers is likely greater than for larger issuers because larger issuers are more experienced with such transactions.[130] Additionally, the SEC frequently changes its standards regarding broker-dealer registration, as it is not precedentially bound by its no-action letters. This creates unpredictability for registered

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[124] *See id.*
[125] *See id.*
[126] *See* Mofsky, *supra* note 98, at 283-90.
[127] ABA Report, *supra* note 16, at 1004-05 (footnotes omitted) (quoting LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 11-B-4 (3d ed., 2001)).
[128] *See* CAL. CORP. CODE § 25501.5 (West 2015).
[129] ABA Report, *supra* note 16, at 968.
[130] *Id.* at 968-69.

broker-dealers and increases transaction costs.[131] The multibillion-dollar private equity industry cannot depend on uncertain doctrine. The consequences of violating broker-dealer registration requirements are dire and can lead to the dissolution or bankruptcy of a business, as demonstrated by the Neogenix case.[132] Blue sky laws add further complications, creating an overlapping layer of regulation that stifles capital acquisition, especially for smaller issuers.

Congress has yet to respond to the problems created by the lack of a cohesive legal framework to regulate brokers' actual practices. The law is asynchronous with current capital-raising practices because small businesses across the United States utilize unregistered brokers to facilitate private transactions of equity securities.[133] Although the SEC has declined to prosecute in some cases due to its recognition that unregistered financial intermediaries are a necessary tool for small-issuer capital acquisition, a literal reading of the Act reveals that these unregistered brokers are technically in violation of both federal law and many state laws.[134]

Registration as a broker-dealer is disproportionately expensive in comparison to the expected gain for brokers who facilitate sales of securities for early-stage businesses. The application fee for NASD membership for a broker-dealer is $3,000, consultants will charge $5,000 for aid with the application process, and experienced legal counsel is usually expensive.[135] The initial legal, compliance, and accounting costs of NASD membership often exceed $150,000, and annual maintenance costs range between $75,000 and $100,000 per year.[136] Cost, however, is only one of the disproportionate aspects of the current regulatory framework. The current application for broker-dealer

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131 *See* Amalgamated Clothing & Textile Workers Union v. SEC, 15 F.3d 254, 257 (2d Cir. 1994); *see also supra* notes 81-84 and accompanying text.

132 See discussion of *Neogenix Oncology*, *supra* notes 1-7 and accompanying text.

133 *See* ABA Report, *supra* note 16, at 970 (referring to anecdotal evidence of unregistered broker-dealer activity from a "large number of attorneys").

134 *See id.* at 960 ("Notwithstanding the various labels, and despite the fact that a great number of the brokers, funded businesses, and even sometimes their attorneys, do not realize that they are operating in violation of securities laws; simply put, they are unlicensed securities brokers whose fee contracts are unenforceable and whose activities are, in fact, illegal.").

135 ABA Report, *supra* note 16, at 1011; *see also Compliance Guide*, *supra* note 15 ("Most 'brokers' and 'dealers' must register with the SEC and join a 'self-regulatory organization,' or SRO.").

136 ABA Business Law Section, Comment Letter on FINRA Regulatory Notice 14-09 Proposing Rules for Limited Corporate Financing Brokers (May 21, 2014), https://www.finra.org/sites/default/files/NoticeComment/p512735.pdf [http://perma.cc/JK6X-LL2L].

registration is needlessly complex for small-issuer transactions.[137] The educational requirements for broker-dealer registration are misaligned with the reality of small-issuer intermediary broker practice.[138] These arduous registration and "compliance requirements effectively limit the [registered] broker to large transactions that yield a substantial return."[139] Since the functions that many brokers perform are limited to introductions, buyer formation, and facilitation of negotiations, the current regulations imposing stringent recordkeeping and financial responsibility requirements are unnecessary to ensure that investors are protected.[140]

III. A PROPOSED LEGISLATIVE SOLUTION

A legislative solution is needed to ameliorate the lack of synchronization between the actual practices of intermediary brokers and the law as it now stands. First, Congress should codify the provisions of the M&A broker no-action letter[141] pertaining to the sale of control of companies in order to protect issuers and brokers who transfer control of privately held corporations from a change in SEC enforcement policies. Second, Congress should amend the Securities Exchange Act to create a separate class of registered broker-dealers (intermediary brokers) who may assist early-stage issuers with capital acquisition. Under this regulatory framework, intermediary brokers should be permitted to engage in a limited range of activities without risking reprisal from the SEC, including (1) receiving transaction-based compensation, (2) introducing potential investors to potential issuers, (3) engaging investors in private placement offers, and (4) initiating negotiations between parties, even if the issuer does not plan to cede control of the company. This proposed legislation would further contribute to the growth of the U.S. economy by providing smaller businesses with a more equitable route to capital acquisition.

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[137] *See* ABA Report, *supra* note 16, at 1010 ("The present broker-dealer registration system, and especially the NASD membership application process, are disproportionately complex for someone acting only as a 'finder' or one who is locating companies as potential merger candidates.").

[138] *See id.* at 1011-12 (discussing the various types of preregistration examinations that broker-dealers are required to pass, and suggesting a new set of examinations to cover topics more congruent to intermediary brokers' actual practices).

[139] Samuel Hagreen, Note, *The JOBS Act: Exempting Internet Portals from the Definition of Broker-Dealer*, 90 DENVER U. L. REV. ONLINE 73, 75 (2013).

[140] *See* 17 C.F.R. § 240.17a-3 to -5, -11 (2013).

[141] M&A Brokers, SEC No-Action Letter, 2014 WL 356983 (Jan. 31, 2014).

A. Policy Considerations

Congress has already enacted statutes that aim to achieve the same goal as the statute proposed in this note. The JOBS Act,[142] which Congress passed in 2012, was calculated to remove the legal barriers preventing startup businesses from advertising to investors and selling securities on the public market.[143] The JOBS Act removed such barriers by lessening restrictions on emerging-growth companies, allowing companies to raise capital over the Internet from ordinary investors, and revising archaic SEC regulations.[144] The Act allows smaller issuers to sell securities to the public and in ways previously limited to larger issuers through registered offerings.[145] Further, the Act permits crowdfunding, a process in which ordinary investors can invest in early-stage companies through online crowdfunding portals.[146] In addition, Title II of the JOBS Act specifically exempted online crowdfunding portals from broker-dealer registration.[147] This exemption was motivated by the perceived need for increased public access to investment opportunities and small-issuer access to capital.[148]

The limited exemption to broker-dealer registration for Title II transactions recognized that the current regulatory scheme actually hinders the financing of small issuers more than it protects investors.[149] The exemption was adopted nearly unanimously, as its provisions were recognized to benefit early-stage businesses and reduce significant costs to investors.[150] The JOBS Act demonstrates that Congress and the executive branch recognize the problems that small issuers face in raising capital and have already taken significant steps to ameliorate the issue. Codification of the provisions of the M&A no-action letter and enactment of a statute specifying a separate registration vehicle for intermediary brokers would

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[142] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[143] *See* JAMES HAMILTON, WOLTERS KLUWER LAW & BUS., GUIDANCE AND COMMENTS INFORM JOBS ACT IMPLEMENTATION 1 (2012), http://news.wolterskluwerlb.com/media/Briefing_Jobs-Act_May_2012.pdf [http://perma.cc/UR8G-35WX].

[144] *See id.*

[145] *See id.*

[146] *See id.*

[147] *See Jumpstart Our Business Startups Act: Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, SEC (Feb. 5, 2013), http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm [http://perma.cc/RDK2-Q6LU].

[148] *See id.*

[149] *See* Hagreen, *supra* note 139, at 77-78.

[150] *Id.*

continue to expedite the same policy goal that drove the JOBS Act—stimulating the growth of business through new avenues for capital formation.

B. Elements of the Proposed Legislation

1. Registration Requirements for Intermediary Brokers

The current registration system for broker-dealers requires maintenance of a minimum net capital equal to the monetary value of the securities transactions the broker-dealer conducts and to its financial ratios.[151] This requirement aims to ensure that a broker-dealer always has enough liquid assets to promptly satisfy the claims of customers.[152] Since broker-dealers typically hold customer funds or securities at certain points in transactions, the net capital requirement ensures that investors and issuers are insured against any loss of such funds or securities. On the other hand, intermediary brokers will not be permitted to handle funds or securities on behalf of any principal at any point during the transaction. Since intermediary brokers primarily engage in introducing parties, organizing groups, and facilitating negotiations, there is no need for a net capital requirement pursuant to intermediary broker registration, because there is no commensurate risk of loss.

2. Transaction-Based Compensation

The SEC has argued that unregistered brokers "edge closer" to becoming full-fledged broker-dealers when they receive transaction-based compensation.[153] In the SEC's view, intermediaries who have a financial motivation in proportion to the size of the transaction are more likely to commit acts inconsistent with investors' best interests.[154] However, recommending an investment strategy or leading negotiations between investors and issuers are not necessarily brokerage activities, because other professionals engage in such enterprises.[155]

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[151] *See Compliance Guide*, *supra* note 15.

[152] *See id.*; *see also supra* note 38 and accompanying text (explaining the concept of equitable solvency).

[153] ABA Report, *supra* note 16, at 974.

[154] *See* Herbruck, Alder & Co., SEC No-Action Letter, 2002 WL 1290291, at *2 (May 3, 2002).

[155] SEC v. Kramer, 778 F. Supp. 2d 1320, 1334-35 (M.D. Fla. 2011) (criticizing the SEC's dependence on transaction-based compensation as the singularly sufficient element of broker-dealer activity). Likewise, the practical outcome of a flat-fee compensation model as opposed to a transaction-based compensation model will lead to

Allowing an intermediary broker to be compensated in proportion to the size of the transaction at issue will lead to positive outcomes, including proper competition between intermediary brokers, market selection, and enhanced value for transaction participants.[156] The market will choose the most efficient outcome, because investors and issuers both aim to reduce transaction costs while effecting their equity investments.[157] Full disclosure and fraudulent misrepresentation rules will protect investors while allowing intermediary brokers to compete for the most valuable transactions.[158] Market competition will lead to enhanced value for issuers because intermediary brokers will have a direct financial incentive to perform.

3. Engaging Investors and Initiating Negotiations

Intermediary brokers must be permitted to engage investors and initiate negotiations in private placement offers because the function of an intermediary broker is to serve as the salesman for the company and the driving force behind the transaction. Without the legal ability to engage potential investors and consult with them on the details of the proposed transaction, an intermediary broker would be essentially useless except as a repository of information for inquirers. Proponents of

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the same result, because the market will adjust to accommodate the skills and expertise of particular brokers. Brokers with more experience and demonstrably better skills will have higher flat fees and will tend to facilitate larger deals for greater compensation. Brokers with less experience and fewer skills will tend to facilitate smaller deals, because presumably, larger corporate actors will prefer the broker with more experience and skill. Thus, although a fee may be labeled a flat fee, brokers will still be compensated commensurate to the size of the transaction.

[156] *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549-50 (1984).

[157] *Id.*

> Of all recent developments in financial economics, the efficient capital market hypothesis ("ECMH") has achieved the widest acceptance by the legal culture. It now commonly informs the academic literature on a variety of topics; it is addressed by major law school casebooks and textbooks on business law; it structures debate over the future of securities regulation both within and without the Securities and Exchange Commission; it has served as the intellectual premise for a major revision of the disclosure system administered by the Commission; and it has even begun to influence judicial decisions and the actual practice of law. In short, the ECMH is now *the* context in which serious discussion of the regulation of financial markets takes place.

Id. (citations omitted).

[158] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 (1977) ("Section 10(b) of the 1934 Act makes it 'unlawful for any person . . . to use or employ . . . any manipulative or deceptive device or contrivance in contravention of [SEC rules]'; Rule 10b-5, promulgated by the SEC under § 10(b), prohibits, in addition to nondisclosure and misrepresentation, any 'artifice to defraud' or any act 'which operates or would operate as a fraud or deceit.'").

the current registration system may assert that it aids in the prevention of fraud; however, full disclosure requirements[159] will continue to protect investors who already have the right to bring a direct claim against brokers in the event of fraudulent misrepresentation.[160] Under the new statutory framework, intermediary brokers may have a duty to disclose relevant information to the investors upon request. The burden of full disclosure, however, should remain on the issuer because the issuer has direct access to relevant company information. Since the role of an intermediary broker is essentially to engage investors and facilitate negotiations, individual issuers are in a stronger position to handle the details of the transaction, including disclosure of all relevant prospectuses.

The SEC currently views the practice of engaging investors and facilitating negotiations as indicative of registered broker-dealer activity.[161] The SEC's position is that the Internet has created opportunities for financial intermediaries to reach millions of individuals, and such communications must be regulated when they relate to the sale of securities.[162] In light of these developments, the SEC no longer believes that brokers that engage investors and initiate negotiations are exempt from broker-dealer registration.[163] For example, in the denial of no-action relief to C & W Portfolio Management, Inc., C & W provided

> services as an intermediary, effecting repurchase transactions between primary dealers involving Treasury notes, bills, and bonds. C & W act[ed] as an intermediary until both principals to the transaction [we]re in agreement as to the rate, amount, and terms of the

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159 For example, in Regulation D offerings, issuers and broker-dealers must provide investors with disclosure documents that are generally the same as those used in registered offerings. *Compare* 17 C.F.R. § 230.502 (2013), *with* Securities Act of 1933, 15 U.S.C. § 77g (2012) (listing information required in registration statement for a registered offering).

160 *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946) (holding that section 10b-5 of the Securities Exchange Act of 1934 creates an implied right of action, allowing civil suits by persons injured as a result of a violation of the rule); *see also In re* Penn Cent. Sec. Litig., 357 F. Supp. 869 (E.D. Pa. 1973), *aff'd*, 494 F.2d 528 (3d Cir. 1974) (observing that Rule 10b-5 was designed "to protect purity of the process of buying and selling securities and to insure that investors [would] receive full disclosure of the information they need if they are intelligently to make significant investment decisions").

161 *See, e.g.*, SEC v. Martino, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003).

162 *See* Dominion Res., Inc., SEC No-Action Letter, 2000 WL 669838, at *2 (Mar. 7, 2000).

163 *Id.*

> transaction. Once agreement [w]as . . . reached, C & W disclose[d] the identities of the principals.[164]

The exchange of funds was always arranged by the principals, not C & W.[165] The principals to each transaction issued confirmations to each other after C & W withdrew from the negotiations.[166] C & W received a set fee, not transaction-based compensation, and notified both principals of the fee that it received.[167] It then requested assurance from the SEC Division of Market Regulation that it would not recommend enforcement action.[168] The Division denied no-action relief, presumably on the basis of C & W's engagement of principals and facilitation of negotiations, since other indicative factors of registered broker-dealer activity were not present.[169] The partial denial of no-action relief to C & W demonstrates the SEC's current strict approach to unregistered brokers who merely engage investors and facilitate negotiations.

Permitting intermediary brokers to engage investors and initiate negotiations is vital to the capital acquisition function. The SEC seems to suggest that as a result of "technological advances," worldwide communication capacity, and digital networking capabilities, unregistered brokers should be precluded from facilitating the negotiation process.[170] Conceding that the Internet has changed the way the world does business and enabled faster and more efficient communication between issuers and investors, the SEC's conclusion that unregistered brokers should be further restricted as a result does not follow. Issuers and investors still need the services of brokers to effectuate transactions, as demonstrated by the continued market demand for brokers' services.[171] Furthermore, the SEC's explanation does not address the core purpose of the registration requirement: protecting investors and ensuring continued market viability

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[164] C & W Portfolio Mgmt., Inc., SEC No-Action Letter, 1989 WL 258821, at *1 (July 20, 1989).

[165] *Id.*

[166] *Id.*

[167] *Id.*

[168] *Id.*

[169] *Id.* Although C & W was not an employee of the issuer, it received a flat fee for the transaction, and there was no indication that it had ever sold securities for the issuer before or provided advice or valuation as to the merit of the investment. The Division's response did not specifically explain its reasoning for denying no-action relief, but such reasoning can be inferred. *Id.*

[170] Dominion Res., Inc., SEC No-Action Letter, 2000 WL 669838, at *2 (Mar. 7, 2000).

[171] *See* ABA Report, *supra* note 16, at 959 (addressing the "vast and pervasive 'gray market' of brokerage activity").

through full disclosure and accountability measures.[172] If the Internet and enhanced technology were sufficient to fill the void between issuers and investors, then there would not be a market for unregistered brokers. Thus, the benefits of allowing intermediary brokers to engage investors and initiate negotiations are substantial, and allowing them to do so is an essential aspect of the proposed legislation.

4. Handling Funds or Securities Exchanged in the Transaction

Currently, section 15(c)(3) of the Exchange Act provides that, with certain exceptions, a broker-dealer may not allow its aggregate indebtedness to surpass 2,000% of net capital, and the broker-dealer must maintain a minimum net capital of $25,000.[173] The aggregate indebtedness to capital ratio and the minimum net capital requirement are cumulative and are not alternative requirements, and both must be met.[174] The purpose underlying these rules is to ensure broker-dealer liquidity in the event of fraud or misappropriation of funds.[175]

Due to the limited nature of the intermediary broker's role in the transaction, there is no need for the intermediary broker to handle funds or securities. An intermediary broker may engage the parties, form groups of buyers, inform the buyers about the issuer's securities, and perform other integral tasks to expedite the transaction. If parties want an intermediary to handle funds or securities, they may set up an escrow account, engage a fully registered broker-dealer, or obtain alternative financing arrangements. Precluding intermediary brokers from handling funds or securities helps to ensure that investors are protected from potentially manipulative practices and conflicts of interest and further justifies eliminating the net capital requirements for the new class of intermediary brokers.

5. SEC and SRO Examinations

Current broker-dealer registration requires the registrant to complete Form BD, a lengthy form that should be modified to

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[172] *See* Orudjev, *supra* note 33 ("Compliance with such requirements is an increasingly costly and time-intensive proposition, but the underlying purpose for the complex fabric of regulations for all broker-dealer activities is to protect the investing public.").

[173] 17 C.F.R. § 240.15c 3-1(a)(1) (2011).

[174] *See* Securities Exchange Act of 1934, Release No. 8024, Jan. 18, 1967, Fed. Sec. L. Rep. (CCH) ¶ 72129.

[175] *See id.*

fit the more limited activities of intermediary brokers.[176] The main purpose of Form BD is to permit the SEC to determine whether the applicant is eligible to provide full broker-dealer services.[177] Under current regulations, broker-dealers must register with a self-regulatory organization (SRO), typically FINRA.[178] As part of the registration process, brokers must pass the Series 7, Series 24, and Series 27 exams,[179] which evaluate the fitness of broker-dealer applicants to provide full broker-dealer services.[180] Under the proposed legislation, intermediary brokers must still register with an SRO; however, the examination requirements would be modified commensurate with the notion that intermediary brokers will not handle funds or securities during the transaction. SEC and SRO examiners should be required to investigate the financial details of transactions in which the intermediary broker has participated in order to determine if the broker has violated the prohibition on handling funds or securities for the principals. The scope of investigations should be reduced to more appropriately suit the limited activities in which intermediary brokers actually engage.

6. Preemption of State Blue Sky Laws

Pursuant to the National Securities Markets Improvement Act of 1996, registered broker-dealers are not subject to state law requirements that differ from those under the U.S. Code.[181] The Act preempted state broker-dealer registration laws for the purpose of regulatory simplification and investor protection.[182] Similarly, states should be curtailed from regulating the new class of intermediary brokers in order to lower barriers to

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[176] *SEC Form BD*, SEC, http://www.sec.gov/about/forms/formbd.pdf [http://perma.cc/K53P-YQKV] (last visited Apr. 25, 2016); Securities Exchange Act of 1934, 15 U.S.C. § 78*o*(b)(7) (2012).

[177] *See SEC Form BD*, *supra* note 176.

[178] *See Compliance Guide*, *supra* note 15.

[179] *See Series 7—General Securities Representative Examination (GS)*, FINRA, http://www.finra.org/industry/compliance/registration/qualificationsexams/qualifications/p011051 [http://perma.cc/6VEH-9VG8] (last visited May 30, 2016); *Series 24—General Securities Principal Examination (GP)*, FINRA, http://www.finra.org/industry/series24#sthash.SKxKeRoG.dpuf [http://perma.cc/4APA-G55P] (last visited May 30, 2016); *Series 27—Financial and Operations Principal Exam (FN)*, FINRA, http://www.finra.org/industry/series27#sthash.aIhcYkgE.dpuf [http://perma.cc/5PQD-86TM] (last visited May 30, 2016).

[180] *See Series 7*, *supra* note 179; *Series 24*, *supra* note 179; *Series 27*, *supra* note 179.

[181] National Securities Markets Improvement Act of 1996, § 103 Pub. L. 104-290, 110 Stat 3416.

[182] *See* Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 1996 WL 302811 (1996).

entry to the field. The U.S. Supreme Court has indicated that state law must be preempted if Congress has "occup[ied] a given field" of legislation or if state laws "stand[] as an obstacle" to a congressional objective.[183] Additional state restrictions on intermediary broker registration and activity would hinder the objective of this legislation: to create a new, viable path for small-issuer capital acquisition.

Blue sky laws are a substantial impediment to intermediary broker activity because they impose additional registration requirements. In fact, most state securities regulations of broker-dealers merely duplicate the prohibitions of the federal securities laws and therefore add no additional protection for investors.[184] As applied to intermediary brokers, the marginal protections conferred by blue sky laws are outweighed by the costs. Since state securities laws, like federal law, generally only recognize one class of broker-dealer,[185] the same problems inherent in the current federal scheme are present in blue sky laws. Preemption of state securities laws pertaining to broker-dealers will eliminate unnecessary overlap and additional impediments to intermediary broker activity.

Federal securities laws will provide investors with full disclosure, and any disclosure provided by state securities laws will be unnecessarily duplicative.[186] In addition, the 1934 Securities Exchange Act provides that "it shall be unlawful . . . to use . . . any manipulative or deceptive device" in the sale of securities.[187] Furthermore, the 1933 Securities Exchange Act provides a private right of action against "any person who . . . sells a security" and makes "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made."[188] Although some minimum framework of blue sky

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[183] *See* Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 248 (1984).

[184] *See* Campbell, *supra* note 79, at 553-54 (arguing that state administrators have an entrenchment motive and thus will not repeal blue sky laws regardless of their detrimental effects). "Today, blue sky laws are ineffective, philosophically unsound, and unnecessarily expensive, and they should be substantially eliminated. Because of the vested interests that have developed, however, it is unlikely that states will respond to this problem, and it will probably take action by the United States Congress to preempt the area." *Id.* (footnotes omitted).

[185] Rogers, *supra* note 108.

[186] Campbell, *supra* note 79, at 558 ("[E]ven assuming the appropriateness of mandated disclosure, the present state requirements regarding disclosure are indefensible. The reason is, quite simply, that the federal disclosure requirements are sufficient, and, as a result, there is no need to impose additional registration requirements at the state level.").

[187] Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2012).

[188] *Id.* § 77*l*(a).

laws should be maintained to regulate strictly intrastate transactions, which are rare in light of modern markets that cross state and national borders,[189] federal preemption of blue sky laws would allow intermediary brokers to effect transactions for smaller issuers without the enormous costs imposed by such laws.

CONCLUSION

The current state of federal securities laws regulating broker-dealers poses many problems for small businesses aspiring to raise capital through the assistance of a broker-dealer. A literal reading of section 78*o*(a)(1) of the Securities Exchange Act would seem to require all financial intermediaries in securities transactions to register as broker-dealers, even if they only engage in a single transaction.[190] Recognizing that the burdens imposed on registered broker-dealers make this regulatory framework highly undesirable, the SEC and the courts have diverged from a literal reading of the Act. The courts apply a multifactor test to determine if intermediaries must register as broker-dealers,[191] while the SEC tends to focus on specific factors, often declaring that the receipt of transaction-based compensation is in itself sufficient to require registration.[192] Recognizing that the regulatory framework in place prevents efficient capital acquisition for many small issuers, the SEC revised its enforcement policy by stating in a no-action letter that it would not recommend enforcement, subject to many limiting conditions, against an M&A broker that transferred control of a business in a private transaction.[193] While providing some relief, this no-action letter is insufficient to ameliorate the tension between the actual practices of securities market professionals and the law as it stands. The lack of precedential effect of the M&A brokers no-action letter, the SEC's history of changing its policies, and the inapplicability of the letter's provisions to intermediaries who do not transfer control of a company, but merely sell equity securities

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189 The intrastate exemption specified in 15 U.S.C. § 77c(11) and 15 U.S.C. § 78j maintains the constitutionality of the statute, and while not the main focus of this note, it is safe to assume that nearly all securities transactions must comply with federal disclosure requirements.

190 *See* 15 U.S.C. § 78*o*(a)(1).

191 *See supra* Section I.A.

192 *See, e.g.*, Herbruck, Alder & Co., SEC No-Action Letter, 2002 WL 1290291, at *2 (June 4, 2002).

193 *See* M&A Brokers, SEC No-Action Letter, 2014 WL 356983, at *1 (Jan. 31, 2014).

has left the law pertaining to financial intermediaries for small-issuer transactions in limbo.

This note proposes a legislative solution as a viable path to capital for small issuers while maintaining the integrity of markets and investor protections. Similar to the JOBS Act, the proposed legislation would relax regulations and registration requirements for brokers that engage in certain limited activities. The specific provisions of the proposed legislation outlined here are flexible and provide maximum maneuverability for intermediary brokers while carefully avoiding enabling greater incidents of fraud and misrepresentation in transactions. Without this or similar legislation that advances the same policy goals, broker-dealer rules will remain in a state of uncertainty to the detriment of smaller issuers and unregistered financial intermediaries alike.

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