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# LEGITIMIZING PRIVATE PLACEMENT BROKER-DEALERS WHO DEAL WITH PRIVATE INVESTMENT FUNDS: A PROPOSAL FOR A NEW REGULATORY REGIME AND A LIMITED EXCEPTION TO REGISTRATION

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## I. THE PROBLEM WITH UNREGISTERED FINDERS AND FINANCIAL INTERMEDIARIES IN SECURITIES OFFERINGS

*Before you speak, listen. Before you write, think. Before you spend, earn. Before you invest, investigate. Before you criticize, wait. Before you pray, forgive. Before you quit, try. Before you retire, save. Before you die, give.*<sup>1</sup>

Protecting investors and preserving the integrity of the securities markets are the primary duties of the federal securities laws and the United States Securities and Exchange Commission (“SEC”).<sup>2</sup> Investments in securities are not provided the same guarantees as certain bank deposits, thus, investors must perform the proper due diligence and ask the right questions in order to protect their investments.<sup>3</sup> Congress enacted the Securities Act of 1933<sup>4</sup> (“Securities Act”) to ensure “full and fair” disclosure is made to investors as to the character of certain offered securities.<sup>5</sup> All investors, from private individuals, to sophisticated

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\* J.D., The John Marshall Law School, 2007.

1. Nonstop English, William A. Ward Quotations, [http://www.nonstopenglish.com/reading/quotations/A\\_William-A1-Ward.asp](http://www.nonstopenglish.com/reading/quotations/A_William-A1-Ward.asp) (last visited Apr. 16, 2007).

2. See U.S. Securities and Exchange Commission, The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://www.sec.gov/about/whatwedo.shtml> (last visited Apr. 16, 2007) [hereinafter The Investor’s Advocate] (providing history and overview of SEC and securities laws).

3. *Id.*

4. 15 U.S.C. § 77a (2000).

5. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2000)).

businesspersons, to large organizations, are entitled to disclosure of this information.<sup>6</sup>

Many investors, rather than dealing directly with the issuer of securities, will utilize brokers or dealers to facilitate the transaction. Thus, Congress enacted the U.S. Securities Exchange Act of 1934<sup>7</sup> ("Exchange Act") to regulate securities exchanges and over-the-counter markets and to prevent unfair practices by the participants within those exchanges and markets.<sup>8</sup> The Exchange Act, by regulating the activities of brokers and dealers, is an important safeguard for investors and the securities market. In recent years, however, the good intentions of the Exchange Act have created obstacles to raising capital for smaller issuers because of the strict regulations imposed on broker-dealers.<sup>9</sup> Many broker-dealers will not work with smaller issuers offering under twenty-five million dollars<sup>10</sup> because there is no financial incentive for the broker-dealer.<sup>11</sup> Therefore, smaller issuers sometimes seek out so-called unregistered finders and financial intermediaries to assist them in finding investors.<sup>12</sup> This activity both places the issuer and its investors at a heightened risk<sup>13</sup> and creates confusion as to how these finders and intermediaries fit into the current regulatory system.

As a result, one of the top issues in securities law facing small and mid-size issuers, as well as securities professionals, is the lack of clear guidance from the SEC regarding finders and other intermediaries in securities transactions, particularly private placements.<sup>14</sup> Under the current SEC rules and regulations, as

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6. See The Investor's Advocate, *supra* note 2 (explaining that all investors should have a right to certain basic information about a security before making a decision to purchase).

7. 15 U.S.C. § 78a (2000).

8. Securities Exchange Act of 1934, Pub. L. No. 73-291; 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78nn (2000)).

9. See Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 968 (2005) [hereinafter *ABA Report*] (noting that most registered brokerage firms are reluctant to get involved in offerings under twenty-five million dollars).

10. *Id.*

11. *Id.* at 968 (stating that brokerage firms make this decision mostly for economic reasons). These firms simply do not have the incentive to get involved with smaller offerings because, among other reasons, the risk of doing a small deal is usually the same as doing a large one that pays a larger commission. *Id.*

12. See *id.* at 960 (explaining that a finder or financial intermediary typically is an individual who brings together an issuer and investor). The finder or intermediary may take part in the negotiations and receive transaction-based compensation if the investor subscribes to the offering. *Id.*

13. See *infra* notes 17-21.

14. See 22ND ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT, 14-17 (2003) [hereinafter 2003

well as those of the states, many of these finders and intermediaries are actually unregistered broker-dealers.<sup>15</sup> This is the case even if all parties involved in the transaction are highly sophisticated, wealthy, experienced, and accredited investors engaging in a private offering exempt from registration.<sup>16</sup>

Registration as a broker-dealer is a burdensome and time-consuming process that requires ongoing reporting and compliance throughout the year.<sup>17</sup> The unregistered broker-dealer faces penalties<sup>18</sup> and possible civil<sup>19</sup> and criminal<sup>20</sup> liability for failing to register, and investors may seek to void their investment and seek rescission.<sup>21</sup> Thus, even though a finder or financial intermediary is neither a full-fledged broker-dealer nor ever intends to engage in traditional broker-dealer activities, the current regulatory system treats that individual as such.

Recognizing this problem, the 2003 Government-Business Forum on Small Business Capital Formation ("Forum") recommended that the SEC address the issue of unregistered finders and intermediaries.<sup>22</sup> Subsequently, in 2005 a special task

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FINAL REPORT], available at [www.sec.gov/info/smallbus/gbfor22.pdf](http://www.sec.gov/info/smallbus/gbfor22.pdf) (discussing the top securities regulation recommendations made by forum participants); see also HUGH H. MAKENS, CAPITAL FORMATION: MAKING "FINDERS" VIABLE 1 (2004), available at <http://www.sec.gov/info/smallbus/hmakens> (explaining the problem with the current regulatory regime); 23RD ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT 7-8 (2004) [hereinafter 2004 FINAL REPORT], available at [www.sec.gov/info/smallbus/gbfor23.pdf](http://www.sec.gov/info/smallbus/gbfor23.pdf) (setting agenda for the 23rd Annual Government-Business Forum on Small Business Capital Formation).

15. See *ABA Report*, *supra* note 9, at 960 (discussing activities of "finders"); see also MAKENS, *supra* note 14, at 7 (noting that, under the current rules, most of the activities of finders and intermediaries fall within the definition of a broker-dealer and would require the individual to register).

16. MAKENS, *supra* note 14, at 7.

17. 15 U.S.C. § 78q (2000); 17 C.F.R. §§ 240.17a-3 to a-5 (2006); see also A.A. SOMMER, JR., FEDERAL SECURITIES EXCHANGE ACT OF 1934 § 3.03-.04 (2005) (discussing reporting and recordkeeping requirements for registered broker-dealers).

18. SOMMER, *supra* note 17, § 3.03.

19. *Id.*

20. *Id.*

21. 15 U.S.C. § 78cc(b) (2000); see also SOMMER, *supra* note 17, at n.13 (citing *Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357 (5th Cir. 1968)).

22. 2003 FINAL REPORT, *supra* note 14, at 14-15. The Forum's recommendations stated that the SEC should: (i) adopt specific regulations for finders and other intermediaries; (ii) assist in finding the proper function of finders in capital-raising activities; and (iii) set forth the instances in which such individuals may be compensated. *Id.* The 2004 and 2005 Forums reiterated these same suggestions, with the 2005 Forum suggesting that the SEC use the *ABA Report* as a starting point for creating a regulatory regime for private placement broker-dealers. 2004 FINAL REPORT, *supra* note 14, at 9-10; 24TH ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS

force within the American Bar Association's ("ABA") Section of Business Law published a report ("ABA Report") regarding so-called "private placement broker-dealers."<sup>23</sup> The ABA Report urged the SEC to establish a simplified registration process for private placement broker-dealers.<sup>24</sup> The ABA Report also identified certain minimum criteria that private placement broker-dealers should meet in order to qualify for simplified registration, including that the private placement broker-dealer restrict its participation to private offerings involving accredited investors and qualified purchasers, as defined by the SEC.<sup>25</sup>

The ABA Report, however, did not address the roles of the suitability doctrine or of sophisticated investors. Further, it did not discuss private investment funds, which are a subcategory of private offerings and typically involve sophisticated, accredited investors on all sides of the transaction.<sup>26</sup> Therefore, this Comment will examine the current broker-dealer regulatory regime and suitability doctrine as they pertain to private

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CAPITAL FORMATION, FINAL REPORT 14 (2005), *available at* <http://www.sec.gov/info/smallbus/gbfor24.pdf>.

Furthermore, the transcript of the 2004 Forum reveals discussions among participants regarding the problem of unregistered finders and financial intermediaries. Transcript of 23rd Annual SEC Government-Business Forum on Small Business Capital Formation at 91-92, 97 (Sept. 20, 2004), *available at* <http://www.sec.gov/info/smallbus/transcript.pdf> [hereinafter "Forum Transcript"]. Brian A. Bussey, Assistant Chief Counsel of the SEC Division of Market Regulation, remarked that his division recognizes the problem of unregistered finders and financial intermediaries and stated that "the possibility of lesser regulation . . . really is a possibility." *Id.* at 91. He noted, however, that embarking on such a massive undertaking would require a lot of review of various regulatory systems, including the SEC, the NASD, and the states. *Id.* at 91-92. He also requested more specificity with respect to the problems faced by finders, intermediaries, and practitioners in order to properly address the issue and balance the interests of both investors and issuers. *Id.* at 91-92, 97.

23. *ABA Report*, *supra* note 9, at 959. The *ABA Report* provides a comprehensive overview of the issue regarding unregistered finders and other intermediaries, especially within the realms of private placements and mergers and acquisitions. *Id.*

24. *Id.* at 961-62.

25. *Id.* The specific criteria set forth by the *ABA Report* were: (i) the private placement broker-dealer cannot participate in public offerings, but may receive referral fees from full-fledged broker-dealers in such offerings; (ii) statutory disqualifications will not apply to the private placement broker-dealer or its principals; (iii) private placement broker-dealers may only make offerings to accredited investors and qualified purchasers; (iv) private placement broker-dealers may not hold or possess funds or securities; (v) offerings will be done on a "best efforts basis"; (vi) funds from the offerings will be held in an unaffiliated escrow account; (vii) the private placement broker-dealer may not participate in trading activity; (viii) principals and representatives of the private placement broker-dealer must complete certain NASD exams developed specifically for private placement broker-dealers. *Id.*

26. *See infra* text accompanying note 39.

placement broker-dealers involved with private investment funds that make offerings solely to sophisticated, accredited investors in exempt offerings.<sup>27</sup> It will demonstrate that the suitability doctrine legitimizes the proposed regulatory regime for private placement broker-dealers.

Part II of this Comment will overview private investment funds, discuss the common exemptions to securities registration utilized by these funds, discuss briefly the rules and regulations pertaining to broker-dealers, including the suitability doctrine, and review the main exemptions to broker-dealer registration.

Part III of this Comment will analyze how courts interpret the statutory definition of the term “broker,” discuss and analyze the main exemptions to broker-dealer registration as they may apply to private investment funds, discuss how some states have approached the issue of regulating finders and other financial intermediaries, and analyze the boundaries of the suitability doctrine as applied to full-service broker-dealers and examine whom the securities laws and courts consider sophisticated investors, particularly with respect to private investment funds.

Finally, Part IV will suggest that the proposed new regulations for private placement broker-dealers should include subcategories allowing limited registration for certain types of private placement broker-dealers, including a category for “private investment fund representatives,” recommend National Association of Securities Dealers (NASD) membership and limited registrations for private investment fund representatives, discuss the characteristics of these private investment fund private placement broker-dealers, including the scope of their activities, propose that the suitability doctrine and the sophistication of the investors legitimize the suggestions made by the Forum and the ABA Report (at least with respect to private investment funds), and propose a limited exception to registration for certain private placement broker-dealers involved in a limited number of transactions involving accredited and sophisticated investors.

## II. BACKGROUND

### A. *Private Investment Funds*

Private investment funds (“Fund” or “Funds”) are pooled investment vehicles through which the Fund’s investors and

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27. The entire spectrum of activity of finders and financial intermediaries is very large and beyond the scope of this Comment; thus, this discussion will focus exclusively on finders and financial intermediaries in the realm of private investment funds. Furthermore, the *ABA Report* discussed mergers and acquisitions as well as private placements, generally, in connection with its analysis. *ABA Report*, *supra* note 9, at 960.

principals contractually agree on certain investment objectives.<sup>28</sup> These Funds perform many roles in the capital and investment markets, including providing venture capital to start-up companies and capital formation to existing companies.<sup>29</sup> The Funds also function as investment vehicles through which investors pool their capital under a common investment strategy.<sup>30</sup> There are several major categories of private investment funds,<sup>31</sup> with each possessing a different investment strategy.<sup>32</sup> The organization and structure of most Funds, however, is the same.<sup>33</sup>

### B. The Private Offering Exemption, Regulation D, and Rule 506

The offering of interests sold by most Funds are exempt from SEC registration under the Securities Act<sup>34</sup> and Rule 506, under Regulation D.<sup>35</sup> Rule 506<sup>36</sup> provides that the offering of securities is exempt from registration as long as there are thirty-five or fewer “non-accredited” investors and that the offering complies with the provisions of Rules 501<sup>37</sup> and 502.<sup>38</sup> Most Funds typically

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28. See JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 1.02[1], at 1-8 (2005) (discussing private investment funds in terms of “the private ordering of a financial intermediary relationship . . . [whereby] the investors provide capital and the Principals, through the General Partner, the Manager and the Fund, provide investment advice and services”).

29. See *id.* § 1.01, at 1-4 (discussing the role of private investment funds in the United States).

30. *Id.*

31. See *id.* §1.02[2], at 1-10 (listing the following categories: “Venture Capital Funds; Leveraged Buyout or Merchant Banking Funds; Hedge Funds; Funds of Funds; Real Estate Funds; Captive Funds; and, Semi-Captive Funds”). Given the myriad of investment strategies and amount of capital among these funds, discussion will be limited to a generalized, broad definition of private investment funds identified in *supra* note 28.

32. See *id.* (categorizing private investment funds).

33. See *id.* § 1.01, at 1-5 to -6. (discussing organization and structure of private investment funds). Generally, the principals organize the Fund as a Delaware limited partnership. *Id.* The general partner of the Fund is an entity (usually a limited liability company) owned by one or more of the principals. *Id.* Investors subscribe for and purchase limited partnership interests of the Fund and enter into a partnership agreement with the general partner. *Id.* The partnership agreement, inter alia, sets forth the capital commitments for the general partner and investors, the investment strategy of the Fund, and how the Fund will distribute profits. *Id.* The Fund, through the general partner, uses the capital contributions to pay expenses and make investments. *Id.*

34. 15 U.S.C. § 77d(2) (2000). Pursuant to § 77d(2) of the Securities Act, the registration provisions do not apply to “transactions by an issuer not involving any public offering.” *Id.*

35. 17 C.F.R. § 230.506 (2006). Regulation D sets forth certain rules promulgated by the SEC with respect to limited offerings.

36. *Id.*

37. 17 C.F.R. § 230.501 (2006). Rule 501 sets forth certain definitions, including “accredited investor.” An accredited investor includes certain

only sell to accredited investors.<sup>39</sup> Thus, the average investor in a Fund is generally either a wealthy individual or entity that meets the regulatory definition of an accredited investor.<sup>40</sup>

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institutions, wealthy individuals, and trusts with high levels of assets. *Id.* With respect to individuals, the person must either: (a) have a net worth (either individually or jointly with their spouse) in excess of \$1 million; or (b) have an individual income in excess of \$200,000, or joint income with their spouse in excess of \$300,000. *Id.* § 230.501(a)(5)-(6). Additionally, that person must have attained that income in each of the previous two years, and that person must have a reasonable expectation of attaining that same level of income during the current year. *Id.* There is no limit on the number of accredited investors that may participate in the offering. 17 C.F.R. § 230.506.

In January 2007, the SEC proposed a new category of accredited investor, called an "Accredited Natural Person," that would apply to investors in certain private investment vehicles. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles 72 Fed. Reg. 400-01 (to be codified at 17 C.F.R. pts. 230, 275). The proposed definition of Accredited Natural Person includes the Rule 506 requirements summarized above, as well as "a requirement that such person also must own (individually, or jointly with the person's spouse) not less than \$2.5 million (as adjusted every five years for inflation) in investments at the time of purchase of securities issued by private investment vehicles under Regulation D or section 4(6)." *Id.* The SEC is attempting to further protect investors raising the eligibility threshold for which investors may participate in Funds. *Id.* This proposal, however, seems to be very controversial judging by the number of negative comments left by people and entities opposed to the new rule. See U.S. Securities and Exchange Commission, Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, <http://www.sec.gov/comments/s7-25-06/s72506.shtml> (containing public comments to proposed rule).

The other categories of accredited investors identified under 17 C.F.R. § 230.501(a)(1) include: (i) banks and savings and loan associations; (ii) registered broker-dealers; (iii) insurance companies; (iv) registered investment companies; (v) certain public employment benefit plans with total assets of more than five million dollars and certain other plans falling within the Employee Retirement Income Security Act of 1974; (vi) certain non-profit organizations and business trusts with assets of more than five million dollars that were not formed for the specific purpose of purchasing the offered securities; (vii) the principals of the issuer; (viii) trusts that have total assets greater than five million dollars that were not formed for the specific purpose of purchasing the offered securities, and the purchase is directed by a sophisticated person (as described in Rule 506(b)(2)(ii)); (ix) entities where all equity owners are accredited investors. *Id.*

38. 17 C.F.R. § 230.502 (2006). Rule 502, inter alia, sets forth what information issuers must provide to non-accredited investors. *Id.* It also limits the amount of general advertising and solicitation, and states that the investors may not re-sell their securities unless the securities are registered or subject to another exemption. *Id.*

39. See SCHELL, *supra* note 28, § 8.01[2], at 8-7 (stating that most private investment funds limit their offering to accredited investors for both regulatory and business purposes).

40. 17 C.F.R. § 230.501; see also *supra* text accompanying note 37 (providing regulatory definition and categories of accredited investors). Sometimes, as in the case of a fund of funds, the investor is another private



### C. Broker-Dealer Rules and Regulations

#### 1. Requirement of Registration and Statutory Definition of "Broker" and "Dealer"

The Exchange Act requires brokers and dealers who "effect any transactions in, or . . . induce or attempt to induce the purchase or sale of, any security" to register with the SEC.<sup>41</sup> The Exchange Act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others."<sup>42</sup> A dealer is "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."<sup>43</sup> However, a person who does not buy and sell securities for his or her own account "as a part of a regular business" is not a dealer under the Exchange Act.<sup>44</sup>

Before a broker-dealer can conduct any regulated business, he must: (i) file a Form BD (Uniform Application for Broker-Dealer Registration) with the SEC, which must then be accepted by the SEC;<sup>45</sup> (ii) join a self-regulatory organization (SRO);<sup>46</sup> (iii) join the Securities Investor Protection Corporation (SIPC);<sup>47</sup> (iv) comply

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investment fund. See SCHELL, *supra* note 28, § 1.06[1], at 1-32 (describing "funds of funds").

41. 15 U.S.C. § 78o(a)(1)(2000).

42. *Id.* § 78c(a)(4)(A).

43. *Id.* § 78c(a)(5)(A).

44. *Id.* § 78c(a)(5)(B). Oftentimes, the terms "broker" and "dealer" are used together as "broker-dealer," regardless of the particular definition being used. See David A. Lipton, *Symposium on Securities Regulation: Article: A Primer on Broker-Dealer Registration*, 36 CATH. U.L. REV. 899, 909-910 (1987) (providing an overview of broker-dealer regulation, including definitions of brokers and dealers). This Comment will use the term "broker-dealer" as a matter of convenience. However, given that activities by the private placement broker-dealers are more commonly associated with that of a broker, analysis will focus on the definition of a broker.

45. See U.S. Securities and Exchange Commission, Guide to Broker Dealer Registration (2005), <http://www.sec.gov/divisions/marketreg/bdguide.htm> (last visited Apr. 16, 2007) [hereinafter Guide to Broker Dealer Registration] (outlining the various registration steps and requirements for broker-dealers).

46. *Id.* A broker-dealer who effects securities transactions within one national exchange, such as the New York Stock Exchange (NYSE), generally only has to be a member of that exchange. *Id.* However, if the broker-dealer does not effect transactions on one of the national exchanges, or is involved in transactions within different exchanges and over-the-counter, then that broker-dealer will have to register with the NASD. *Id.*

47. *Id.* Registered broker-dealers pay membership dues to the SIPC. *Id.* The SIPC, in turn, insures that those broker-dealers' customers will, in the event the broker-dealer is liquidated, receive back their cash and securities up to a certain amount. *Id.* The SIPC's website notes that:

When a brokerage firm is closed due to bankruptcy or other financial difficulties and customer assets are missing, SIPC steps in as quickly as possible and, within certain limits, works to return customers' cash, stock and other securities. Without SIPC, investors at financially

with the appropriate state rules and conditions;<sup>48</sup> and (v) ensure all associated persons of the broker-dealer are properly qualified.<sup>49</sup>

## 2. *The Suitability Doctrine*

The suitability doctrine refers to the principle that a broker-dealer must only recommend securities that are suitable to a customer, given that customer's investment objectives and financial condition.<sup>50</sup> The broker-dealer ascertains the customer's investment objectives and financial condition based upon facts disclosed by the customer to the broker-dealer.<sup>51</sup> The SEC enforces this principle through the anti-fraud provisions of the Securities Act, the Exchange Act, and the rules promulgated under those Acts.<sup>52</sup> The NASD's Conduct Rule 2310 sets forth detailed suitability requirements that member broker-dealers must follow before recommending a security to a customer.<sup>53</sup> The national exchanges have similar, albeit less specific, rules that are commonly referred to as the "know your customer rule."<sup>54</sup>

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troubled brokerage firms might lose their securities or money forever or wait for years while their assets are tied up in court. Securities Investor Protection Corporation, The SIPC Mission, <http://www.sipc.org/who/sipcmision.cfm> (last visited Apr. 16, 2007).

48. Guide to Broker Dealer Registration, *supra* note 45.

49. *Id.*

50. See Charles R. Mills & Ronald A. Holinsky, *Customer Transactions: Suitability, Unauthorized Trading, and Churning*, in BROKER-DEALER REGULATION 6-1, 6-2 (Clifford E. Kirsch ed., 2004) (discussing the suitability doctrine under securities law).

51. *Id.*

52. *Id.* For example, Rule 10b-5 states that a registered person, in connection with the purchase and sale of a security, cannot utilize devices or schemes to commit fraud, fail to disclose material facts, make untrue statements, or engage in fraudulent acts. 17 C.F.R. § 240.10b-5.

53. National Association of Securities Dealers, NASD Manual § 2310 (2005), <http://nasd.complinet.com/nasd/display/index.html> [hereinafter NASD Manual] (last visited Apr. 16, 2007). The NASD rule requires that, when a member broker-dealer makes a recommendation to a customer, that broker-dealer "shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." *Id.* In addition, the broker-dealer must also "make reasonable efforts" to acquire information about the financial and tax status of their customer, the investment objectives of their customer, and any other information the member broker-dealer may consider reasonable in order to make a recommendation. *Id.*

54. See Louis Loss & Joel Seligman, *Fraud*, in 3 SECURITIES REGULATION 3547, 3846-48 (Aspen 2004) (1951) (discussing the suitability doctrine and the rules of the various exchanges). The NYSE's rule states that every member of the Exchange must "[u]se due diligence to learn the essential facts relative to every customer." New York Stock Exchange, NYSE Rules, Rule 405, [http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp\\_1\\_5&manual=/nyse/nyse\\_rules/nyse-rules/](http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_5&manual=/nyse/nyse_rules/nyse-rules/) (last visited Apr. 16, 2007).

#### D. Exemptions to Broker-Dealer Registration

The two main exemptions to the broker-dealer registration requirement are the Rule 3a4-1 “safe harbor” for associated persons of an issuer<sup>55</sup> and the limited exemption for “finders” who bring potential investors and issuers together.<sup>56</sup>

##### 1. Rule 3a4-1 Safe-Harbor for Associated Persons of Issuers

The safe-harbor exemption, on a very limited basis, allows an associated person of an issuer to effect securities transactions without registration.<sup>57</sup> In short, that person cannot: (i) be

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The American Stock Exchange has a similar rule: “Every member or member organization shall use due diligence to learn the essential facts relative to every customer . . . .” American Stock Exchange, AMEX Constitutin and Rules, Rule 411, [http://wallstreet.cch.com/AMEXtools/PlatformViewer.asp?SelectedNode=chp\\_1\\_2&manual=/AMEX/rules/amex-rules/](http://wallstreet.cch.com/AMEXtools/PlatformViewer.asp?SelectedNode=chp_1_2&manual=/AMEX/rules/amex-rules/) (last visited Nov. 17, 2005).

55. 17 C.F.R. § 240.3a4-1 (2003).

56. See 1 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 19:3 (Jason Conklin et al., eds., West 2006) (1977) (discussing exceptions to broker-dealer registration).

57. 17 C.F.R. § 240.3a4-1. The safe-harbor rule states that an associated person of an issuer must first meet all three of the following conditions: (i) at the time of their participation in the offering, the person is not subject to any statutory disqualification pursuant to § 3(a)(39) of the Exchange Act, *id.* § 240.3a4-1(a)(1); (ii) the person does not receive, either directly or indirectly, transaction-based compensation, *id.* § 240.3a4-1(a)(2); and, (iii) the person is not an associated person of a broker-dealer at the time of his or her participation with the offering, *id.* § 240.3a4-1(a)(3).

If the associated person meets those initial three conditions, that person must then meet one of three additional conditions. *Id.* § 240.3a4-1(a)(4). The first condition limits that person’s participation either (1) to offerings and sales made to certain institutions; (2) to exempt securities as defined by §§ 3(a)(7), 3(a)(9), or 3(a)(10) of the Securities Act; or (3) to securities as part of a reorganization, merger, consolidation, transfer of assets, or other similar acquisition in exchange for securities of the issuer. *Id.* § 240.3a4-1(a)(4)(i). With respect to the last circumstance, the security holders must have consented to the transaction. *Id.* § 240.3a4-1(a)(4)(i)(C). In addition, the associated person may offer securities in connection with a pension, profit sharing, or other comparable employee profit sharing or dividend reinvestment plan. *Id.* § 240.3a4-1(a)(4)(i)(D).

The second condition is that if the associated person’s substantial duties on behalf of the issuer are or will be unrelated to the transaction at issue, that person was neither a registered broker-dealer nor associated with one within the past twelve months, and the associated person does not participate in a securities transaction more than once every twelve months. *Id.* § 240.3a4-1(a)(4)(ii). With respect to the last requirement, however, there is an exception for those employee-benefit offerings for providing basic, ministerial duties, and for responding to investor inquiries regarding an offering. *Id.* § 240.3a4-1(a)(4)(ii)(C). An associated person may partake in these activities more than once every twelve months. *Id.*

The third condition is that the activities of the associated person are restricted to primarily clerical and ministerial work involving the offering. *Id.* § 240.3a4-1(a)(4)(iii). This can include preparing or delivering written

disqualified by statute;<sup>58</sup> (ii) receive transaction-based compensation;<sup>59</sup> and, (iii) be associated with a registered broker-dealer at the time of the participation.<sup>60</sup> In addition, that person must meet other conditions that limit his or her involvement to either certain limited investors,<sup>61</sup> certain exempted securities,<sup>62</sup> or certain limited activities.<sup>63</sup>

## 2. *Finder's Exemption*

The Exchange Act does not explicitly set forth an exemption for finders. Rather, the finder's exemption is limited to narrow circumstances as set forth in a collection of SEC no-action letters granted pursuant to the exemptive authority of the Exchange Act.<sup>64</sup> Generally, this exemption is limited to those who introduce investors to issuers, but who do not take part in the negotiations and do not receive commission or compensation relative to the size of the transaction.<sup>65</sup>

Given the Forum's findings,<sup>66</sup> the ABA Report,<sup>67</sup> as well as comments from at least one SEC representative,<sup>68</sup> the current broker-dealer regulatory system is not appropriate for private placement broker-dealers, and a less restrictive, "lighter" regime is necessary. In order to determine the boundaries of a possible new regulatory regime, especially with respect to the suitability doctrine, it is necessary first to analyze how courts interpret the statutory definition of "broker" and second to analyze the current

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communication as long as that does not involve solicitation of a potential purchaser and so long as a principal of the issuer approves the content of the communication. *Id.* § 240.3a4-1(a)(4)(ii)(A). Further, the associated person may respond to purchaser-initiated inquiries regarding the offering. *Id.* § 240.3a4-1(a)(4)(ii)(B). However, the response must be limited to the information found in the registration statement or offering documents. *Id.*

58. *Id.* § 240.3a4-1(a)(1).

59. *Id.* § 240.3a4-1(a)(2).

60. *Id.* § 240.3a4-1(a)(3).

61. *Id.* § 240.3a4-1(a)(4)(i).

62. *Id.* § 240.3a4-1(a)(4)(ii).

63. *Id.* § 240.3a4-1(a)(4)(iii).

64. 15 U.S.C. § 78mm(a) (2000). With the exception of certain provisions in the Exchange Act regarding government securities, the SEC may "by rule, regulation, or order . . . conditionally or unconditionally exempt any person, security, or transaction, or any class [thereof from registration and regulation] to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." *Id.*

65. BLOOMENTHAL, *supra* note 56, § 19:3.

66. See 2003 FINAL REPORT, *supra* note 14, at 14-19 (explaining the problem with the present regulatory system as applied to certain finders and intermediaries and proposing certain solutions).

67. See ABA Report, *supra* note 9, at 961-62 (proposing relaxed regulatory regime for private placement broker-dealers).

68. See Forum Transcript, *supra* note 22, at 91-92, 97 (noting that a relaxed regulatory regime for certain finders or intermediaries is possible).

regulatory regime and doctrines as they apply to private investment funds.

### III. ANALYSIS

#### A. *The Federal Regulatory Regime*

The primary purpose and goal of the Exchange Act is investor protection.<sup>69</sup> Therefore, any changes to the existing regulatory system must not conflict with the SEC's mission.<sup>70</sup>

##### 1. *Definition of Broker*

As noted, the Exchange Act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others."<sup>71</sup> There are three required criteria within this definition: (1) "engaged in the business"; (2) "effecting transactions in securities"; and (3) "for the account of others." The first two criteria have received the most analysis by courts and commentators.

##### a. "Engaged in the Business"

The Exchange Act does not define this phrase; rather, its definition comes from case law and SEC no-action letters.<sup>72</sup> An essential element in determining whether one is "engaged in the business" is the "regularity of participation" in securities transactions.<sup>73</sup> In discussing various rulings and SEC no-action letters that have construed what activities encompass "regularity of participation," one commentator states that such regularity is necessary in order for one to be considered to be "engaged in the business" of securities transactions.<sup>74</sup>

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69. 15 U.S.C. § 78b (2000). "[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . ." *Id.*

70. See The Investor's Advocate, *supra* note 2 (providing history and overview of SEC, including the SEC's mission).

71. 15 U.S.C. § 78c(a)(4)(A) (2000).

72. See Lipton, *supra* note 44, at 910 (discussing the definition of "brokers").

73. See Lipton, *supra* note 44, at 909-10 & n.59 (quoting *Mass. Fin. Servs., Inc. v. Sec. Investor Protection Corp.*, 411 F. Supp 411, 415 (D. Mass. 1976), *aff'd*, 545 F.2d 754 (1st Cir. 1976)). In *Massachusetts Financial Services*, the court analyzed the definitions of broker and dealer in the context of whether or not the plaintiff's brokerage activities fell within an exception to membership in the Securities Investor Protection Corporation. 411 F. Supp. at 414. The court stated that both statutory definitions of broker and dealer "connote a certain regularity of participation in securities transactions at key points in the chain of distribution." 411 F. Supp. at 415.

74. See Lipton, *supra* note 44, at 911-12. Among those activities are: (i)

The SEC and courts analyze past and future experiences in securities transactions when determining regularity.<sup>75</sup> For instance, an issuer is not considered a broker-dealer if it has not offered or sold securities in the past and does not intend to in the future apart from the present transaction.<sup>76</sup> Conversely, if an issuer was involved in similar offerings in the past and planned on similar offerings in the future, that issuer is likely a regular participant in securities transactions and would have to register.<sup>77</sup> Finally, the offer and sale of securities does not have to be the primary business of the broker-dealer in order to be “engaged in the business.”<sup>78</sup>

Given these parameters, most courts would classify many finders and intermediaries involved with private investment funds to be broker-dealers. Some private investment intermediaries participate in only one or two transactions, which make it likely they would be exempt from registration.<sup>79</sup> There are, however, many other such intermediaries who are involved in more than one such transaction,<sup>80</sup> and many of them make such activities their primary business, thereby clearly satisfying the “engaged in the business” criterion.<sup>81</sup>

#### b. “Effecting Transactions in Securities”

In addition to being regularly “engaged in the business,” the finder’s or intermediary’s activity must amount to “effecting transactions in securities.”<sup>82</sup> Courts identify several activities or factors that may bring a finder or intermediary within this definition.<sup>83</sup> These are all simply factors that the courts will

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active solicitation of investors over several years; (ii) purchasing “several million dollars’ worth of securities”; (iii) advertising one’s interest to engage in a securities transaction for one’s own account more than “on a single isolated basis”; and (iv) holding oneself out as being willing to participate in securities transactions. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 912.

79. *See ABA Report, supra* note 9, at 960, 976 (providing background and overview of finders and indicating that the SEC and most states view the taking of a finder’s fee for the introduction of capital on more than one occasion as being “engaged in the business of selling securities for compensation”).

80. *Id.*

81. *Id.*

82. *See* Lipton, *supra* note 44, at 909-12 (discussing the definition of brokers).

83. *SEC v. Thorn*, 426 F.3d 786, 797 (6th Cir. 2005); *SEC v. Hansen*, No. 83 Civ. 3692, 1984 U.S. Dist. LEXIS 17835, at \*26 (S.D.N.Y. Apr. 6, 1984); *SEC v. Margolin*, No. 92 Civ. 6307 (PKL), 1992 U.S. Dist. LEXIS 14872, at \*15-16 (S.D.N.Y. Sept. 30, 1992). Among the activities and factors identified by these courts are: (i) being employed by the issuer of the securities; (ii) receiving

examine when determining whether the defendant acted as a broker-dealer. No particular combination of factors will qualify one as a broker-dealer.

For example, in *SEC v. Thorn*,<sup>84</sup> one of the defendants argued he was not an employee of the issuer and did not receive any compensation for his services because the investment scheme suffered a loss.<sup>85</sup> According to the court in that case, even if it accepted these arguments, the defendant was still a broker-dealer because he frequently communicated with and recruited investors to purchase securities.<sup>86</sup>

Another court held the defendant corporation was a broker-dealer based on the number of investors solicited and the dollar amount collected from those investors.<sup>87</sup> In that case, the defendant corporation's exclusive purpose was to take part in trading programs, and it had solicited over forty investors who had pledged to invest over \$17.45 million, collecting over \$1.7 million from twelve of those investors.<sup>88</sup>

Transaction-based compensation seems to be an important factor in determining whether broker-dealer registration is required. The SEC has indicated that this factor is important in determining whether one is acting as a broker-dealer because such compensation can attract abusive sales techniques by unregistered individuals.<sup>89</sup> Based on court decisions, however, it is uncertain whether this factor alone is enough to warrant registration. For example, one court noted that a defendant's receipt of transaction-based compensation was especially important in holding that the

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commission rather than a salary; (iii) having a history of selling securities for other issuers; (iv) participating in several transactions for various clients; (v) giving advice to investors; (vi) participating in negotiations between the investors and issuer; (vii) actively recruiting investors; (viii) providing clearing services for the trading of securities; (ix) being in possession of the securities and funds of clients; and (x) actively, rather than passively, finding investors.

84. 426 F.3d at 797.

85. *Id.*

86. *Id.* at 798.

87. *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 31 (D.D.C. 1998).

88. *Id.*

89. Persons Deemed Not to Be Brokers, Exchange Act Release No. 20,943, 1984 SEC LEXIS 1585, at \*14-15 (May 9, 1984) [hereinafter "1984 Safe Harbor Release"]. In this release, the SEC explained why, under Rule 3a4-1, an associated person may not receive transaction-based compensation. The SEC stated, "the receipt of transaction-based compensation often indicates that . . . [an associated person] is engaged in the business of effecting transactions in securities," and may be used to determine whether such person is in fact a broker. *Id.* at \*16. The SEC also stated that investor protection issues arise when transaction-based compensation is involved, including the possibility of high-pressure sales tactics. *Id.* As well, the SEC indicated that the prohibition against transaction-based compensation for associated persons was to prevent compensation agreements that depend upon the successful sales efforts of the associated persons. *Id.* at \*15.

defendant acted as an unregistered broker-dealer.<sup>90</sup> In addition to the transaction-based compensation, the defendant in that case actively solicited investors and gave securities recommendations to investors.<sup>91</sup>

Most private investment intermediaries will have an arrangement with the issuer to receive transaction-based compensation rather than a flat finder's fee.<sup>92</sup> Therefore, although courts generally do not find such compensation to be the sole determinant in holding a broker to be unregistered, the SEC hints that such a compensation agreement may be enough to require registration.<sup>93</sup>

Finally, at least one district court decision suggests certain intermediary activities, including assisting with securities transactions among others, may fall outside the statutory definition of a broker.<sup>94</sup> That court stated that "businessmen (who identify potential merger partners) and opportunists (who like to take a small cut of a big transaction)" are not commonly regarded as brokers.<sup>95</sup>

## B. Exemptions in Broker-Dealer and Securities Law

### 1. Rule 3a4-1 Safe Harbor for Associated Persons of Issuers

The policy underlying the broker-dealer rules and regulations of the Exchange Act and the various self-regulatory organizations is to provide protection to investors by ensuring that registered

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90. SEC v. Corp. Relations Group, Inc., No. 6:99-cv-1222-Orl-28KRS, 2003 U.S. Dist. LEXIS 24925, at \*58-59 (M.D. Fla., March 28, 2003).

91. *Id.*

92. See *ABA Report*, *supra* note 9, at 960 (discussing background and overview of finders in private offerings, including compensation of finders).

93. See 1984 Safe Harbor Release, *supra* note 89, at \*15-16, and accompanying text (discussing SEC's position on why transaction-based compensation may trigger broker-dealer registration).

94. SEC v. M & A West, Inc., No. C-01-3376 VRW, 2005 U.S. Dist. LEXIS 22452, at \*26-27 (N.D. Cal., June 20, 2005).

95. *Id.* at \*27. In dismissing the SEC's motion for summary judgment, the district court stated the SEC cited no authority showing the defendant's actions amounted to "effecting transactions in securities for the account of others." *Id.* at \*25. In response to the district court's request for authority showing the defendant's actions fell within the definition of a broker, the SEC responded by relying on the statute. *Id.* The court rejected this argument stating that relying on a "bare statutory definition without interpretive authority" is not enough to find against the defendant. *Id.* at \*27. The court added that if there really is such a lack of authority regarding what constitutes being a broker, then the SEC should provide further guidance by promulgating rules beyond Rules 3a4-1 to 3a4-6. *Id.* at \*28. While this case does not offer much in the way of authority, it is interesting to note that this particular district court is just as confused about the issue of unregistered finders ("businessmen" and "opportunists" as the court calls them) and whether they really should be classified as broker-dealers. *Id.* at \*27.



broker-dealers both possess the necessary training and are obligated to conduct their business under certain prescribed standards.<sup>96</sup> The Rule 3a4-1 safe harbor codifies past SEC interpretive advice and no-action letters concerning broker-dealer registration requirements when an issuer intends to sell its securities through its partners, officers, or employees rather than hiring a registered broker-dealer.<sup>97</sup> This rule gives certain associated persons of an issuer a safe harbor from the broker-dealer registration requirement.<sup>98</sup>

Under the safe harbor, unregistered principals in a private investment firm cannot offer investment interests in a Fund more than once in a twelve-month period without either registering as a broker-dealer or hiring a registered broker-dealer.<sup>99</sup> Further, those principals are limited as to whom they may offer the interests.<sup>100</sup> Generally, a finder or intermediary will not fall within the scope of the safe-harbor because he does not meet the regulatory definition of an "associated person" and because he will likely receive transaction-based compensation.<sup>101</sup> A private placement broker-dealer is likely to receive transaction-based compensation rather than a flat fee,<sup>102</sup> thus disqualifying him from the safe harbor even with no statutory disqualification or association with a broker-dealer.

## 2. *The Finder's Exemption*

The level of finding activity may have some bearing on whether or not registration is required, such that if one's finding activities are more than passive, registration may be required.<sup>103</sup> For example, one court identified "active and aggressive" activities as one factor in ruling that an unregistered broker-dealer violated the Exchange Act.<sup>104</sup> The court indicated the defendant was an aggressive finder because of his combined "advertisements,

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96. Persons Deemed Not to Be Brokers, Exchange Act Release No. 22,172, 1985 SEC LEXIS 1217, at \*4 (June 27, 1985) [hereinafter "1985 Safe Harbor Release"].

97. *Id.* at \*3.

98. 17 C.F.R. § 240.3a4-1; see also *supra* text accompanying note 57 (providing overview of safe-harbor rule).

99. 17 C.F.R. at § 240.3a4-1(a)(4)(ii)(C).

100. § 240.3a4-1(a)(4)(i).

101. As noted, there are three primary requirements to qualify for the safe-harbor: the associated person is not disqualified from participating by statute; the associated person must not receive direct or indirect transaction-based compensation; and the associated person must not be an associated person of a broker-dealer. § 240.3a4-1(a).

102. See *ABA Report*, *supra* note 9, at 960 (discussing background and overview of finders in private offerings, including compensation of finders).

103. *Hansen*, 1984 U.S. Dist. LEXIS 17835, at \*26-27.

104. *Id.*

correspondence, and oil and gas development seminars.”<sup>105</sup> Additionally, the defendant in that case received sales commissions,<sup>106</sup> previously sold securities of another issuer,<sup>107</sup> and often gave extensive advice to investors.<sup>108</sup> According to that court, those activities, combined with the “active and aggressive” finding activities, amounted to broker activities under the Exchange Act.<sup>109</sup>

The SEC has addressed the registration requirements of certain finders or intermediaries through no-action letters issued on a case-by-case basis. Those letters set parameters similar to those drawn in various courts’ definitions of a broker-dealer.<sup>110</sup> The parameters focus on whether the finder was involved in negotiations, solicited investors, received transaction-based compensation, gave advice, or participated in securities transactions in the past.<sup>111</sup>

### C. The State Regulatory Regimes

Michigan is the only state with a registration system for finders.<sup>112</sup> The state defines a finder as “a person who, for consideration, participates in the offer to sell, sale, or purchase of securities or commodities by locating, introducing, or referring potential purchasers or sellers.”<sup>113</sup> Presently, Michigan’s system involves the finder registering as an investment advisor.<sup>114</sup> Other

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105. *Id.*

106. *Id.* at \*26.

107. *Id.*

108. *Id.* at \*27.

109. *Id.*

110. See *ABA Report, supra* note 9, at 975 (summarizing various no-action letters addressing the issue of finders and intermediaries).

111. *Id.* Namely, these parameters are: (i) was the intermediary involved in negotiations; (ii) did the finder solicit investors; (iii) did the finder make recommendations or engage in discussions with the prospective investor regarding the nature of the securities; (iv) did the intermediary receive transaction-based compensation; (v) was the intermediary previously involved in other securities transactions; (vi) was the intermediary disciplined in the past? *Id.*

112. MICH. COMP. LAWS § 451.801 (2005); see also *ABA Report, supra* note 9, at 966 (discussing Michigan registration system for finders).

113. MICH. COMP. LAWS § 451.801.

114. MICH. COMP. LAWS § 451.502 (2005). As noted in the statute and mentioned in the *ABA Report, supra* note 9, at 966 n.7, Michigan sets forth certain obligations for finders. First, a finder who receives payment for his finding services may not take possession of funds or securities in connection with that transaction for which such payment is made. MICH. COMP. LAWS § 451.502. Second, before the sale or purchase of any securities, the finder must, “clearly and conspicuously” disclose in writing to everyone involved in the transaction that he is acting as a finder. *Id.* The finder must also disclose any payment received for his services as a finder, including the amount and method of payment. *Id.* Further, the finder must disclose any beneficial

states allow registration of agents of an issuer that sell securities in private placements.<sup>115</sup>

#### D. The Suitability Doctrine and Accredited Investors

With respect to accredited investors, the NASD's position is that the investor's assets alone do not satisfy the broker-dealer's suitability responsibilities under the NASD's suitability Rule 2310.<sup>116</sup> Yet, the NASD has hinted that accredited investors do have some level of sophistication.<sup>117</sup> However, this may not

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interest in the issue of the subject securities, whether indirect or direct, of either the finder or a member of his immediate family. *Id.* Third, a finder may not take part in the offer, purchase, or sale of a security that would violate the security registration requirements of the Michigan Uniform Securities Act § 451.301. *Id.* If, however, the finder has no knowledge that the proposed transaction would violate § 451.301 after making a reasonable effort to determine either if a registration had been made or whether an exemption has been claimed or granted, then the finder may proceed. *Id.* Fourth, before participating in a transaction, the finder must acquire information regarding (a) the risks involved in the transaction, (b) the direct and indirect compensation of the principals and their affiliates, (c) the issuer's financial condition, and (d) how the proceeds will be used. *Id.* However, no independent investigation or alteration of the offering materials provided to the finder is required. *Id.* Fifth, the finder must, until the end of the particular transaction, provide disclosure of any material information that the finder knows or should know is material in one making an investment decision to all persons found by him. *Id.* Sixth, the finder may only locate, introduce, and refer individuals who are suitable investors based on their "financial condition, age, experience, or need to diversify investments." *Id.* Finally, there is no requirement that the finder independently generate information. *Id.*

115. See *ABA Report, supra* note 9, at 966 n.6 (noting certain states register placement agents rather than finders); see also 950 MASS. CODE REGS. § 12.202(3) (2005) (setting forth procedures for issuer-agent registration).

116. See *Mills & Holinsky, supra* note 50, at 6-20 (discussing the customer-specific suitability requirements for broker-dealers when recommending hedge funds to customers); see also, National Association of Securities Dealers, NASD Notice to Members: NASD Recommends Best Practices for Reviewing New Products, Apr. 2005, 2005 NASD LEXIS 7, \*16 ("NASD cautions that there is no substitute for a suitability analysis, and 'accredited' status under Regulation D of the Securities Act of 1933 is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage of his or her net wealth."); National Association of Securities Dealers, NASD Notice to Members: NASD Reminds Members of Obligations When Selling Hedge Funds, Feb. 2003, 2003 NASD LEXIS 3, \*10 (stating that an investor's level of assets is not the sole criteria upon which to base a suitability determination).

117. National Association of Securities Dealers, Special NASD Notice to Members: NASD Regulation Requests Comment On Proposal To Adopt Recommendation And Disclosure Rules For Over-The-Counter (OTC) Equity Securities; Comment Period Expires February 16, 1998, Jan. 1998, 1998 NASD LEXIS 17, \*13 (discussing proposed rules for OTC securities, the NASD stated that the proposed rule would not apply to transactions exempt under § 4(2) of the Securities Act). The NASD stated that "[t]hese transactions are

necessarily mean that sophisticated investors can make their own suitability determinations.

The SEC's 1984 Safe Harbor Release solicited comments regarding whether the then proposed Rule 3a4-1(a)(4)(i)(A) should include sales to accredited investors.<sup>118</sup> Following that, the SEC's 1985 Safe Harbor Release noted that some commentators felt that accredited investors have the capability to require issuers to make full disclosures about the offering, and such investors can protect themselves from possible sales pressures from the issuer's employees.<sup>119</sup> But the SEC ultimately excluded accredited investors from the final rule. The SEC reasoned that the ability of some accredited investors to transact business without the protections provided by registration under the Securities Act does not mean "that a broad exemption from broker-dealer registration is appropriate."<sup>120</sup> The SEC also stated that the existing rules under the Exchange Act and the self-regulatory organizations are "no less important" in the context of accredited investors than they are in others.<sup>121</sup>

### 1. *Sophisticated Investors*

With the exception of the definition of an accredited investor,<sup>122</sup> there is little mention of sophisticated investors in the securities laws.<sup>123</sup> Courts do, however, make a distinction between sophisticated and unsophisticated investors.<sup>124</sup> For instance, in

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excluded from the scope of the proposed rule since they are deemed either

transactions not involving a public offering or transactions generally involving certain qualified or sophisticated investors (i.e., accredited investors)." *Id.*

118. 1984 Safe Harbor Release, *supra* note 89, at \*17. According to this Release, the proposed Rule 3a4-1(a)(4)(i)(A) stated that an associated person would not be deemed a broker if sales were restricted to certain financial institutions and intermediaries, such as registered broker-dealers, registered investment companies, banks, insurance companies, etc. *Id.* These institutions and intermediaries were included because of their financial sophistication. *Id.*

119. 1985 Safe Harbor Release, *supra* note 96, at \*17-18.

120. *Id.* at \*18.

121. *Id.* The only reference to any specific rules was to those that "ensure adequate supervision." Presumably, this relates back to ensuring an unregistered broker-dealer does not subject the investor to high-pressure sales tactics.

122. 17 C.F.R. § 230.501 (2006); see also *supra* text accompanying note 37 (discussing regulatory definition of "accredited investor").

123. See C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1083 (1988) (noting that although there is little mention of sophisticated investors in the securities laws, the courts do make a distinction between sophisticated and unsophisticated investors).

124. *Id.* Unfortunately, courts have been inconsistent in their treatment of sophisticated investors. *Id.* at 1085.

deciding Rule 10b-5<sup>125</sup> cases involving fraud and deceit, courts take various approaches in determining whether there is a connection between the plaintiff's injury and the defendant's conduct.<sup>126</sup> Regardless of the approach taken, the sophistication of the investor is an issue.<sup>127</sup> In a Rule 10b-5 case, courts look at an investor's "background, education, special expertise, and general investment sophistication" in determining whether the investor reasonably relied on the defendant's alleged misrepresentations.<sup>128</sup> Sophisticated investors face higher standards in determining reliance, which makes it more difficult for them to show causation in Rule 10b-5 cases.<sup>129</sup>

## 2. *Pre-existing Relationship between Intermediary and Investor*

As set forth in the State of New York's Policy Statement 101<sup>130</sup> and Policy Statement 105,<sup>131</sup> New York allows for certain exemptions to the registration of securities offerings when those offerings, inter alia, involve persons with whom the issuer has a pre-existing relationship.<sup>132</sup> Notwithstanding the separate broker-dealer registration and notice requirements in New York, these exemptions, involving investors with a pre-existing relationship to the issuer, indicate that such a relationship is a factor in determining certain exemptions to registration of the offering.<sup>133</sup>

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125. 17 C.F.R. § 240.10b-5 (2006). This is the rule prohibiting fraud and deceit.

126. See Fletcher, *supra* note 123, at 1086 (discussing investor sophistication and the causation requirement of Rule 10b-5).

127. See *id.* at 1085-86 (pointing to the difficulty of developing a prima facie case under Rule 10b-5). For example, in cases representing misrepresentations of fact, courts often decide causation by determining whether the plaintiff reasonably relied on the defendant's misstatements. *Id.* at 1087. In determining reasonable reliance, the plaintiff's sophistication is relevant, and his sophistication may show unjustifiable reliance on the alleged misrepresentations. *Id.* at 1088.

128. *Id.* at 1088.

129. *Id.* at 1089-1090.

130. See *infra* note 132.

131. See *infra* note 132.

132. See, e.g., Policy Statement 105, Instructions for Issuers of Real Estate Syndication Offerings Requesting No-Filing Letters from the Attorney General, available at <http://www.oag.state.ny.us/realestate/policy/ps105.html> (providing instructions for issuers offering real estate interests who wish to obtain a no-filing letter); Policy Statement 101, Exemption Application Under § 352-g(1) and § 359-f(2) of the General Business Law for Real Estate Syndication Offerings Made to Persons Not Exceeding Forty in Number, available at <http://www.oag.state.ny.us/realestate/policy/ps101.html> (providing instructions for issuers of real estate syndication offerings that certain exemptions for offerings limited to forty or less investors).

133. Policy Statement 105 sets forth six no-filing categories in which the attorney general will take no action in response to an issuer of real estate interests' failure to file an offering statement. Policy Statement 105, *supra* note 132. For example, Policy Statement 105 provides an exemption for small

Further, Policy Statement 101 and Policy Statement 105 both state that accredited investors (as defined by Rule 501 of Regulation D) are automatically assumed to be sophisticated investors.<sup>134</sup> This indicates that, with respect to certain sophisticated investors with whom the issuer has a pre-existing relationship, less formality is required with the disclosure and registration requirements of New York's securities laws.

Given the findings set forth above,<sup>135</sup> it is evident that most private placement intermediaries would likely be required to register as broker-dealers even though the finding activity is not their primary business and even though they deal exclusively with sophisticated, accredited investors. But given the findings of the ABA Report,<sup>136</sup> as well as the comments of at least one court,<sup>137</sup> the

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private offerings, which the Statement defines as "one in which sales are made to nine or fewer investors within and without the State of New York who are sophisticated, have sufficient means for the investment and have a pre-existing relationship with the promoters of the offering." Policy Statement 105, *supra* note 132.

There is also an exemption for isolated sales made to no more than two New York residents who: (i) are "sophisticated"; (ii) "have sufficient means for the investment"; and, (iii) "have a pre-existing relationship with the promoters of the offering." Policy Statement 101, *supra* note 132. A "pre-existing relationship" is defined in Policy Statement 105 as either a close familial or a "significant business or social relationship" of a year or more between the investor and a principal of the issuer. Policy Statement 105, *supra* note 132. Policy Statement 101 adds that the existing relationship must be direct; that is, it cannot be through a broker, investment advisor, accountant, or lawyer of either party. Policy Statement 101, *supra* note 132.

134. Policy Statement 101, *supra* note 132; Policy Statement 105, *supra* note 132. In addition to the presumption for accredited investors, the policy statements define sophisticated investors as those having "experience in real estate investments, investments in securities or other substantial business or financial experience, or a person having a personal advisor with such experience." Policy Statement 105, *supra* note 132.

The personal advisor cannot be a principal of the issuer nor receive commissions from the issuer based on the sale to the investor. Policy Statement 105, *supra* note 132. Policy Statement 101 adds that the personal advisor, in addition to commissions, cannot receive "other compensation from the issuer or its principals for the organization of or sale of interests in the issuer." Policy Statement 101, *supra* note 132.

This begs the question: may an intermediary who has a pre-existing relationship with a sophisticated, accredited investor introduce that investor to the issuer and, should the investor invest, may the intermediary receive payment based on that investment?

135. See *supra* text accompanying notes 72-121.

136. See *ABA Report*, *supra* note 9, at 961 (proposing recommendations "to bridge the gap between the current regulatory system and a system better targeted at the unregistered financial intermediaries").

137. See *supra* text accompanying notes 94-95 (finding that the Northern District of California deems some intermediary actions outside the current definition of broker).

current regime does not fit these particular transactions. Finally, the proposals offered by the ABA Report do not address either

private investment funds or how the suitability doctrine fits within the new regime.<sup>138</sup>

#### IV. PROPOSAL

In light of the foregoing analysis and the ABA Report,<sup>139</sup> this Comment proposes a relaxed regulatory regime that takes into account the suitability doctrine imposed by the NASD and implicit in the Exchange Act. This new regime will allow private placement broker-dealers to introduce accredited investors to issuers and receive payment based on that transaction. It will also set forth certain due diligence requirements, including restrictions upon private placement broker-dealers who have a pre-existing relationship with sophisticated, accredited investors. Finally, it will propose a limited registration exemption for private placement broker-dealers who deal with only one transaction per year.

##### *A. Private Investment Fund Private Placement Broker-Dealer: NASD Membership & Limited Registrations*

The SEC should promulgate rules under Section 15 of the Exchange Act<sup>140</sup> setting forth a definition for "private placement broker-dealers" and the requirements for registration.<sup>141</sup> Additionally, the SEC should require NASD membership for private placement broker-dealers. Given the growth of enforcement activity by the SROs, it seems reasonable for the SEC to confer upon the NASD certain rulemaking and enforcement responsibilities with respect to private placement broker-dealers.<sup>142</sup>

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138. See *ABA Report*, *supra* note 9, at 961 (addressing private placement broker relationships).

139. See *id.* (making recommendations for private placement broker-dealers).

140. 15 U.S.C. § 78o(a)(1) (2000).

141. Given the SEC's interpretation of the statutory definition of "broker," it seems unlikely and unnecessary for Congress to amend the Exchange Act to differentiate between "full-service" brokers and "private placement" brokers. Rather, both should fall within the Exchange Act's definition. The rules promulgated under that definition should set forth the distinctions between the two, as well as the qualifications and responsibilities of each.

142. In addition to the growth of SRO enforcement, the Exchange Act requires SROs to implement rules that cover nearly all facets of the securities industry. See Richard D. Marshall & Sean E. Kreiger, *SEC and SRO Enforcement*, in *BROKER-DEALER REGULATION 24-4 to -5, 24-19*, *supra* note 50 (discussing the role of SROs).

The NASD should set forth certain rules for limited registrations based on the type and scope of activities of the private placement broker-dealer. For example, while an entity or individual may qualify to be a private placement broker-dealer, in order to engage in certain securities transactions, that entity or individual must register as a specific type of private placement broker-dealer. Thus, there should be limited registrations for private placement broker-dealers engaging primarily in capital-raising for start-up companies, mergers and acquisitions, private investment funds, and other private offerings. This limited registration system would be similar to the "Limited Representative" subcategories of NASD Rule 1032.<sup>143</sup>

### *B. Characteristics of a Private Investment Fund Private Placement Broker-Dealer*

#### *1. Deals Only With Private Investment Funds*

"Private investment fund private placement broker-dealers," as their title suggests, would engage in securities transactions involving only private investment funds.<sup>144</sup> Although finders and intermediaries may perform securities-related services in other areas, such as raising capital for start-up companies or pooling merger and acquisition candidates, given the varied nature of these transactions, it seems appropriate to differentiate among them using a limited registration.<sup>145</sup>

The question remains whether there should be a cap on either the dollar amount of an offering in which a private placement broker-dealer may be involved, or a cap on the amount of investment by the investor or investors that the private placement broker-dealer brought to the issuer. On one hand, given that full-service broker-dealers generally do not handle deals under twenty-

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143. NASD Rule 1032 requires persons associated with broker-dealers "to register with the Association as a General Securities Representative and shall pass an appropriate Qualification Examination before such registration may become effective unless his activities are so limited as to qualify him for one or more of the limited categories of representative registration specified hereafter." NASD Manual, *supra* note 53, § 1032.

144. The NASD should define the term "private investment fund." The definition should be broad enough to cover all of the commonly used funds. See SCHELL, *supra* note 28, at 1-8 and accompanying text (setting forth common categories of private investment funds). The Author's suggested definition for "private investment fund" is "a pooled investment vehicle through which accredited investors and the fund's principals contractually agree on certain investment objectives." See *id.*

145. Under this proposal, a private placement broker-dealer may obtain limited registrations for more than one category. Thus, if a private placement broker-dealer is qualified to engage in both private investment funds and start-up companies, then that private placement broker-dealer could obtain limited registrations for both.



five million dollars,<sup>146</sup> it seems that private placement broker-dealers should be involved with offerings up to this amount.<sup>147</sup> A more plausible solution, however, would be to either set a cap on the amount of money an investor introduced by a private placement broker-dealer may bring to the offering, or perhaps limit the number of investors brought to the issuer by a private placement broker-dealer.<sup>148</sup>

## 2. *Accredited, Sophisticated Investors Only*

Generally, private investment funds only sell interests to accredited investors.<sup>149</sup> Notwithstanding this practice, the new rule should specifically restrict registered private placement broker-dealers to dealing with accredited investors only, as defined by the SEC.<sup>150</sup> Congress and the SEC previously determined that certain sophisticated and wealthy investors do not require the same level of regulation as average investors.<sup>151</sup> Additionally,

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146. See *ABA Report*, *supra* note 9, at 968 (discussing findings from *ABA Report* that most full-service broker-dealers do not get involved with private offerings under twenty-five million dollars).

147. If the proposed rule allows private placement broker-dealers to participate in offerings up to an unlimited dollar amount, at some point they will intrude on the turf of full-service broker-dealers. This will certainly bring protest from the fully regulated broker-dealers. Yet, the amount of the offering should not make a difference if the private offering involves accredited and sophisticated investors. Although the stakes are higher, the duties and responsibilities of either a private placement broker-dealer or a full-service broker-dealer remain the same.

148. For example, a private placement broker-dealer might be limited to the greater of either fifteen investors or a total of thirty million dollars in individual investments.

149. SCHELL, *supra* note 28, at 8-7.

150. See 17 C.F.R. § 230.501 (defining “accredited investor”); see also *supra* note 37 and accompanying text (discussing Rule 501’s definition of “accredited investor” as it pertains to private offerings under Regulation D).

151. See, e.g., *supra* note 37 and accompanying text (describing definitions in Regulation D); see also Defining “Qualified Purchaser” Under the Securities Act of 1933, Securities Act Release No. 33-8041, 66 Fed. Reg. 66839, at 8-9 (Dec. 19, 2001) (proposing a definition of the term “qualified purchaser” under the Exchange Act in order to apply a provision of the National Securities Markets Improvement Act of 1996 (“NSMIA”). The SEC proposed that the term “qualified purchaser” have the same meaning as the term “accredited investor” under Rule 501. *Id.* at 8. In the release, the SEC stated, “the regulatory and legislative history of both terms are based upon similar notions of the financial sophistication of investors, and accredited investor is a long-standing concept familiar to the small business community and other industry participants.” *Id.* at 8-9 (footnote omitted). The release also noted the “[SEC’s] considerable regulatory experience with the use of the term ‘accredited investor’ leads [it] to believe it strikes the appropriate balance between the necessity for investor protection and meaningful relief for issuers offering securities, especially small businesses.” *Id.* at 9. The SEC also stated that Congress considered “accredited persons as sophisticated and able to protect their financial interests without regulatory assistance.” *Id.* at 9 n.20.

courts hold sophisticated investors to a higher standard in securities fraud cases.<sup>152</sup> Therefore, while the accredited investors brought to an issuer by a private placement broker-dealer still receive protection under the Exchange Act, courts assume that these investors have greater investment sophistication and thus should bear a heightened burden when pursuing fraud cases against private placement broker-dealers.<sup>153</sup>

### 3. *Suitability*

The NASD should set forth specific suitability<sup>154</sup> requirements for private-placement broker-dealers. The NASD's current suitability rule<sup>155</sup> contemplates full-service broker-dealers dealing with ongoing relations with their customers. Therefore, the NASD should implement a new suitability rule specifically tailored for the limited role of private placement broker-dealers.

### 4. *No or Very Limited Involvement in Negotiations.*

Private placement broker-dealers generally act more like finders<sup>156</sup> than like traditional broker-dealers.<sup>157</sup> That is, most private placement broker-dealers introduce the investor to the issuer and receive payment based on that investor's investment. The private placement broker-dealer leaves the negotiation to the issuer and the investor, or their respective attorneys. Therefore,

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However, the term "accredited investor" is used in connection with exemptions to registration of securities offerings under the Securities Act. *See supra* notes 35-38 and accompanying text (discussing Regulation D). The Exchange Act does not exempt a broker-dealer's responsibilities because an investor is accredited. *See supra* Part III(D) (discussing comments from the SEC in the 1984 Safe Harbor Release stating that exemption from the registration requirements of the Securities Act does not equate to exemption from the protective provisions of the Exchange Act).

152. *See* discussion *supra* Section III(D)(1) and text accompanying notes 123-132 (discussing sophisticated investors in securities fraud cases and the various standards to which courts hold them).

153. *Id.*

154. *See supra* notes 50-54 and accompanying text; *supra* notes 116-121 and accompanying text (discussing and analyzing suitability doctrine).

155. *See* NASD Manual, *supra* note 53, § 2310 (discussing NASD suitability rule).

156. *See* discussion *supra* Section II(D)(2) and text accompanying notes 64-68 (providing background regarding finders in the securities industry); *see also* discussion *supra* Section III(B)(2) and text accompanying notes 103-111 (analyzing administrative and court decisions and scholarship regarding finders).

157. *See* discussion *supra* Section II(C)(1) and text accompanying notes 41-44 (providing background regarding definition of broker-dealers); *see also* discussion *supra* Section III(A) and text accompanying notes 69-93 (analyzing court and administrative decisions and scholarly materials regarding the definition of broker).

the scope of traditional “broker” activity<sup>158</sup> undertaken by the private placement broker-dealer should remain very limited and involve very little in the way of negotiation.

*C. The Exchange Act, NASD Rules, and Suitability Doctrine  
Legitimize the Proposed Private Placement Broker-Dealer Rule*

Essentially, the proposed private placement broker-dealer rule allows the private-placement broker-dealer to legitimately engage in traditional finder<sup>159</sup> activities and receive transaction-based compensation for those activities. The Exchange Act and NASD rules further legitimize this rule because they would require the private placement broker-dealer to introduce to the investor only those Funds that are suitable to that investor. Furthermore, in keeping with the mission of the federal securities laws and the SEC, the proposed rule protects investors because, under the new rule, private placement broker-dealers will be regulated and subject to discipline.

*D. Limited Exception for Certain Defined Finders or  
Intermediaries*

Finally, the SEC should promulgate a rule under which private placement broker-dealers, finders, or intermediaries involved in a single transaction per year are not required to register. The individual claiming the exemption would be very limited in the scope of his or her activities. First, the offering must qualify under the proposed “private placement broker-dealer” rules. Second, the investor brought to the issuer would have to be both accredited and sophisticated, as the SEC chooses to define such terms.<sup>160</sup> Third, the investor must have a pre-existing relationship with the private placement broker-dealer.<sup>161</sup>

158. *Id.*

159. *See supra* text accompanying notes 64-68 (regarding the traditional activities of finders).

160. 17 C.F.R. § 230.506; 17 C.F.R. § 230.501; *see also supra* text accompanying notes 35-37 (regarding Regulation D and accredited investors); *supra* text accompanying notes 122-129 (discussing sophisticated investors). The SEC should define the term “sophisticated investor” as it would relate to this exemption.

One commentator suggests there are certain relevant criteria in determining who is a sophisticated investor. Fletcher, *supra* note 123, at 1149-55. Professor Fletcher explains these criteria apply to almost every case involving an analysis of whether an investor was sophisticated. *Id.* These criteria are: “(1) financial and business acumen, (2) individual characteristics of sophistication, and (3) investment-specific behavior.” *Id.* Professor Fletcher sets forth a checklist of considerations under each of the aforementioned categories that are relevant in making a sophistication determination. *Id.*

161. *See discussion supra* Section III(D)(2) and text accompanying notes 132-134 (discussing New York’s definition of “pre-existing relationship”). The New York definition of “pre-existing relationship” is a good starting point. It would

If a private placement broker-dealer or finder meets this exception, he or she should be entitled to receive transaction-based compensation based on that isolated transaction without having to register.

## V. CONCLUSION

One of the SEC's primary missions is to protect investors.<sup>162</sup> However, fully regulated broker-dealers are not providing their services to certain smaller issuers.<sup>163</sup> As a result, smaller issuers are seeking the assistance from finders and intermediaries to help raise capital.<sup>164</sup> Rather than deal with this problem on an ad hoc basis through no-action letters, the SEC should promulgate a new rule under the Exchange Act that provides for limited registration for private placement broker-dealers. Additionally, it should set forth a rule exempting certain persons involved in only one transaction per year. These new rules would clarify the definition of "broker-dealer" under the Exchange Act, and bring into compliance many who are arguably engaging in unregistered broker-dealer activities. This would be consistent with the SEC's mission of investor protection and preserving the integrity of the securities markets.

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essentially codify the relationship many finders already have with the investors they bring to Funds. Namely, many of these finders and investors are businesspersons and colleagues who have done business with each other in the past and, based on these past transactions, would likely know enough about each other professionally to make a suitability determination.

162. See *The Investor's Advocate*, *supra* note 2 (discussing purpose and mission of the SEC and the securities laws).

163. *ABA Report*, *supra* note 9, at 968.

164. See *supra* text accompanying note 12 (discussing finders and intermediaries in the capital markets).

