

Are you selling securities legally?

In the public capital markets and in particular markets involving retail investors, SEC regulations and FINRA rules are straight forward when it comes to the definition of a security and what constitutes securities activity. In the private capital markets, not so much.

Companies looking to raise private capital spend a ton on securities attorneys to determine what constitutes a securities transaction. We here at FNEX get questions regarding this daily. This article will cover two common areas of confusion: Issuer's exemption, and finder arrangements.

1. The Issuer's Exemption

Section 15(a)(1) of the Exchange Act of 1934 makes it unlawful to affect or induce a securities transaction without registering with the SEC as a broker/dealer and joining FINRA. Many issuers of securities attempt to circumvent this using the Issuer's Exemption, SEC Rule 3(a)4-1.

Entities that raise capital by issuing securities generally do not need to be registered as a broker/dealer. This is because they are selling securities for their own accounts and not for the accounts of others (broker). Issuers also generally do not buy, then sell securities of others for their own accounts (dealer).

Issuers often believe since they are the entity raising the funds, that their employees or associated persons performing capital raising activities do not need to be registered with a broker/dealer.

Under certain circumstances, employees or associated persons may be able to assist in capital raising activities for their respective issuers without registering with a broker/dealer, through the Issuer's exemption.

The fact is, there are several tall hurdles to jump before one can utilize the Issuer's exemption. The individuals raising capital:

1. cannot be subject to a statutory disqualification;
2. cannot be compensated based on the successful completion of a transaction (commission, bonus, salary increase, etc.);
3. cannot be associated with a B/D for 12 months prior, during, or after the capital raise.
4. main responsibility cannot be raising capital, they can only do one securities transaction per 12 months; and
5. must be a 'passive participant' meaning they cannot cold call potential investors. They can provide written communication, and respond to inquiries, do clerical, or research work, etc. Any written or verbal response cannot go beyond information contained in the offering documents.

As you can see, it can be very difficult to utilize the Issuer Exemption if a person is actively engaging potential investors, regardless of how they are compensated.

2. Finder arrangements

For many years there has been significant uncertainty regarding the need for finders to register with a BD. A finder is a person who assists private issuers in raising capital from accredited investors. Their involvement with the investor is limited and is typically only to the extent of an introduction to the issuer. Issuers who may not have the capabilities or audience to effectively raise capital will engage finders for assistance.

Many finders believe they only need to register with a BD if they are being compensated with a success/transaction-based fee. While transaction-based compensation almost always requires registration, it is not always the only indicator. Below is a non-exhaustive list of activities that may require you to become registered, regardless of how you are compensated.

1. Actively soliciting or recruiting investors, or otherwise finding investors for “issuers” (entities issuing securities), even in a consultant capacity;
2. finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers, investment companies (or mutual funds, including hedge funds), or other securities intermediaries;
3. persons that market real-estate investment interests, such as tenancy-in-common interests, that are securities;
4. persons that act as “placement agents” for private placements of securities;
5. participating in negotiations between the issuer and the investor;
6. advising investors as to the merits of an investment or opining on its merits;
7. handling customer funds and securities;
8. having a history of selling securities of other issuers; and
9. receiving commissions, transaction-based compensation, or payment other than a salary in connection with the purchase or sale of securities.

In the case of both the Issuer’s Exemption and Finder arrangements, you can see that regardless of how you are compensated, it can be difficult and risky to actively engage with potential investors regarding Issuers of securities without becoming registered.

FNEX is here to help you mitigate this risk. If you are unsure if your capital raising activities require registration, please do not hesitate to reach out for a free consultation.

FNEX provides registration and compliance services to independent private capital market professionals.