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FINANCIAL INTERMEDIARIES AND THE EFFECTS OF THE JOBS ACT ON THEM AND THE ISSUERS THEY MAY SERVE

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Since the advent of Regulation D, the number of private securities offerings by both privately held and public companies have skyrocketed.[1] However, anecdotal evidence from potential issuers in some industry, size and other categories is that it is as difficult as ever to find equity investors that are appropriate and add value to the issuer's business. It is difficult to ensure that an investment in a private offering is suitable for certain kinds of investors and unclear who has responsibility for ensuring that in every situation. And, while the number of offerings and amount raised have both increased, involvement of financial intermediaries in those transactions has not increased commensurately. Why? In terms of promoting capital formation as well as investor protection, is it important or significant that intermediaries have not been involved? What is the effect of federal legislation and rulemaking done in the wake of the 2008 financial crisis on financial intermediaries and the issuers or investors they could be serving?

This is also a story of a regulatory framework on the federal and state level that had a certain intellectual coherence for many years – and no longer does. The economics of the financial intermediary's business has changed substantially over time – first, through deregulation of pricing and then through the use of information technology. The U.S. economy as a whole has changed substantially since the 1930s. Nationwide and even international flows of capital are an accepted part of the system. The ease with which issuers can raise equity capital affects whether and when financial intermediaries are involved in their offerings. Presumably, the size of the transaction, the characteristics of the issuer's business and regulatory constraints on both the issuer and intermediary are all factors. However,

- when the U.S. Securities and Exchange Commission's regulatory reach expanded over time and then contracted with respect to issuers but simply expanded over time with respect to financial intermediaries, and
- when state securities law began to be pre-empted for some issuers and not others but never pre-empted for financial intermediaries,

we believe dislocations occurred in the capital raising system that particularly affect the involvement of financial intermediaries in securities offerings. There seems to no longer be a consistent rationale why some participants in some securities offerings are more regulated than others[2].

I. Setting the Stage: Pre-2010 Regulation of and Case Law About Financial Intermediaries in "Private" Transactions

Federal Registration as a Broker or Alternative Trading System is Required

While the lower incidence of private transactions in the earlier years of securities regulation in this county may have led some intermediaries to believe that they did not have to register as brokers or dealers unless they were dealing in securities traded in the public markets. Securities regulators on both the federal and state levels have long taken the view that most should be registered. It is important to begin with the fundamental premise that a financial intermediary will have to find a solution under federal law <u>and</u> for each state jurisdiction in which: 1) it resides or has its primary place of business; and 2) each investor with whom it does business in the transaction at hand is domiciled. In this paper, we will examine both federal and Texas law and consider each of these alternatives and whether they are available.

The standard for who or what kind of entity operating as a financial intermediary is required to register is located in the definition of the term "broker" in Section 3(a)(4) and the term "dealer" in Section 3(a)(5) of the Securities and Exchange Act of 1934:

§3(a)(4)(A)

The term "broker" means any **person engaged in the business** of effecting transactions in securities **for the account of others**.

§3(a)(5)

A. In general

The term "dealer" means **any person engaged in the business** of buying and selling securities **for such person's own account through a broker or otherwise**.

B. Exception for person not engaged in the business of dealing

The term "dealer" does not include a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

The interpretation of each of these definitions centers around the phrases “engaged in the business” or “as a part of a regular business”. If “engaged in the business”, a broker or dealer must register unless the SEC has exempted a particular class of brokers or dealers. It is important to remember that any broker or dealer exempted from the requirement to register or even any person involved in the sale of securities but not “engaged in the business” is still subject to anti-fraud provisions of the securities laws.[3]

In addition, the statutory provision of the Securities and Exchange Act of 1934 which requires registration also provides some carve-outs or exceptions to the definition:

§15(a) Registration of all persons utilizing exchange facilities to effect transactions; exemptions

(1) It shall be **unlawful for any broker or dealer** which is <u>either</u> 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 (*other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange*) **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** *(other than an exempted security or commercial paper, bankers' acceptances, or commercial bills)* **unless** such broker or dealer is **registered** in accordance with subsection (b) of this section.

(2) **The Commission**, **by rule or order**, as it deems consistent with the public interest and the protection of investors, **may conditionally or unconditionally exempt** from paragraph (1) of this subsection **any** broker or dealer or **class of brokers or dealers** specified in such rule or order.

The primary way in which firms or individuals are excepted from the definition of broker or dealer is to present a set of facts and circumstances that the SEC agrees does not constitute “engaging in the business” of effecting transactions in securities. In 1980, a federal district court put together a concise set of factors to consider in making that determination in an administrative proceeding that turned into litigation against National Executive Planners, Ltd. [4] Those relevant factors included whether the person: 1) actively solicited investors; 2) advised investors as to the merits of an investment; 3) acted with a “certain regularity of participation in securities transactions”; and 4) received commissions or transaction-based remuneration.

Since the mid-1970’s, the SEC has, through a series of responses to No Action Letters, attempted to clarify what falls in and outside that phrase “engaged in the business”. In the process, it has added two more factors to the National Executive Planners list: 1) negotiations on behalf of one of the parties, and 2)

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