Commentary: FINRA's Latest Attempt to Deal with Finders

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It happens at this point in every business cycle.

It all starts when broker-dealers lay off a lot of their employees. It is often impossible for these former employees to replace what was lost. Even if they find a job at another firm, and most of them will not, the compensation will be less, often much less, and the working conditions will be terrible.

The inability to find work, more than anything else, inspires entrepreneurial zeal. Since no firm will hire them, laid off employees put themselves to work by starting their own businesses. Former investment bankers, institutional sales-traders and retail brokers call up their old customers to see if something can be done, essentially attempting to perform the same functions they used to accomplish with their former employers. Former customers may be happy to hear from their old rep, particularly if they think that the same work can be performed for a lower fee.

Sadly, these activities are unlawful if they are not conducted by a registered broker-dealer. It isn't easy, and costs a fair amount of money, to register a broker-dealer. People who are out of work generally are not in a position to make this sort of commitment.

But, isn't there such a thing as a "finder?" This is a question I have been asked at least once each year during my career as a securities lawyer, more often at times like these. The answer is that finders may exist, but I have never met one. Finders are something like the Loch Ness monster, Bigfoot or unicorns – mythical creatures.

The finder concept, as it exists in the securities laws, emerges out of a Second Circuit decision that sought to interpret the terms "broker" and "dealer" in the Securities Exchange Act of 1934. These definitions are important because anyone that is a "broker" or a "dealer" as defined in the Exchange Act is required to register with the SEC.

The term "broker" is defined as any person that is engaged in the business of purchasing or selling securities for the account of others. A "dealer" is engaged in the business of purchasing or selling securities for its own account. The Court reasoned that a person that purchased and sold securities for the account of others,

or for its own account, but was not actually "engaged" in that business, must not be a broker or dealer. Such a person might be a "finder."

There was a case involving a baker in Rochester, New York, who realized that one of his clients was looking to buy a business, while another was looking to sell. The baker hooked them up, and to express their delight, they wished to pay him for thinking about them. However, since the transaction involved the purchase of securities, the cautious lawyers involved decided to ask the SEC's views before advising their clients to pay the baker. With extreme reluctance, the SEC agreed that the baker probably was not "engaged in the business" of purchasing or selling securities for the account of others and therefore was entitled to receive payment for his efforts. The SEC's no-action letter strongly suggested that the baker should not try to do this twice.

Former employees of broker-dealers who are trying to start a business providing investment services are not in a position to claim they aren't "engaged in the business" and therefore cannot satisfy the "baker's test."

FINRA and the New York Stock Exchange each have rules that make it difficult to pay "finders," thereby supporting the prohibition on engaging in a securities business without broker-dealer registration. FINRA Rule 2040, NYSE Rule 353 and NYSE Rule Interpretation 345(a)(i)/01, /02 and /03 prohibit FINRA or New York Stock Exchange member firms from sharing compensation from securities transactions with any non-member. Since most securities transactions ultimately require the help from a registered broker-dealer to execute, clear and settle them, and broker-dealers are not all that enthusiastic about sharing commissions anyway, these Rules usually operate to prevent finders from earning a living doing a securities business.

FINRA, as part of its long-running effort to create a consolidated rulebook, proposes to simplify these rules. The old rules focused on whether the person receiving commissions was a FINRA or NYSE member. The new rules, in contrast, focus on whether the person receiving the commissions can do so without registration as a broker-dealer. In other words, the target of the new rules is the unregistered finder.

For many years now, the small business community has urged the SEC to create a finder exemption to broker-dealer registration. They have argued that current rules restrict the ability of small businesses to raise capital. So far, this request has fallen on deaf ears.

Many state laws permit some limited brokerage activities by "agents for the issuer" that make intra-state offerings of securities in private placements. The SEC has never approved any "agent for the issuer exemption," and I do not believe these activities pass muster under federal securities laws. But, I am not aware of any

enforcement actions brought by the SEC against state-registered agents for engaging in a broker-dealer business without federal registration.

To get a transaction done, investment bankers sometimes agree to share their commissions with some "friend" of the board of directors that they would like to see compensated for his work in raising capital for a corporation. These sharing arrangements are not popular with investment bankers because they reduce the fees received in transactions. In any event, I doubt that very many, if any, of these payments actually comply with the SEC's strict construction of the Exchange Act.

Any regulation, by its very nature, restricts competition. In the case of broker-dealer registration, the cost of registration is a bar to entry. This means that investment services are more expensive than they would otherwise be if registration were not required.

If we have learned anything from the ongoing financial crisis, it is the danger to the taxpaying public of unregulated financial services. So, I am not in favor of exempting a class of "finders" from broker-dealer regulation.

On the other hand, it is surely also a bad idea to allow some groups to escape regulation, so long as no fraud is committed, no one complains or the enterprise is of sufficiently small size. The SEC has for too long looked the other way while "agents for the issuer" conduct a broker-dealer business under state law and "finders" have received payments at the behest of corporate management so that a corporate financing transaction can go forward without interruption.

No harm, no foul is not a valid method of regulation. Capricious regulatory enforcement fosters disrespect for the law. It would be much better to institute a less restrictive broker-dealer registration scheme to accommodate useful transactions than ignore flagrant, albeit small, violations.

A more flexible registration regime might also provide some employment opportunities for cast off employees of broker-dealers, perhaps resulting in a more humane business cycle. Would that be such a bad thing?