

Commentary: Regulatory Hemlines

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Originally Published in *Traders Magazine* on May 25, 2010

<http://www.tradersmagazine.com/news/unregistered-securities-105777-1.html>

Every few years, the popular press recycles an article that wonders whether changing fashion hemlines can tell us something about the future of the national economy: do somber, longer skirts mean recession is near, and can fresh, exuberant miniskirts predict boom times ahead? From hemlines to groundhogs, folkloric methods of prognostication have pretty spotty records. However, the changing fashions themselves are fairly easy to spot, and the changing fashions in securities regulation may give us some insight into the current mood of the regulators.

One area where we see an emerging regulatory fashion trend is in the rules governing the marketing of unregistered securities and the sale of securities by unregistered broker-dealers. It's an area that has two compelling policy vectors, which, unfortunately, tend to be diametrically opposed. One of those policy imperatives is to encourage access to capital for smaller businesses that cannot afford the full trappings of underwritten public offerings and the related public company reporting regime. The other policy imperative is preventing fraud, since scammers can be relied upon to take advantage of any relaxation of regulatory oversight.

An emphasis on anti-fraud efforts frustrates the small business community, which chafes at the idea that their policy suggestions are viewed by the SEC as the functional equivalent of fraud. Thus, the spectacle of the American Bar Association's Business Law Section, Committee on Small Business, which in 2005 produced paroxysms of purple prose to champion the cause of "unlicensed brokers" operating in violation of the laws requiring registration of broker-dealers:

" . . . [A] great number of the unlicensed brokers currently operating in the gray market are ethical and honest individuals. These persons are in a situation similar to that of our parents and grandparents who were social drinkers during prohibition; they did not suddenly become 'good people' when the twenty-first amendment to the Constitution was ratified. They were, and a large majority of the unlicensed [finders] are, violating laws which are over-broad and largely ignored because of the need of the community to act in disregard of those laws."

The SEC, for its part, tries to be responsive to the needs of small businesses. Among other efforts, it holds an annual “Government-Business Forum on Small Business Capital Formation” that attempts to find ways to accommodate the dueling policy imperatives. Earlier this month, the Report of the most recent such gathering was published and, predictably, two of the top three recommendations of the business participants were relaxation of the rules for private placements (sales of unregistered securities) and relaxation of the rules for business brokers to allow them to market securities (sales of securities by unlicensed broker-dealers). Those two recommendations are a staple of the annual forum.

Notwithstanding the entreaties of the small business sector, the SEC has always worried that any relaxation of the rules to allow unlicensed “finders” to market securities or to permit licensed broker-dealers to market unregistered securities inevitably will lead to unfortunate newspaper headlines featuring widows, orphans and fraud. Thus, it has been slow to formally relax its rules in the area. It has, nevertheless, attempted to accommodate the concerns of the small business community, primarily by assuming a posture of regulatory *laissez-faire*.

For a number of years, the SEC effectively has turned a blind eye to the operations of unlicensed “business brokers” and “finders.” When asked, they have pointed out that marketing securities (including unregistered securities, such as ownership interests in a “Mom and Pop” variety store, pizza parlor, local sporting goods shop or the corner bar) requires registration as a broker-dealer. However, they haven’t gone to the trouble of initiating many enforcement actions against unlicensed brokers. Hence, the “gray market” referred to in the American Bar Association’s report.

In 2006, the SEC even went so far as to issue a “no-action letter” to Country Business, Inc., an unregistered business broker. The SEC gave assurances that it would not recommend enforcement action against Country Business under Section 15(a) of the Exchange Act of 1934 when the broker proposed to advise in connection with the sale of a small business and proposed to receive a transaction-based fee. The circumstances of the advice were constrained—the broker would advertise only assets of the business, not securities; and if the sale took the form of a stock transaction, rather than an asset sale, it would be a sale of all of the business’s equity securities to a single purchaser or to a group of purchasers formed without the assistance of Country Business. In other words, the broker was not intending to widely or publicly market securities, so any sale of securities would be incidental to a sale of the entire business as a going concern.

Similarly, the SEC and FINRA for many years took little action to curb offerings of unregistered securities by registered broker-dealers. Even in formal rulemaking, the trend was permissive and private offering exemptions were steadily expanded. On the enforcement side, policing of the market for unregistered securities tended to be

left to often overburdened state regulators, and FINRA took little or no action to establish standards for the participation by broker-dealers in a public market for privately offered securities.

Lately, however, we're seeing a significant change in regulatory hemlines.

The SEC appears to be getting more serious about regulating the activities of unlicensed finders. On May 17, 2010, the SEC's Division of Trading and Markets denied a request for a no-action letter from a small Virginia law firm, which had requested assurances that the SEC would not recommend enforcement action under Section 15(a) of the Exchange Act if it were to assist a client's financing efforts in exchange for transaction-based compensation. The law firm proposed to introduce the client to individuals who "may have an interest" in investing in the client's debt or equity securities. The SEC Staff concluded that such activities amounted to pre-screening investors and pre-selling securities, and that transaction-based compensation would encourage the law firm to engage in sales efforts. Therefore, the SEC would require broker-dealer registration pursuant to Section 15(b) of the Exchange Act. At the very least, this denial of no-action assurance signals a change in the regulatory attitude toward unlicensed finders since the Country Business no-action letter was issued in 2006.

There also is recent evidence that regulators are more serious about private placements and the participation by broker-dealers in the marketing of unregistered securities. Last year, FINRA published Regulatory Notice 09-05, "reminding" broker-dealers of their obligations to determine whether securities are eligible for public sale before participating in their distribution. FINRA required registered broker-dealers to have specific procedures to supervise or manage their role in sales of securities to prevent participation in illegal or fraudulent sales. For the first time, FINRA specifically required that broker-dealers make a due-diligence inquiry when asked to sell a substantial block of thinly-traded securities.

In April of this year, FINRA followed up. It fined five firms for participating in sales of penny stocks in circumstances where the firms should have known that the issuer of those securities had been charged with fraud by the SEC and enjoined from further stock sales by a federal court. The firms continued to execute sell orders with respect to large blocks of the stock, apparently without any due diligence effort to determine whether the issuer of the securities or the sellers were engaged in fraud. FINRA found that four of the five firms had "failed to establish, maintain and enforce a reasonable supervisory system designed to prevent the sale of unregistered stock."

FINRA also followed up on the regulatory front, issuing another regulatory notice to its members (Regulatory Notice 10-22). In this notice, FINRA sends another more-than-gentle reminder, this time “reminding” registered broker-dealers that they have obligations in connection with private placements, including the obligation to conduct reasonable investigations of the issuers and of the securities they recommend in offerings made pursuant to Regulation D under the Securities Act of 1933. FINRA notes that with more than \$600 billion of securities sold in Regulation D offerings in 2008, this important source of capital for many U.S. companies also has led to significant problems in the regulation of broker-dealers participating in private placements, including fraud and sales practices abuses.

The small business community’s arguments are important, especially as the financial crisis has made it harder for small businesses to obtain bank financing and the need for job growth remains critical. However, we also have to confront the seemingly bottomless pit of fraud that was at least partly the fault of a decade or more of regulatory laissez-faire. Regulatory fashionistas take note: the SEC and FINRA seem to have come down on the side of combating fraud.