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The Latest Developments for Emerging & Tech Companies

Navigating Broker-Dealer Regulation: Potential Pitfalls in Private Offerings

April 19, 2023

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Agenda

- "Broker-Dealer" Status and Registration Requirements
- Activities and Compensation Structures that May Trigger Broker-Dealer Registration
- Risks and Consequences of Using, or Acting as, an Unregistered Broker-Dealer
- Exemptions from Broker-Dealer Registration, including "Issuer Exemption" and "M&A Brokers"
- Special Situations
- Use of Digital Engagement Practices ("DEPs") in Connection with Offerings
- DEPs: What Concerns Regulators?

“Broker-Dealer” Status and Registration Requirements

What is a Broker-Dealer?

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- Section 3(a)(4)(A) of the Securities Exchange Act of 1934 (the "Exchange Act") generally defines a "**broker**" as any person engaged in the business of effecting transactions in securities *for the account of others*.
- Section 3(a)(5)(A) of the Exchange Act generally defines a "**dealer**" as any person engaged in the business of buying and selling securities *for his own account*, through a broker or otherwise.
- In March 2022, the U.S. Securities and Exchange Commission ("SEC") proposed new rules (SEC Rules 3a5-4 and 3a44-2) that could require "dealer" registration by certain principal trading firms, private funds, investment advisers and other market participants.

Broker-Dealer Registration Requirements

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- **Exchange Act Registration.** Section 15(a)(1) of the Exchange Act generally requires registration with the SEC for any *broker* or *dealer* using the mails or any means or instrumentality of U.S. interstate commerce (*e.g.*, telephone, email, website) to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security.
- **Self-Regulatory Organization ("SRO") Membership.** In addition to registering with the SEC under the Exchange Act, broker-dealers must become members of an SRO (generally, the Financial Industry Regulatory Authority, Inc. ("FINRA"), the primary SRO for U.S. broker-dealers).
- **State Registration.** Each U.S. state/territory imposes registration requirements for any person conducting a securities business as a broker-dealer, or on behalf of a broker-dealer, within that jurisdiction. For example, in Utah, the broker-dealer and related personnel licensing requirements are set forth in Sections 61-1-3(1) and (2) of the Utah Uniform Securities Act, respectively.
- **Associated Persons of Broker-Dealers.** Certain "associated persons" of a broker-dealer must register as "representatives" and/or "principals" with FINRA (and potentially other SROs) and as "agents" or "salespersons" under state securities laws.

Activities and Compensation Structures that may Trigger Broker-Dealer Registration

Activities Triggering Broker-Dealer Registration

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- In determining whether a person is a "broker," courts and the SEC apply a facts-and-circumstances analysis that involves looking at the activities the person actually performs as well as the compensation the person receives therefor.
- The following is a non-exhaustive list of activities that may cause a person to act as a "broker":
  - Assisting an issuer in structuring securities transactions;
  - Identifying potential investors for a securities offering;
  - Soliciting securities transactions (including advertising/marketing);
  - Screening potential participants in a transaction for creditworthiness;
  - Negotiating between the issuer and the investor(s);
  - Making valuations as to the merits of an investment or giving advice;
  - Taking "orders" or facilitating the execution of a securities transaction; and
  - Handling customer funds or securities.
- While a particular activity may not be sufficient on its own to trigger "broker" status, it must be viewed in conjunction with other criteria, including the compensation that will be received.

Compensation Structures

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- **Transaction-based compensation** refers to compensation based, directly or indirectly, on the size, value or completion of any securities transactions (*e.g.*, a commission or "success fee").
- Transaction-based compensation is viewed as a hallmark of "broker" activity and generally considered to be a determinative factor in assessing whether a person is a "broker" subject to applicable broker-dealer registration requirements.
- Importantly, the SEC looks behind the label and/or terms of a compensation arrangement to determine its economic substance. For example, a flat fee that is recalculated periodically to reflect an increase or decrease in the number of transactions could be viewed as transaction-based compensation and trigger "broker" status.
- Even if a person does <u>not</u> receive transaction-based compensation, such person may be a "broker" based on the person's activities in connection with a securities transaction.
  - For example, the SEC declined to grant no-action relief regarding broker-dealer registration to an investment adviser that proposed to locate issuers, solicit clients, and negotiate the terms of the private placement transaction and securities on behalf of clients, but would not receive transaction-based compensation. *See* PRA Securities Advisers, L.P., SEC Denial of No-Action Request (Mar. 3, 1993).

Risks and Consequences of Using, or Acting as, an Unregistered Broker-Dealer

Unregistered Brokers: Risks & Consequences

- Potential adverse consequences of acting as an unregistered “broker” include:
  - Cease-and-desist orders from the SEC and/or applicable state securities regulators;
  - Court injunctions;
  - Civil penalties, including fines and disgorgement;
  - Criminal liabilities;
  - Potential rescission rights of investors under federal and/or state law; and
  - Reputational harm.
- Section 20 of the Exchange Act imposes liabilities on “control” persons, subject to a good faith defense, as well as persons who aid and abet anyone in violation of the Exchange Act. The securities laws of some states have similar liability provisions.

Exemptions from Broker-Dealer Registration, including "Issuer Exemption" and "M&A Brokers"

“Issuer Exemption”

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- Issuers generally are not “brokers” because they sell securities for their own accounts and not for the accounts of others. Additionally, issuers generally are not “dealers” because they do not buy and sell their securities for their own accounts *as part of a regular business*.
- The so-called “Issuer Exemption” under SEC Rule 3a4-1 provides that an associated person of an issuer is exempt from “broker” registration under the Exchange Act if such person:
  - Is <u>not</u> subject to a “statutory disqualification,” as defined in Section 3(a)(39) of the Exchange Act (*i.e.*, has not committed certain “bad actor” events);
  - Is <u>not</u> paid transaction-based compensation, such as commissions or bonuses based upon success in placing securities or the amount of funds raised through securities transactions;
  - Is <u>not</u> an associated person of a broker-dealer (*e.g.*, is not a registered representative of a broker-dealer engaged in sales activities away from the supervision of such broker-dealer); and
  - Meets the conditions of one of three alternative arrangements prescribed in the rule.
- SEC Rule 3a4-1 only provides an exemption from “broker” registration under the Exchange Act. Associated persons of an issuer must also assess whether they are required to register under applicable state securities laws.

"Issuer Exemption" (continued)

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- First exemption ("Restricted Sales") – The associated person may engage in sales (i) to certain financial institutions, (ii) of securities that are exempt from registration by reason of Section 3(a)(7), 3(a)(9) or 3(a)(10) of the Securities Act of 1933 (the "Securities Act"), (iii) in connection with reorganizations, or (iv) pursuant to an employee benefit plan.
- Second exemption ("Limited Sales") – The associated person must:
  - Primarily perform (or is intended primarily to perform at the end of the offering) substantial duties for or on behalf of the issuer other than selling securities;
  - <u>Not</u> have been a broker or dealer, or an associated person of a broker-dealer, within the past twelve months; and
  - <u>Not</u> participate in the sale of securities for any issuer more than <u>once</u> every 12 months.
- Third exemption ("Passive Sales") – The associated person may only engage in passive sales activities, such as responding to unsolicited requests by prospective investors or performing clerical/ministerial work involved in effecting any transaction.

“M&A Broker” Exemption

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- On March 29, 2023, a new federal exemption from broker-dealer registration under the Exchange Act for qualifying brokers that facilitate merger and acquisition (“M&A”) transactions involving certain privately held companies (the “M&A Broker Exemption”) became effective (*see* Section 15(b)(13) of the Exchange Act).
- The M&A Broker Exemption essentially codifies the SEC Division of Trading & Markets’ 2014 “M&A Broker” no-action letter, although the new statutory exemption imposes limitations on the size of the privately held company that is the subject of an M&A transaction. The staff withdrew its 2014 no-action letter effective March 29, 2023.
- Importantly, the Exchange Act does not preempt the broker-dealer registration requirements under state securities laws, and the M&A Broker Exemption did not make any changes in this regard. Therefore, M&A brokers relying on the M&A Broker Exemption must also assess whether they can rely on an exclusion or exemption from broker-dealer registration under applicable state securities laws.

“M&A Broker” Exemption (continued)

- “**M&A broker**” for purposes of the exemption means a broker, and any person associated with a broker, engaged in the business of effecting securities transactions solely in connection with the transfer of ownership of an *eligible privately held company* (defined below) through the purchase, sale, exchange, issuance, repurchase or redemption of, or a business combination involving, securities or assets of the eligible privately held company, if the M&A broker reasonably believes that:

  1. Upon consummation of the transaction, any person acquiring securities or assets of the eligible privately held company, acting alone or in concert will both:

     (i) *Control* (defined below) the eligible privately held company or the business conducted with the assets of the eligible privately held company; and

     (ii) Directly or indirectly *be active in the management* of the eligible privately held company or the business conducted with the assets of the eligible privately held company, including without limitation, for example, by: electing executive officers; approving the annual budget; serving as an executive or other executive manager; or carrying out such other activities as the SEC may, by rule, determine to be in the public interest; and

  2. If any person is offered securities in exchange for securities or assets of the eligible privately held company, such person will, prior to becoming legally bound to consummate the transaction, receive or have reasonable access to the most recent fiscal year-end financial statements of the issuer of the securities as customarily prepared by the management of the issuer in the normal course of operations and, if the financial statements of the issuer are audited, reviewed, or compiled, any related statement by the independent accountant, a balance sheet dated not more than 120 days before the date of the offer, and information pertaining to the management, business, results of operations for the period covered by the foregoing financial statements, and material loss contingencies of the issuer.

“M&A Broker” Exemption (continued)

- “**Eligible privately held company**” means a privately held company that:
  - Has no class of securities registered (or required to be registered) under Section 12 of the Exchange Act or with respect to which the company files (or is required to file) periodic information, documents and reports under Section 15(d) of the Exchange Act; and
  - In the fiscal year ending immediately before the fiscal year in which the services of the M&A broker are initially engaged with respect to the securities transaction, the company meets either or both of the following conditions (determined in accordance with the historical financial accounting records of the company): (i) earnings before interest, taxes, depreciation and amortization (“EBITDA”) less than $25 million or (ii) gross revenues less than $250 million. The Exemption provides for an inflation adjustment of the dollar amounts of the EBITDA/gross revenue limitation five years after the date of enactment and every five years thereafter.
- “**Control**” means the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. There is a presumption of control if, upon completion of a transaction, the buyer or group of buyers has the right to vote, sell or direct the sale of 25% or more of a class of voting securities, or, in the case of a partnership or limited liability company, has contributed or has the right to receive upon dissolution 25% or more of the capital.
- **Disqualification** – An M&A broker is not eligible to rely on the M&A Broker Exemption if such broker (and if and as applicable, including any officer, director, member, manager, partner or employee of such broker): (i) has been barred from association with any broker-dealer by the SEC, any state or any SRO or (ii) is suspended from association with a broker-dealer.

“M&A Broker” Exemption (continued)

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Excluded Activities

- Directly or indirectly receiving, holding, transmitting, or having custody of the funds or securities to be exchanged by the parties in connection with a transaction for the transfer of ownership of an eligible privately held company.
- Engaging on behalf of an issuer in a public offering of any class of securities registered (or required to be registered) under Section 12 of the Exchange Act or with respect to which the issuer files (or is required to file) periodic information, documents and reports under Section 15(d) of the Exchange Act.
- Engaging on behalf of any person in a transaction involving a “shell company”, other than a “business combination related shell company.”
- Directly, or indirectly through any of its affiliates, providing financing related to the transfer of ownership of an eligible privately held company.
- Assisting any party to obtain financing from an unaffiliated third party without (i) complying with all other applicable laws in connection with such assistance, including, if applicable, Regulation T and (ii) disclosing any compensation in writing to the party.
- Representing both the buyer and the seller in the same transaction without providing “clear written disclosure” as to the parties the M&A broker represents and obtaining written consent from both parties to the joint representation.
- Facilitating a transaction with a group of buyers formed with the assistance of the M&A broker to acquire the eligible privately held company.
- Engaging in a transaction involving the transfer of ownership of an eligible privately held company to a passive buyer or group of passive buyers.
- Binding a party to a transfer of ownership of an eligible privately held company.

Special Situations

Finders

- A “finder” is a person who places potential buyers and sellers of securities in contact with one another for a fee.
- There is no “finder” exception or exemption in the Exchange Act or the rules thereunder.
- Rather, SEC guidance permits a finder to engage in certain *limited* activities in relation to a potential securities transaction without registration as a “broker.”

SEC Proposed Exemptive Order for Finders

- In October 2020, the SEC proposed a conditional exemption from broker-dealer registration under the Exchange Act for natural persons to engage in certain limited capital raising activities involving accredited investors (the “Proposed Exemption”).
- The Proposed Exemption would create two classes of finders, each subject to conditions tailored to the scope of their respective activities:
  - Tier I – Limited to sharing investor contact information of potential investors in connection with only a single capital raising transaction by a single issuer in a 12-month period, provided the finder does not have any contact with potential investors about the issuer.
  - Tier II – Permitted activities include: (i) providing investor contact information to the issuer; (ii) identifying, screening, and contacting potential investors; (iii) distributing issuer offering materials to investors; (iv) discussing issuer information included in any offering materials, provided the finder does not provide advice as to the valuation or advisability of the investment; and (v) arranging or participating in meetings with the issuer and investor.
- Tier I and Tier II finders would be prohibited from: (i) being involved in structuring the transaction or negotiating the terms of the offering; (ii) handling customer funds or securities or binding the issuer or investor; (iii) participating in the preparation of any sales materials; (iv) performing any independent analysis of the sale; (v) engaging in any “due diligence” activities; (vi) assisting or providing financing for such purchases; or (vii) providing advice as to the valuation or financial advisability of the investment.
- Tier II finders would be required to provide to a potential investor, prior to or at the time of the solicitation, disclosures that include: (i) the names of the finder and the issuer; (ii) a description of the relationship between the finder and the issuer, including any affiliation; (ii) a statement that the finder will be compensated for his or her solicitation activities by the issuer and a description of the terms of such compensation arrangement; (iv) any material conflicts of interest resulting from the finder’s arrangement or relationship with the issuer; and (v) an affirmative statement that the finder is acting as an agent of the issuer, is not acting as an associated person of a broker-dealer, and is not undertaking a role to act in the investor’s best interest.

SEC Proposed Exemptive Order for Finders

- Tier I and Tier II finders would both be permitted to accept transaction-based compensation under the terms of the Proposed Exemption.
- The Proposed Exemption would be available only where:
  - The issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;
  - The issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act (*e.g.*, a private placement under Regulation D);
  - The finder does not engage in general solicitation;
  - The potential investor is an "accredited investor" as defined in Rule 501 of Regulation D or the Finder has a reasonable belief that the potential investor is an "accredited investor";
  - The finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
  - The finder is not an associated person of a broker-dealer; and
  - The finder is not subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, at the time of his or her participation.

Private Placement Agents

- Private placement agents generally must register as "brokers" under the Exchange Act and any applicable state securities laws, unless they are able to rely on an available exemption.
- Effecting transactions in a security sold in a transaction that is *exempt under the Securities Act* does not necessarily exempt from the broker-dealer registration requirements of the Exchange Act.
- Placement agent agreements must be carefully reviewed for broker-dealer regulatory considerations.

Engaging with Private Placement Agents

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- Due diligence should be performed prior to engaging a private placement agent.
- Placement agent agreements should be reviewed by counsel for Securities Act and Exchange Act, including broker-dealer regulatory, considerations.

Use of DEPs in Connection with Offerings

What Are DEPs?

- Generally, any form of consumer or customer engagement via digital platforms (such as an app or a website) and/or digital communication channels (such as social media) using analytical and technological tools, including artificial intelligence ("AI")/machine learning ("ML").
- DEPs allow for:
  - Real time interaction;
  - Without the need for human interface.
- DEPs typically incorporate analytical or technological tools (*e.g.*, tracking/AI/ML) that use customer/consumer data generated from the apps/websites.

Examples of Market Participants Using DEPs

- Wealth Management (Robo-Advisers)
- Broker-Dealers (Digital Brokerages)
- Banks and Mortgage Lenders (Digital Banks)
- Insurance (Insurtech)

Examples of DEP Usage

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- Educational/informational purpose
- Advertising purpose
- Relationship building/branding
- Data gathering and tracking/analytics

Examples of DEPs in Financial Services

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- DEPs are increasingly used by financial market participants to engage with customers:
  - To educate (*e.g.*, "how-to" videos) or provide informational tools (*e.g.*, retirement calculator);
  - To cross-sell or highlight services or products; and/or
  - To enable customers to connect with other customers interested in similar topics.
- Technology has the potential to enable greater personalization for customers based on the data that they are willing to share with financial institutions.

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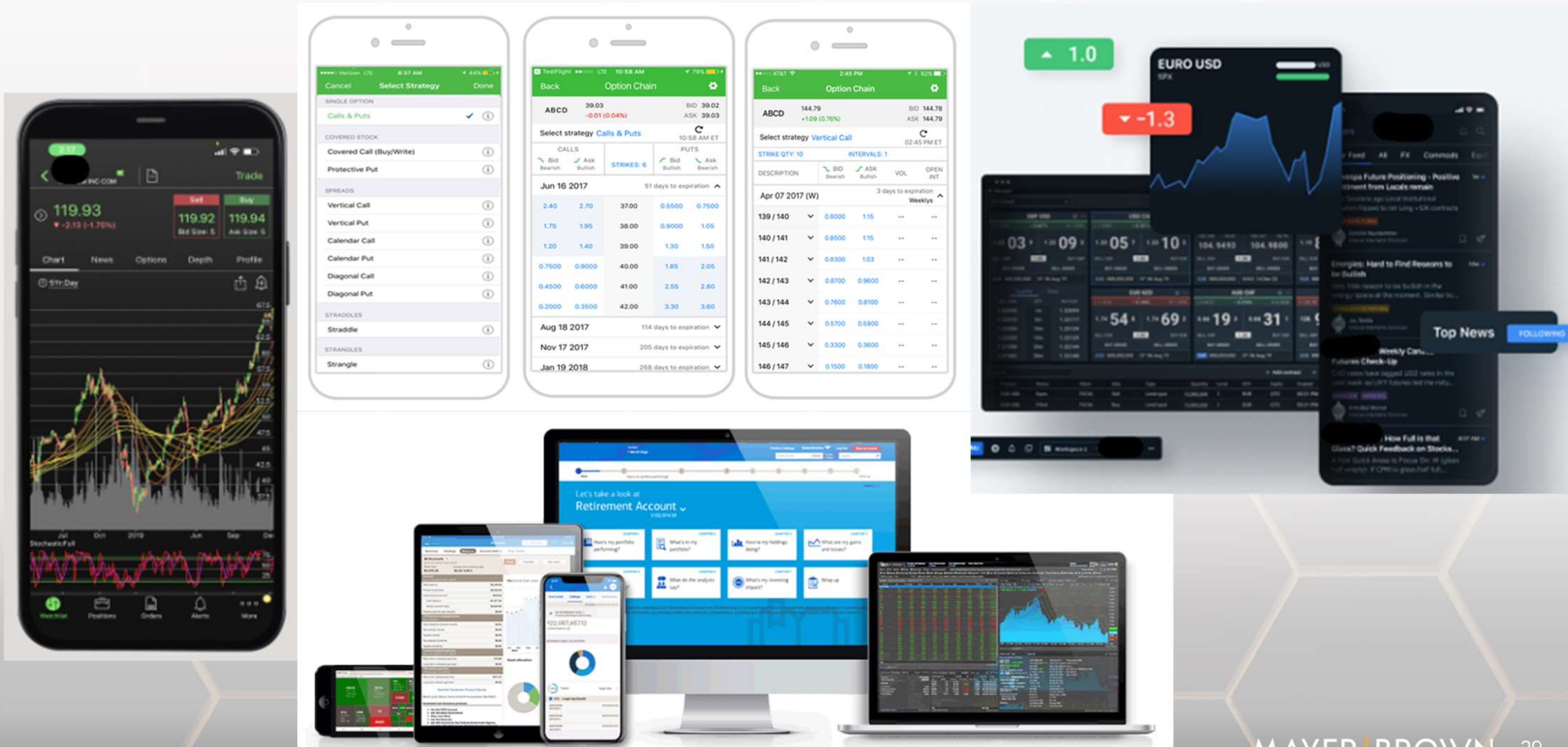
DEP Example: Digital Brokerages



DEPs:
What Concerns Regulators?

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Certain Regulatory Guidance & Publications from SEC & FINRA

- **August 2021**: SEC publishes a request for information and comments ("SEC 2021 RFI") on the use of DEPs by broker-dealers and investment advisers.
- **September 2021**: FINRA publishes targeted exam letter on social media influencers, customer acquisition, and related information protection.
- **January 2023**: FINRA publishes 2023 Report on its Examination and Risk Monitoring Program, which discusses certain DEPs used by broker-dealers.
- **February 2023**: SEC issues 2023 examination priorities, which include the use of DEPs by broker-dealers and investment advisers.
- **February 2023**: FINRA provides an update on its targeted exam on social media influencers, customer acquisition, and related information protection and summarizes selected practices FINRA has observed during the examinations.
- **April 2023**: Anticipated rule proposals regarding use of DEPs by broker-dealers and investment advisers.

SEC Focus on DEPs (SEC 2021 RFI)

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- Social networking tools;
- Games, streaks and other contests with prizes;
- Points, badges, and leaderboards;
- Notifications;
- Celebrations for trading;
- Visual cues;
- Ideas presented at order placement and other curated lists or features;
- Subscriptions and membership tiers; and
- Chatbots.

Examples of Regulatory Focus on DEPs

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Certain Areas of Regulatory Focus:

Conflicts of Interest

- Optimization functions to meet firm's specific goals
- Encouragement of frequent trading

Disclosures

- Free vs. no commissions
- "Finfluencers"
- Risk disclosures

Suitability

- Interface designs and functionality encouraging certain trading activities and strategies
- Recommendation/advice

Information/Data Management

- Bias/ethical concerns
- Disclosure on client data usage
- Data protection

2023 SEC Exam Priorities

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- On February 7, 2023, the SEC's Division of Examinations (the "Division") announced its 2023 examination priorities. The Division noted that broker-dealer and investment adviser examinations will focus on firms that employ DEPs.
- For example, the Division will assess whether:
  - Recommendations or advice was provided;
  - Representations are fair and accurate;
  - Operations and controls in place are consistent with disclosures made to investors;
  - Any advice or recommendations are in the best interest of the investor; and
  - Risks associated with such practices are considered, including the potential impact on vulnerable population.

Recent Cases

- Use of WhatsApp
- Finfluencers
- Use of Alternative Data

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Steffen Hemmerich is a partner in the New York office of Mayer Brown, Co-Head of the firm's Financial Markets Regulatory & Enforcement practice and Head of the firm's Broker-Dealer Regulatory & Compliance practice. He provides broker-dealer regulatory and transactional advice to domestic and foreign investment banks, financial institutions, insurance companies, investment advisers, hedge funds, private equity funds and EC/VC clients.

Steffen regularly counsels clients on federal and state broker-dealer regulatory matters and applicable SRO matters; US SEC financial responsibility rules, including SEC Rule 15c3-1, as well as SEC Rule 15c3-3 and custody issues arising thereunder; custody arrangements with domestic and foreign custodians, including the negotiation of custody agreements; broker-dealer registration/formation, including structural advice, and SRO membership (FINRA, exchanges and clearing agencies); successor registration; material changes in business operations/business expansions; merger/acquisition/restructuring transactions; business transfers/consolidations; joint ventures; registration and qualification of personnel (state/SRO); foreign broker-dealer/cross-border issues under SEC Rule 15a-6 and "chaperoning" arrangements thereunder; broker-dealer "status" questions; books and records requirements; regulatory reporting and disclosure obligations; vendor/outsourcing relationships; compliance and operational systems/technologies; product development; FINRA advertising issues; digital platforms, including mobile trading apps, and digital engagement practices; SEC risk assessment requirements (Form 17-H filings); and Bank Secrecy Act/Anti-Money Laundering and Office of Foreign Assets Control compliance.

Steffen also advises financial services firms and fintech companies on securities and broker-dealer regulatory matters relating to digital assets and blockchain technology, including business expansion and broker-dealer registration and custody issues.

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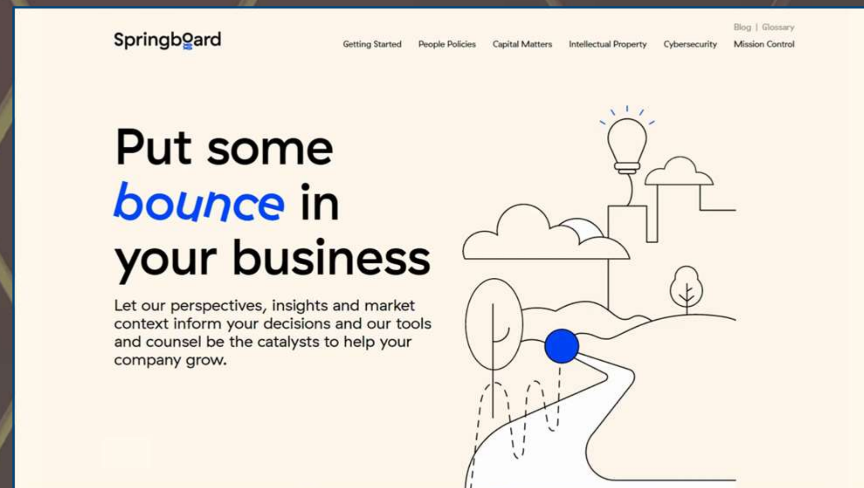
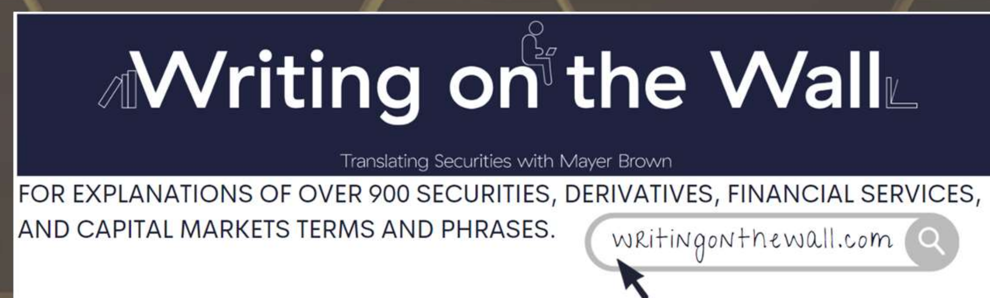
Jim Kelly is a partner in Mayer Brown's Salt Lake City office and a member of the Private Equity, Funds & Investment Management and Emerging Companies & Venture Capital practices. Jim advises a wide range of investment management firms, providing alternative investment managers and investors experienced counsel regarding innovative investment products.

Jim assists clients with the structure and organization of investment funds and accounts and with regulatory compliance, operational, and investment matters. He also provides counsel on the formation and operation of sponsor and management entities and arrangements among firm principals.

Additional Resources





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