

# BUSINESS ALERT

CURRENT LEGAL ISSUES FOR THE BUSINESS COMMUNITY

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## **PRIVATE OFFERINGS USING NON-REGISTERED BROKER/DEALERS**

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Effective January 1, 2005, California Corporations Code Section 25501.5, provides that a person who purchases a security from or sells a security to an unlicensed broker/dealer may bring an action for rescission of the sale or purchase or, if the security is no longer owned by one of the parties, for damages. The statute further provides that the court in its discretion may award reasonable attorneys' fees and costs to a prevailing plaintiff under the Section. The new law also provides for additional treble damages, up to a maximum of \$10,000. The addition of Section 25501.5 also raises the question of whether the investor who purchases a privately offered security from an issuer that pays a commission to an unregistered broker/dealer may seek rescission of his investment against the issuer under California law.

Issue arises as to whether the use of unregistered broker/dealers vitiates the issuer's exemption from the registration requirements under the Securities Act of 1933, as amended (the "'33 Act") and the analogous state law qualification requirements for the issuer's sale of securities. If so, using an unlicensed broker/dealer will give rise to a statutory right of rescission for such registration/qualification violations.

Most private offerings today are made pursuant to Rule 506 of Regulation D. Regulation D under the '33 Act provides a private offering exemption from registration under the '33 Act, provided the issuer does not use means of general solicitation or advertising to find investors. In interpreting this requirement, the SEC's staff has stated that the existence of a pre-existing and substantive relationship is important in establishing an absence of general solicitation or advertising because it ensures that, prior to any offer by the issuer or persons acting on its behalf, the offeror can determine that the proposed investor has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the proposed investment.

The SEC, in a series of no-action letters, has stated that the issuer, or persons acting on its behalf, must have established a substantive relationship with a potential investor before a private offering is commenced in order to avoid general solicitation. Thus, a selling agent must have, prior to commencement of any private offering, a coterie of qualified investors (either accredited investors or investors meeting the sophistication test of Rule 506(b)(ii)). But, with the exception of several matching services and networks, mostly non-profit entities, all of these no-action letters involved *registered broker/dealers*.

Thus, if the issuer is relying on pre-existing relationships with potential investors established by the unregistered broker/dealer, the offering may not satisfy the requirements of Regulation D, giving rise to a federal statutory right of rescission. Moreover, a private offering that does not satisfy the requirements of Rule 506 will be subject to state regulation, which similarly precludes general solicitation and may provide for longer statutes of limitation on rescission actions. In addition, many states' limited offering exemption expressly precludes the payment of commissions to persons who are not registered in the state as a broker/dealer.

If the issuer is deemed to have engaged in a general solicitation and violates the '33 Act registration provision, it can be subject to liability for failure to disclose the contingent liability resulting from the violation. Even if the issuer has not engaged in a general solicitation, the failure of an issuer to disclose that it is using an unregistered person might be considered a material fact that was required to be disclosed. Section 25501.5 does not appear to provide a rescission right against the issuer, the statute's ambiguity may discourage finders from helping small companies raise capital and discourage issuers from using finders because of having to disclose that retaining a non-registered person as a finder may violate California law.

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*Actual resolution of legal issues depends upon many factors, including variations of fact and state laws. This article is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this article.*