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Legal Consequences for Using or Acting as an Unregistered Broker-Dealer in the Cannabis Industry 60

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Unregistered broker-dealers are on the rise in business mergers and acquisitions in the cannabis industry. This article defines “broker-dealer,” provides insight into when a third party might be acting as such, and addresses the potential legal consequences for both the cannabis businesses who engage unregistered broker-dealers and the unregistered broker-dealers themselves.



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Legal Consequences for Using or Acting as an Unregistered Broker-Dealer in the Cannabis Industry

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I. INTRODUCTION

As the cannabis industry continues to grow, the players have begun to change a bit and cannabis business owners face the daunting task of navigating the private and public markets along with many hefty regulations. Whether it is finding private investors to raise capital via a private placement or looking for merger and acquisition (“M&A”) activity, cannabis operators and their legal counsel should be aware of individuals or firms that claim they have connections to private investors or an ability to make introductions to interested buyers or potential acquisitions. Those parties are likely acting as broker-dealers and, if unregistered, can pose significant legal headaches for a business and its legal counsel down the road.

This article will proceed as follows. Section II will define the term “broker-dealer” as well as provide insight into when a third party might be acting in the capacity of a broker-dealer. Section III will discuss the legal consequences of a cannabis business that engages with an unregistered broker-dealer to help raise money in the private markets from the viewpoint of the business, the unregistered broker-dealer, and the investors. Section IV will discuss the legal consequences of a cannabis business engaging an unregistered broker-dealer in M&A activity from the viewpoint of the buyer, the unregistered

broker-dealer, and the seller. Lastly, Section V will discuss instances of enforcement against unregistered broker-dealers in the cannabis industry.

II. WHAT IS A BROKER-DEALER?

A broker is “engaged in the business of effecting transactions in securities for the accounts of others.”¹ Factors the SEC considers when determining whether an individual or firm is acting as a broker include: finding investors for issuers (which includes acting in a “consultant” capacity), engaging or finding investors for venture capital, angel financing, or private placements, acting as “placement agents” for private placement of securities, or finding buyers and sellers of businesses.²

While the terms “broker” and “dealer” are typically used in conjunction, technically a dealer is “engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”³ The factors the SEC considers include the following:

- a person who issues or originates securities that he or she also buys and sells;
- a person who holds himself or herself out as being willing to buy and sell a particular security on a continuous basis; or
- a person who runs a matched book of repurchase agreements.⁴

For the purposes of this article, the definition of broker is the more relevant consideration because it relates to finders, which are the focus of this article.

Even with these definitions, crossing the threshold into acting as a broker-dealer can at times be unclear. In addition, the SEC will look at the activities that the actual party performs.⁵ Thus, the following questions about the third party are pertinent:

- Does the party participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does the party's compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal?
- Is the party engaged in the business of effecting or facilitating securities transactions?
- Does the party handle the securities or funds of others in connection with securities transactions?⁶

A “yes” to any of these questions means that the party must be registered as a broker-dealer.

While there are some exemptions from broker-dealer registration requirements⁷ in addition to SEC No-Action Letters in which the SEC states that it will forgo enforcement in certain factual scenarios,⁸ most individuals and firms participating in the above activities must register with a self-regulatory organization (most commonly the Financial Industry Regulatory Authority (“FINRA”)) and the SEC. Additionally, some states require registration to conduct business within the respective state. California requires registration in most instances.⁹ Registration allows organizations like FINRA to help reduce fraud by establishing practices that registered broker-dealers must adhere to, and it encourages more transparency by allowing businesses to vet a registered broker-dealer for past violations before forming a business relationship.

Given these regulations, there are a few business participants in particular that a cannabis operator should reasonably be wary of. Firstly, real estate agents are not considered to be registered broker-dealers by the SEC. As the SEC notes, “[t]here is no general exception from the broker-registration requirements for licensed real estate brokers or agents who engage in the business of effecting transactions in . . . securities.”¹⁰ Similarly, a licensed attorney probably would still be deemed to be an unregistered broker-dealer unless he or she is registered as such with FINRA. Moreover, even a party simply acting in a “consultant” capacity may be acting as a broker-dealer who should be registered with FINRA.¹¹

III. CONSEQUENCES OF USING AN UNREGISTERED BROKER-DEALER TO RAISE CAPITAL

Since cannabis remains illegal under federal law, cannabis businesses often face great difficulty raising capital as many of the large banks are reluctant to provide business loans to

cannabis startups. Consequently, many cannabis businesses turn to Regulation D private offerings to raise money. However, such fundraising with the assistance of an unregistered broker-dealer can have adverse ramifications for both the issuer (i.e. the cannabis business) and the unregistered broker-dealer.

A. Consequences for the Issuer

By engaging with an unregistered broker-dealer, whether it be helping to find investors in the private placement or otherwise helping to facilitate the transaction, the issuer runs the risk of providing investors the right to rescind the purchase of the issuer's securities. Section 29(b) of the Exchange Act provides that any contract made in violation of any provision of the Exchange Act can be voided by the innocent party.¹² Because a Form D filing made with the SEC in connection with the private placement requires the issuer to disclose any payment to a broker-dealer in connection with the offering, failure to disclose such payment to a broker-dealer or disclosing payment to an unregistered broker-dealer could provide investors with a rescission right.

Thus, under federal law, an investor could have the right to return the purchased securities in exchange for invested funds. In such situations, the investor's right of rescission is available until the later of three years from the date the securities were issued or one year from the date of discovery of the violation,¹³ effectively serving as an option to sell for an investor. Moreover, some state securities laws—which the issuer is subject to in each state where an investor is domiciled—have investor rescission rights that go beyond federal law. For example, California allows an investor domiciled in the state the right to rescind the purchase of a security from a broker-dealer that is required to be licensed and is not licensed, in exchange for the invested funds plus legal interest.¹⁴ Moreover, investors in California can also be entitled to recover damages in relation to a security purchased from a broker-dealer that is required to be licensed and is not licensed, even if the investor has already disposed of the security.¹⁵

Issuers also face risks for a failure to disclose. Rule 10b-5 of the Exchange Act prohibits making materially misleading statements in connection with the sale or purchase of any security.¹⁶ Thus, failure to disclose payments made to an unregistered broker-dealer on federal filings like the Form D could lead to potential fraud liability.¹⁷ Since many state securities laws have similar requirements, further liability on the state level is also possible.

Further, issuers who follow the advice of unregistered broker-dealers may be more susceptible to poor business or legal advice during the course of a private offering. This could

potentially lead to other violations such as the failure to verify accredited investor status among investors in the offering, or unauthorized solicitation of potential investors. Issuers may also face future roadblocks to raising capital. An issuer could lose potential exemptions from securities registration requirements under federal and state securities laws. Additionally, potential future investors are likely to be much more wary of investing in subsequent offerings. If an issuer has issued securities in violation of the Exchange Act due to poor legal advice from an unregistered broker-dealer, future legal counsel would be unable to deliver legal opinions in connection with future fundraising efforts stating that the company has not violated any securities laws, which could thereby hinder future efforts to raise capital.

B. Consequences for the Unregistered Broker-Dealer

Under Section 29(b) of the Exchange Act, an issuer could claim that its obligations to a finder under the finder's engagement agreement are void if the finder is acting within the scope of a broker-dealer and is not registered.¹⁸

Moreover, an unregistered broker-dealer also becomes liable to penalties to the SEC or any relevant state regulators.¹⁹ After determining that a violation exists, the SEC has broad authority to remedy the situation. Penalties for an unregistered broker-dealer include a cease-and-desist order, civil penalties, requiring accounting, and disgorgement of ill-gotten gains.²⁰ The SEC can also seek a court action for a permanent or temporary injunction enjoining the unregistered broker-dealer from participating in securities or provide evidence of securities laws violations to the attorney general who can choose to pursue a criminal action under the Exchange Act.²¹ An unregistered broker-dealer may also be subject to penalties under applicable state securities laws.

C. Consequences for Investors

There are not any adverse consequences with respect to the investors. As noted above, investors may be able to rescind the investment contracts in certain instances.

IV. CONSEQUENCES OF USING AN UNREGISTERED BROKER-DEALER IN PRIVATE M&A

A. 2014 SEC No-Action Letter

In 2014, the SEC published a No-Action Letter that stated that an "M&A Broker" will not have to register with FINRA if certain representations are met. Such representations include: The M&A Broker will not have the ability to bind a party to

the transaction, the M&A Broker will not provide financing for the transaction, the transaction will not involve a public offering, the M&A Broker will provide clear written disclosure if it represents both parties in a transaction, the buyer will control all operations at the conclusion of the transaction, the transaction will not result in the transfer of interests to a passive buyer, and the M&A Broker is not barred or suspended by the SEC, FINRA, or any other self-regulating organization.²² Regardless of this SEC No-Action Letter, a cannabis business should still be highly cognizant of the third parties it engages with during the course of a potential M&A deal.

B. Consequences for the Seller

Assuming the buyer is the innocent party,²³ Section 29(b) of the Exchange Act²⁴ potentially provides the buyer a private right to rescind the contract.²⁵ Further, because most purchase agreements contain representations regarding the use and compensation paid to broker-dealers in the transaction, the seller could be liable for a claim of an omission of material fact if the seller does not disclose the use of an unregistered broker-dealer.²⁶

C. Consequences for the Unregistered Broker-Dealer

As with private offerings discussed in Section III(B), the SEC has a similar scope of authority to punish unregistered broker-dealers with respect to M&A transactions.²⁷ Moreover, state securities and contract laws may also apply.

D. Consequences for the Buyer

Assuming the buyer is the innocent party, it does not face any adverse consequences.²⁸ As noted above, the buyer may be able to rescind the contract in certain instances.

V. INSTANCES OF ENFORCEMENT AGAINST UNREGISTERED BROKER-DEALERS IN THE CANNABIS SPACE

Though the cannabis industry is in its infancy compared to other business sectors, there have already been a number of instances of regulators at both the state and federal level penalizing cannabis businesses that engage with unregistered broker-dealers or the unregistered broker-dealers themselves. In early 2017, the then-Colorado Securities Commissioner issued a cease and desist order to a marijuana business for having a representative who was not registered with the Colorado Division of Securities solicit prospective investors, among other violations.²⁹ In June of 2018, FINRA suspended and fined a previously registered broker-dealer \$5,000 for performing side work for a cannabis consultant firm and a

medical marijuana firm in exchange for compensation and an expectation of future compensation, without notifying his FINRA member firm.³⁰ In August of 2018, FINRA suspended and fined a previously listed registered broker-dealer \$15,000 for publishing content on a website that violated FINRA standards for broker-dealer communications with the public while he was serving as the placement agent for a company raising money to invest in cannabis-related businesses.³¹ As the wave of legalization continues across the country coupled with the natural scrutiny that comes with a relatively new industry, regulators are likely to continue to pour resources into monitoring all aspects of the cannabis space.

VI. CONCLUSION

Unregistered broker-dealers have increasingly flocked to the cannabis industry, such that the SEC even published an investor alert regarding increased investment fraud in the cannabis space.³² Cannabis businesses and their legal counsel should remain vigilant whenever engaging with a third party when raising funds or seeking out potential M&A activity, always making sure that such third parties are registered with FINRA if they are going to be acting as broker-dealers. As this article discussed, the potential ramifications of failing to do so can pose significant legal headaches for the business.

Endnotes

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1 Securities Exch. Act of 1934 § 3(a)(4).

2 Guide to Broker-Dealer Registration, U.S. Securities and Exch. Comm'n (Dec. 12, 2016), <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html>.

3 Securities Exch. Act of 1934 § 3(a)(5).

4 Guide to Broker-Dealer Registration, *supra* note 2.

5 *Id.*

6 *Id.*

7 An issuer and its associated persons are exempt from registration if certain conditions of the sale are met.

8 *See, e.g. SEC Provides No-Action Relief for M&A Brokers*, Morgan Lewis (Feb. 5, 2014), https://www.morganlewis.com/pubs/im_lf_secprovidesnoactionreliefformabrokers05feb14.

9 Cal. Dep't of Fin. Protection and Innovation, About Broker-Dealers and Broker Dealer Agents, <https://dfpi.ca.gov/about-broker-dealers-and-broker-dealer-agents/>.

10 *Id.*

11 *Id.*

12 Securities Exch. Act of 1934 § 29(b).

13 *Id.*

14 Cal. Corp. Code § 25501.5(a)(1).

15 *Id.*

16 Securities Exch. Act of 1934 R. 10b-5.

17 *See, e.g. SEC Litigation Release No. 20501.*

18 *See, e.g. Torsiello Capital Partners v. Sunshine State Holding Corp.*, 2008 N.Y. Slip Op. 30979 (Apr. 7, 2008) (holding that the finder's agreement was rescindable because the finder was unregistered and providing services that would require registration).

19 Robert L.D. Colby, et al., *What Is a Broker-Dealer?* 129, https://www.davispolk.com/files/whats_a_broker_dealer_2.pdf

20 *Id.*

21 *Id.* at 130.

22 SEC No-Action Letter (Jan. 31, 2014).

23 Meaning, the seller is in privity with the unregistered broker-dealer and the buyer is not.

24 Securities Exch. Act of 1934 § 29(b). This provides that any contract made in violation of any provision of the Exchange Act may be voided by the innocent party.

25 Colby, *supra* note 19, at 132.

26 M&A Sec. Grp., *Why Should a Company Use a Broker-Dealer That Is Registered?*, https://www.securities-group.com/wp-content/uploads/2018/07/MAS__WhyShouldaCompanyusearegisteredBD.pdf.

27 *See supra* note 19-20 and accompanying text.

28 *See supra* note 24.

29 Colo. Dep't of Regulatory Agencies, *Nederland Marijuana Business Ordered to Cease all Investment Solicitations*, <https://www.colorado.gov/pacific/dora/news/nederland-marijuana-business-ordered-cease-all-investment-solicitations>.

30 Rita Raagas De Ramos, *Broker-Dealer Cannabis Activity Comes Under Scrutiny*, Fin. Advisor IQ (May 20, 2019), https://financialadvisoriq.com/c/2293493/278443/broker_dealer_cannabis_activity_comes_under_scrutiny.

31 *Id.*

32 *See SEC, Investor Alert: Marijuana Investments and Fraud* (Sept. 5, 2018), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_marijuana.