// By Jon Uretsky, Esq.

VAST CHANGES COMING TO THE FUNDAMENTAL STRUCTURE OF MICROCAP FINANCING

HAS THE SEC THOUGHT THIS THROUGH?

A paradigm shift is coming to microcap financing. Currently, regardless of the specific method used to acquire shares in a public company direct from the issuer, most microcap financing involves some version of funds sent to the public company in exchange for shares issued directly from the public company in question. After a six-month waiting period, the shares can become unrestricted, and are then sold at a discount to the market. When things work out, both the lender and public company are happy with the deal. When the deal doesn't work out, one of the parties to the deal sues the other. But for decades, even when they were suing each other, neither the lenders nor the issuers – or critically, *the regulators - ever believed that the structure was illegal. The SEC just changed its mind.*

It is difficult to overstate how much change this may cause to microcap financing. First, some background. Traditionally, when a microcap public company wants funds to finance something, it doesn't bother going to Goldman Sachs – because there's no point. Most of the financing available for microcap companies come from the same funds and firms that attend conferences like Planet Microcap – and very few are registered dealers. That's because, for at least the past several decades, the entire industry had an understanding that these funds and firms weren't required to be registered dealers. Which makes sense - there's a significant difference between E-Trade executing trades for clients on the NYSE and a microcap fund selling its own shares onto the OTC after a Rule 144 waiting period.

THE LAW

The actual language of the law doesn't make that distinction. The Exchange Act defines a "dealer" as "any person engaged in the business of buying and selling securities… for such person's own account through a broker or otherwise." So, you know, everyone.

Traditionally, though, the SEC didn't prosecute everyone, and the reason was something known as the "trader exception." Whether that exception applies turns on two questions: (1) whether a person is "buying and selling securities for its own account," and (2) whether a person is engaged in that activity "as part of a regular business." Microcap finance was built on this trader exception. Now the SEC thinks it doesn't apply…and never did.

The underlying question behind the SEC's pursuit is this: Should a person who regularly lends/buys/converts and then sells securities with their own capital be considered someone who is "engaged in the business of buying and selling securities"? For the past several decades, the answer was "no." Recently, the SEC changed its mind. Notably, the various courts to weigh in on the SEC's new crusade disagree with each other, as discussed below.

JMJ FINANCIAL

On January 21, 2022, the Court granted the SEC's motion for summary judgment against Justin Keener and his firm, JMJ. The SEC persuaded the Court that

Keener/JMJ failed to register as a securities dealer with the SEC when he bought convertible notes from penny stock issuers, converted those notes into new shares and sold them for a profit on a voluminous and consistent basis. According to the SEC and the Court, Keener avoided certain regulatory obligations for dealers that govern their conduct in the marketplace.

The Court considered, but left unanswered, the real question: how much is too much? When a retired person sits at home, making three trades a day, are they a dealer? What about 10? 100? Refusing to answer the question, the Court characterized this threshold as being "more than a few isolated transactions." This definition is arguably so broad that it likely captures fund managers, family officers, day traders, and other similar investors.

JDF CAPITAL

The SEC filed an identical complaint against John D. Fierro and his business, JDF Capital. The court here also denied Fierro's motion to dismiss in December 2020, stating that the factors set forth in various SEC no-action letters and other guidance are neither exclusive nor controlling.

BEYOND COMMERCE[1]

The District of Nevada Court came to a different conclusion. This Court ruled in November, 2021 that Discover Growth Fund, who the Court acknowledged "has invested in convertible securities of many small public companies, which it has converted into billions of shares of common stock that it resold into the public markets," should be deemed a trader and was thus not required to register as a dealer. The Court delineated the plain language "part of a regular business" to mean "a dealer must be engaged in the securities business and be buying and selling for his own account." Ultimately, the Court did not find that Discover engaged in these activities.

IRONRIDGE GLOBAL IV

Similarly, in November 2021, the Delaware Bankruptcy Court analyzed the difference between the term "dealer" and "trader" and held that Ironridge was not a dealer. According to the Court, Ironridge's practice of acquiring stock at a discounted price was distinct from acquiring stock in the open market.

CONCLUSION

The takeaway here is that even the courts don't know what to make of the SEC abruptly changing the way it interprets the "trader exception" after several decades. The SEC plainly hasn't thought this through. The fundamental architecture of most of microcap financing structures was built on the premise that the trader exception applied. According to the SEC, now it doesn't, and retroactively never did. PULLP represents both issuers and investor/lender funds – funds often sue issuer public companies and vice versa – and as such can say that if this new interpretation prevails, the whole of microcap financing will see a paradigm shift that may be harmful to both issuers and funds. Companies need some way of financing operations, and lender/investor funds won't make any money without companies to fund. What does that mean going forward? The best approach is for issuers and funds to work together, using the Beyond Commerce approach as an example. Retaining experienced microcap litigators like PULLP will be crucial to proving to courts that each new case is distinguishable from JMJ, and is more like Beyond Commerce. We invite you to contact uretsky@pullp.com or 212.571.1164 for a complimentary analysis.

PULLP is one of the only law firms specializing in microcap litigation. Jon Uretsky is the founding and managing partner of PULLP. Mr. Uretsky has a broad multidisciplinary practice that includes extensive experience in litigation and dispute resolution, regulatory investigations (including FINRA and SEC matters like those described above). In addition, he counsels corporate boards, board committees (including special committees) as well as being a personal adviser to many entrepreneurs, business leaders and corporate executives. He has counseled clients on significant litigation, regulatory and transactional matters across multiple industry sectors. Additionally, the PULLP team has extensive experience negotiated mergers and acquisitions (including reverse mergers); domestic and cross-border investments/joint ventures; the representation of private equity; venture capital and other private investment funds; securities offerings; and private and public financings.
Notes:

1. Special thanks to Anna Adelstein, Counsel at PULLP, and Kayshana Mohanaraj, a Law Clerk at PULLP, for their assistance in researching and the preparation of this article, as well as their help in the many matters PULLP handles.
2. This article is not an attempt to provide investment advice. The content is purely the author's personal opinions and should not be considered advice of any kind. Investors are advised to conduct their own research or seek the advice of a registered investment professional.

For more information about PULLP, please visit: www.pullp.com

1 The author of this article serves as outside counsel to Beyond Commerce and was involved in the referenced case.