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## **"Anything Goes": Regulating the Conduct of Money-Bundling Broadway Co-Producers**

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## **“Anything Goes”: Regulating the Conduct of Money-Bundling Broadway Co-Producers**

*David Manella\**

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## INTRODUCTION

We got a nice respectable business now, money coming in regular and—since we’re careful to pick and choose—only strangers and such like wot won’t be missed—who’s going to catch on?

— *Sweeney Todd, the Demon Barber of Fleet Street*

In 2011, *The New York Times* published an interview with West End and Broadway producer Sonia Friedman (*The Book of Mormon, Harry Potter and the Cursed Child, Dreamgirls*) commenting on the “staggeringly” high cost of producing Broadway shows.<sup>1</sup> Whereas in the mid-1980s, it cost approximately five million dollars to produce a Broadway musical and seven hundred thousand dollars to produce a Broadway play,<sup>2</sup> by 2011, those average costs were reported to be approximately ten million dollars and two-and-one-half million dollars respectively.<sup>3</sup>

To incentivize investors to bankroll Broadway shows, productions now give above-the-title producer credit (as defined in Section I) to individuals solely for raising or contributing a portion of the show’s capitalization. *The New York Times* describes this practice:

When Elizabeth Taylor announced “42nd Street” as the best musical Tony winner in 1981, only one producer walked to the stage: David Merrick, a giant in the business. He had investors, sure—but back then they were content to be anonymous, fancying themselves as angels who performed little financial miracles (i.e., writing checks) to get shows on. But even in 1981, multiple producers were starting to appear above the title, to Ms. Taylor’s chagrin as she kept flubbing their names. Bottom line: Musicals cost much less in Merrick’s era—\$1 million or \$2 million, compared with \$10 million to \$15 million now—so a few big checks or a small pool of steady investors did the trick. . . . [T]oday, anonymity won’t do. In exchange for their money, investors want a say (they’re invited to marketing meetings), love the limelight (free opening-night tickets) and otherwise expect to be treated like producers.<sup>4</sup>

Take, for example, the 2014 Tony Award-winning Best Musical, *A Gentleman’s Guide to Love and Murder*. The show was an “unlikely hit”—it was written in the style of British operetta, and it boasted neither big-name Hollywood stars nor a recognizable underlying brand.<sup>5</sup> During previews (public performances before a show’s official opening), lead producer Joey Parnes was still short one-third of the seven-and-one-half million-dollar capitalization, which he had to raise by opening

1. Patrick Healy, *The Staggering Cost of Broadway*, N.Y. TIMES (July 21, 2011, 11:15 AM), <https://perma.cc/XK7F-SUXJ>.

2. MARTIN BANHAM, *THE CAMBRIDGE GUIDE TO THEATRE* 1150 (1995).

3. Ken Davenport, *What’s the Average Cost of Putting on a Broadway Show?*, THE PRODUCER’S PERSPECTIVE (June 7, 2012), <https://perma.cc/QTM4-UKW5>.

4. Patrick Healy, *I Want to Be a Producer (Me Too!)*, N.Y. TIMES, Aug. 17, 2014, at AR1.

5. Michael Paulson, *‘Gentleman’s Guide’ Kills It in Final Week on Broadway*, N.Y. TIMES (Jan. 19, 2016, 4:30 PM), <https://perma.cc/9CTJ-ZV8T>.

night.<sup>6</sup> To close his fundraising gap, Mr. Parnes offered above-the-title producer credit to individuals for investing or bundling small units of the remaining capitalization. Louise H. Beard, a sixty-four-year-old former tap dance teacher, received above-the-title producer credit for investing thirty-five thousand dollars in the show, as did Larry Hirschhorn,<sup>7</sup> a former actor, for forming a syndicate of investors who put in a total of two hundred thousand dollars.<sup>8</sup> Ultimately, *Gentleman's Guide* gave billing to forty-four above-the-title producers.<sup>9</sup>

This practice is often celebrated for helping deserving shows that would otherwise never be produced make it to the Broadway stage.<sup>10</sup> Still, the practice is not without its critics. Some industry leaders worry that this proliferation of billed producers will diminish the work that lead producers do. More importantly, others fear that co-producers, if left unregulated, will fail to abide by the laws that govern fundraising activity.<sup>11</sup>

This Note will analyze industry concerns relating to the practice of granting above-the-title producer credit to individuals solely for contributing or bundling a share of a production's capitalization, specifically by asking whether money-bundling Broadway co-producers are acting as unregistered broker-dealers in violation of applicable Security Exchange Commission ("SEC") registration requirements. In Section I of this Note, I provide a history of Broadway producing models, so as to understand how today's dominant model developed. In Section II, I unpack that model by describing the structure of theatrical investment vehicles and identifying the different types of Broadway producers. In Sections III and IV, I outline the applicable provisions of the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), and in Section V, I apply the SEC's four-factor "broker-dealer" test to the conduct of money-bundling Broadway co-producers, thereby isolating industry practices that might trigger registration requirements. Finally, in Sections VI through VII, I identify the potential consequences of using unregistered brokers and develop a list of recommendations that production companies can follow to avoid violating SEC registration requirements.

## I. A HISTORY OF BROADWAY PRODUCING MODELS

The history of "Broadway" as we know it—a district with over forty professional theaters running from 42nd to 53rd Street in midtown Manhattan—owes much to the Shubert family, and I begin my narrative history with them. Sam, Lee, and Jacob Shubert, three brothers from Syracuse, New York, launched their theatre empire in the late nineteenth century, when they acquired four theaters

6. Healy, *supra* note 4.

7. Larry Hirschhorn received billing as his syndicate, Cricket-CTM Media/Mano-Horn Productions.

8. Healy, *supra* note 4.

9. *Id.*

10. *Id.*

11. Interview with David Stone, Broadway Producer, in N.Y., N.Y. (Aug. 10, 2016).

in upstate New York.<sup>12</sup> In 1905, the Shuberts signed a three-year lease on the Herald Square Theatre in Manhattan's Garment District, thereby expanding into New York City.<sup>13</sup> Over the next twenty years, the Shuberts purchased or constructed over eighty additional theaters throughout the United States, including Broadway's Ambassador, Booth, Broadway, Schoenfeld, Longacre, Shubert, and Winter Garden Theatres.<sup>14</sup>

Under the auspices of the Shubert Theatrical Company, a publicly traded corporation, the Shuberts actively produced shows—usually operettas and revues—to fill their many theatres.<sup>15</sup> Often, the Shuberts created a production for a New York theatre that they then would duplicate across the United States and Canada. This practice continued until the Stock Market Crash of 1929, the effects of which eventually forced the company to place its assets in receivership under the Irving Trust Company, which held the theaters for two years in close consultation with Lee Shubert.<sup>16</sup> In 1933, Lee purchased the theaters back from the bank for four hundred thousand dollars.<sup>17</sup> At this point, however, the Shuberts withdrew from producing and focused their efforts on theater proprietorship.<sup>18</sup> The Shubert Organization still invests in many shows—this season alone, it is listed as a co-producer of *The Band's Visit*, *Meteor Shower*, *Escape to Margaritaville*, and *Angels in America*—but, except on rare occasions, the organization no longer “suppl[ies] their own product” like it did in the 1920s.<sup>19</sup>

The Shubert's retreat from lead producing opened the door for independent producers to enter the Broadway landscape. Emblematic of the independent producer model, David Merrick is often considered “the most prolific [producer] in Broadway history.”<sup>20</sup> A trained lawyer, Merrick made his lead producing debut with the musical *Fanny*, which ran for 888 performances between 1954 and 1956 in two different Shubert theaters.<sup>21</sup> Throughout his career, Merrick produced over eighty musicals and plays—including the original productions of *42<sup>nd</sup> Street*, *Gypsy* and *Hello Dolly!*—and won eleven Tony awards.<sup>22</sup> Most impressive was Merrick's skill for “weighing the use of his own money versus that of investors.”<sup>23</sup> When Merrick was “certain of a show's success, as was the case with *42<sup>nd</sup> Street*,” he

12. Anthony Vickery, *Did the Shuberts Save Broadway? The Corporate Producers*, in THE PALGRAVE HANDBOOK OF MUSICAL THEATRE PRODUCERS 69, 71 (Laura MacDonald & William A. Everett eds., 2017).

13. *Id.*

14. NATHAN HURWITZ, A HISTORY OF THE AMERICAN MUSICAL THEATRE: NO BUSINESS LIKE IT 60 (2014); *Theatres*, THE SHUBERT ORGANIZATION, <https://perma.cc/9S3J-SX3R>.

15. Vickery, *supra* note 12, at 74.

16. *Id.*, at 78; MICHAEL RIEDEL, RAZZLE DAZZLE 33 (2015).

17. Vickery, *supra* note 12, at 78.

18. RIEDEL, *supra* note 16, at 34.

19. *Id.*

20. Ryan McKinney, ‘He Cold Get It for You Wholesale’: *The Producing Genius of David Merrick*, in THE PALGRAVE HANDBOOK OF MUSICAL THEATRE PRODUCERS, *supra* note 12, at 217, 219.

21. *Id.*

22. Michael Phillips, *David Merrick, Legendary Broadway Producer, Dies*, L.A. TIMES, April 27, 2000, <https://perma.cc/Z3U8-Q553>.

23. McKinney, *supra* note 20, at 222.

invested only his own money.<sup>24</sup> With riskier projects, however, Merrick relied primarily on outside investments.

To minimize accounting expenses and organizational difficulties, Merrick and his contemporaries often sought investments from only a small number of wealthy individuals.<sup>25</sup> Sometimes, producers would accept investments from “investor groups”—similar to the investment syndicate described in the Introduction—that would act through a “nominee” who served as the limited partner of record and distributed financial statements and payments received from the producer to the other investors.<sup>26</sup> And in the early 1960s, some producers turned to investment companies that employed registered brokers to pool investment funds into diversified portfolios of theatrical productions.<sup>27</sup> Whatever the model used, however, producers rarely billed investors or invited them to participate in the management of the production entity.<sup>28</sup>

Eventually, the independent producer model became unsustainable. Most significantly, the fortification of theatrical labor unions in the 1970s quadrupled the labor costs involved in producing a Broadway show:

Actors, musicians, stagehands, directors, choreographers, designers, ushers—all theater employees covered by unions saw spiraling increased wages and benefits. In 1956, the weekly expenses of *My Fair Lady* were \$46,000 a week; in 2012, weekly expenses of *Spider-Man: Turn Off the Dark* were \$1,000,000 per week, an increase of roughly 2,174 percent. These increases had begun in the 1970s, and by the 1980s, the effect of these costs was seen in how Broadway was financed.<sup>29</sup>

In addition, to compete with the proliferation of home-viewing options including cable television and video-cassette tapes, producers turned from challenging “art house” fare to more widely appealing big-budget spectacles.<sup>30</sup> In the 1980s and 1990s, two new producing models emerged to accommodate these growing costs:

24. *Id.*

25. Paul Sherman, *Legal and Business Aspects of Financing Broadway Productions*, in FINANCING A THEATRICAL PRODUCTION 491 (Joseph Taubman ed., 1964).

26. *Id.*

27. *Id.* The most successful example of a “Broadway broker” is the Mutual Benefit Financial Service Company, also known as “Fisco.” Fisco was an almost dormant broker-dealer operation when Karen Goodwin, the Vice President in charge of corporate strategy, recruited her friend Elizabeth Williams, an art history professor, to serve on the board of Fisco’s new art fund. Ms. Goodwin and Ms. Williams had the idea “to approach theater producers and offer, in effect, to serve as their investment banker.” In 1983, the Goodwin-Williams team led Fisco to directly invest \$150,000 in the Royal Shakespeare Company’s New York run of *All’s Well That Ends Well*. Although Fisco lost two-thirds of its investment, it later seized the opportunity to raise one-third of the capitalization of the original London production of *Les Misérables*. After the success of *Les Misérables*, Ms. Goodwin and Ms. Williams left Fisco to form their own production company, but they remained Fisco’s exclusive advisers on entertainment investments for a number of years. See Brooke Kroeger, *Raising a Million for ‘Les Mis’*, N.Y. TIMES (July 19, 1987), <https://nyti.ms/2Hh6HMz>.

28. Patrick Healy, *I Want to Be a Producer (Me Too!)*, N.Y. TIMES (Aug. 15, 2014), <https://nyti.ms/2k8yVgk>.

29. HURWITZ, *supra* note 14, at 203.

30. *Id.*

the corporate producer model and the multiple producers (or co-producers) model.<sup>31</sup>

The “corporate producer” refers to a corporate entity formed to develop, produce, or participate in the production of Broadway shows. Clear Channel Entertainment, for example, produced thirty-six productions between 1995 and 2005.<sup>32</sup> Because Clear Channel Entertainment was a subsidiary of larger corporation that owned billboards, radio stations, and television stations, Clear Channel Entertainment could exploit these media outlets to market and advertise its own theatrical productions.<sup>33</sup>

Perhaps the best illustration of the corporate producer is Disney Theatrical Productions. A part of Walt Disney Studios—one of four major business segments of the Walt Disney Company—Disney Theatrical’s finances are managed in combination with the Studios’ finances.<sup>34</sup> Still, under the leadership of its president, Thomas Schumacher, Disney Theatrical enjoys “unprecedented” independence from its parent corporation.<sup>35</sup> Interestingly, Disney aroused both skepticism and hostility when it entered the Broadway landscape:

This season, the role of the Beast, usually played on Broadway by the Shubert Organization with its 16 theaters, will be played instead by the Walt Disney Company, which is almost single-handedly rejuvenating 42d Street by renovating the New Amsterdam Theater. It is also producing the most expensive Broadway musical in theater history, opening tomorrow night at the Palace Theater. What’s that? Booing? Applause? Both. It is the oldest tradition in the theater to giveth with one hand and clubbeth with the other, and this year is no different. Broadway is finding that it loves to love Disney. But it still can’t help hating itself in the morning. . . . The rivalry is intensified because this time, real estate is involved, not to mention government subsidy in the form of a \$21 million low-interest loan to help Disney renovate the 91-year-old New Amsterdam, a perk that other Broadway theater owners

31. The 1980s also saw the emergence of the mega-musical: “By the 1980s the costs of production had risen so high and the market had been so fractured that the only way to recoup and make a profit was to have a long run in New York with cloned companies of the show in major cities around the world and on tours, to strategically saturate the market. This spawned the mega-musical; instead of distributing investment across a range of musicals in a season, one massive hit was the only route to financial success. . . . Mega-musicals leaned heavily on spectacle. Just as simple stories and car chases made action movies easily exportable to foreign markets, simple stories with heavy elements of stage spectacle made musicals easily exportable to foreign markets and highly attractive to foreign tourists with little command of English.” HURWITZ, *supra* note 14, at 206-7. Cameron Mackintosh, the mastermind of the mega-musical, exploited this idea with his productions of *Cats*, *Les Misérables*, and *The Phantom of the Opera*. Although Mackintosh’s international-focus proved novel, his producing model was not very different from Merrick’s. Mackintosh retained almost exclusive control over his properties, and raised money from a limited number of large investors. See Jessica Sternfeld, *Cameron Mackintosh: Modern Global Impresario*, in THE PALGRAVE HANDBOOK OF MUSICAL THEATRE PRODUCERS, *supra* note 12, at 311, 314.

32. HURWITZ, *supra* note 14, at 216; *The Dodgers*, INTERNET BROADWAY DATABASE, <https://perma.cc/ZEJ2-ADXY> (last visited Apr. 19, 2018).

33. HURWITZ, *supra* note 14, at 216.

34. Amy S. Osatinsky, *Disney Theatrical Productions: Anything Can Happen If You Let It*, in THE PALGRAVE HANDBOOK OF MUSICAL THEATRE PRODUCERS, *supra* note 12, at 413, 414.

35. *Id.*

have historically been denied. One of them calls the Disney situation similar to Wal-Mart opening in a small town, sending the local merchants into an escalating panic.<sup>36</sup>

But after producing ten musicals, including the long-running *The Lion King*—now the highest grossing entertainment property in history<sup>37</sup>—Disney has demonstrated both its staying power and its value to the Broadway economy.

Along with the corporate producer model—which has been utilized by a number of additional movie and television studios with live stage subsidiaries—the co-producers model dominates the Broadway landscape today. As described in the Introduction, the co-producers model involves the recognition of a large number of producers who collectively raise a production’s capitalization. Motivated by the rising cost of Broadway shows, this practice has grown over time:

*Victor/Victoria* listed seven lead producers, a co-producer and four associate producers. Broadway grew further removed from the single visionary producer mounting a production based on his or her personal aesthetic. The “David Merricks,” “Joseph Papps” and “Stuart Ostrows” were replaced by board of individuals and corporate representatives each with their own interests to protect . . . . And it got worse; although twelve producers were not uncommon on a single show in the 1990s, the number would escalate. *Hairspray* (2002) listed twenty producing partners; *Catch Me If You Can* (2011) listed thirty.<sup>38</sup>

The next section will describe the co-producers model in greater detail.

## II. THE CURRENT MODEL OF BROADWAY PRODUCING

Under the current model of Broadway producing, after a producer has chosen a play or musical to stage, hired core members of the creative team, and outlined a timeline for the production, they will begin to raise the show’s capitalization.<sup>39</sup> The timing of fundraising requires “careful consideration.”<sup>40</sup> Investors might be hesitant to contribute funds before “essential elements” such as the theater or stars are in place, but producers will need cash on hand to cover a show’s start-up costs, including legal and accounting services and developmental workshops.<sup>41</sup> Under New York securities law, a production can raise “front money”—that is, money to cover these early start-up costs—without triggering state filing requirements (as described in Section III) if the producer limits the front money offering to a maximum of four accredited investors (as defined in Footnote 60).<sup>42</sup> In return for

36. Alex Witchel, *Is Disney the Newest Broadway Baby*, N.Y. TIMES (Apr. 17, 1994), <https://nyti.ms/2K2RAUW>.

37. Lee Seymour, *Over the Last 20 Years, Broadway’s ‘Lion King’ Has Made More Money for Disney than ‘Star Wars’*, FORBES (Dec. 18, 2017), <https://perma.cc/KAK8-CHJU>.

38. HURWITZ, *supra* note 14, at 216.

39. JOHN BREGLIO, I WANNA BE A PRODUCER: HOW TO MAKE A KILLING ON BROADWAY...OR GET KILLED 161 (2016).

40. *Id.*

41. *Id.*

42. N.Y. Comp. Codes R. & Regs. tit. 13, § 50.1. However, many theatrical attorneys believe that after the passage of the 1996 National Securities Market Improvement Act, a principle feature of which is “the federal preemption of state securities laws in connection with offerings of securities which



waiving any claim for reimbursement of the investment in the event that the producer abandons the production, the investor will often receive an additional share of the adjusted net profits (as defined in Section V(D)) from the producer.<sup>43</sup>

To finance theatrical productions, producers typically form investment vehicles and then sell investment interests in those vehicles. Until 1990, producers structured theatrical syndication financing arrangements via limited partnerships (“LPs”).<sup>44</sup> The adoption of state legislation during the 1990s, however, authorizing limited liability companies (“LLCs”),<sup>45</sup> offered producers a “viable alternative financing structure.”<sup>46</sup> Today, producers use both LP and LLC arrangements to finance their shows. Under both structures, an investor’s<sup>47</sup> liability is limited to the amount invested.<sup>48</sup> However, a general partner in a LP is liable for losses realized by the production beyond the partner’s initial investment, and even beyond the show’s total capitalization.<sup>49</sup> As such, if the lead producer is an individual rather than an incorporated entity, they may use an LLC to shield themselves from any personal liability.

If an individual or entity contributes or bundles a large enough share of the production’s capitalization, they may receive billing as a co-producer of the production, on marketing materials above-the-title of the play (“above-the-title producer credit”). Typically, the production will recognize the general partner or managing member as the lead producer by listing their name before all others, often on a line of their own.<sup>50</sup> Productions also distinguish between executive producers, who supervise the day-to-day management of the production, and associate producers, who raise or invest at a level below the other co-producers.<sup>51</sup> The capital requirements for co-producers and associate producers, however, vary from show to show.

### III. SECURITIES REGULATIONS

A security is “a share, participation, or other interest in [a] property or in an entity of [an] issuer” that entitles the holder to a share of the issuer’s earnings.<sup>52</sup>

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comply with the requirements of Rule 506 of Regulation D” (*see infra* note 58), the limitation to four front money investors is no longer enforceable. Elliot H. Brown & Daniel M. Wasser, *A Practical Guide to Theatrical Financing*, 16 ENT. & SPORTS LAW 6, 9 (Fall 1998).

43. BREGGIO, *supra* note 39, at 161.

44. Limited partnerships are run by general partners, who pool the capital of limited partners to form the investment vehicle.

45. Limited liability companies are run by managing members, who pool the capital of investment members to form the investment vehicle.

46. Brown & Wasser, *supra* note 42.

47. Here, the term “investor” refers to any individual or entity who contributes or bundles a share of the production’s capitalization other than the general partner or managing member.

48. BREGGIO, *supra* note 39, at 162.

49. *Id.*

50. *Id.* at 193.

51. Interview with Steven Chaikelson, Head of the Theatre Management & Producing Concentration, Colum. Univ. School of the Arts Theatre Program, in N.Y., N.Y. (Feb. 21, 2017).

52. Securities, Accounting Standards Codification, § 320-10-20 (Fin. Accounting Standards Bd. 2009).

Examples of securities include banknotes, bonds, and shares of equity interest in a company's capital stock. Because the sale of investment interests in a LP or LLC constitutes the sale of securities, it may be subject to both state and federal securities regulations.<sup>53</sup>

In 1933, Congress passed the Securities Act, the objective of which was (1) to ensure that investors receive certain "significant information concerning securities being offered for public sale" and (2) to "prohibit deceit, misrepresentations, and fraud in the sale of securities."<sup>54</sup> To achieve these objectives, the Securities Act required that securities sold in the United States be registered with the SEC. Generally, registration forms compel advance disclosure of the offering including a description of the company's business, a description of the security being offered for sale, information about the management of the company, and financial statements certified by independent accountants.<sup>55</sup>

Under authority granted in the New York Arts and Cultural Affairs Law, the New York Department of Law developed its own regulatory scheme, separate from federal registration requirements, specifically related to offerings of theatrical investment interests.<sup>56</sup> Section 23.03(3)(a) of the Law provides:

[N]o offering of syndication interests in a theatrical production company, as defined herein, shall be made within or from this state without the use of a prospectus or offering circular making full and fair disclosure of material facts pertaining to the particular venture. The attorney general may also issue rules and regulations requiring the submission to prospective investors in such offerings an offering circular and amendments thereto containing a concise and accurate description of the nature of the offering, profits to promoters and others, the background of the producers, a description of subsidiary rights and other pertinent information as will afford potential investors or purchasers and participants an adequate basis upon which to found their judgment[.]

Broadway producers complained that these overlapping state and federal securities regulations increased the cost and time involved in raising the requisite capital for a Broadway show.<sup>57</sup> In fact, the state regulatory framework often delayed the production timeline, with production counsel required to submit multiple drafts of the offering papers to the New York State Attorney General's office before they were approved for distribution to potential investors—a process that could take weeks or even months. Fortunately for producers, Section 5 of the Securities Act exempts from federal registration requirements certain private offerings made to a limited number of investors, the rules for which are contained in Regulation D. And in 1996, Congress passed the National Securities Market Improvement Act ("NSMIA"), a principle feature of which is "the federal preemption of state securities laws in connection with offerings of securities which

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53. *Id.*

54. U.S. Sec. and Exch. Comm'n, *The Laws That Govern the Securities Industry* (Oct. 1, 2013), <https://perma.cc/TG62-4Y6K>.

55. *Id.*

56. Brown & Wasser, *supra* note 42.

57. *Id.*

comply with the requirements of Rule 506 of Regulation D.”<sup>58</sup> Now, theatrical offerings that comply with Rule 506 of Regulation D are exempt from both federal and state registration requirements.

When producers sell equity interests in theatrical productions to investors, they typically try to fit their offerings into the Regulation D, Rule 506 safe harbor.<sup>59</sup> Under Rule 506, a company can be assured that its offering falls within the safe harbor if it: (1) does not use general solicitation or advertising to market the securities, and (2) does not sell the securities to more than thirty-five non-accredited, sophisticated investors.<sup>60</sup> Rule 506 imposes no limitation on the amount of money that companies can raise.

Even under Regulation D private offerings, however, companies are subject to the anti-fraud provisions of federal securities law, and cannot engage unregistered broker-dealers to effectuate transactions for their accounts.<sup>61</sup> The next section will ask whether money-bundling Broadway co-producers are acting as unregistered broker-dealers in violation of the applicable SEC requirements.

#### IV. BROKER-DEALER REGULATIONS

Section 3(a)(4)(A) of the Exchange Act defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” Under Section 15(a)(1) of the Exchange Act, it is “unlawful for any broker or dealer . . . to induce or attempt to induce the purchase or sale of any security . . . unless such broker or dealer is . . . registered” with the SEC.<sup>62</sup>

“A person or entity may perform a narrow scope of activities without triggering broker/dealer [sic] registration requirements.”<sup>63</sup> Through the issuance of several no-action letters, the SEC has differentiated “broker-dealers” from “finders,” which are “persons who do nothing more than introduce prospective investors to the issuer”.<sup>64</sup> A finder “will be performing the functions of a broker-dealer, triggering registration requirements, if activities include: analyzing the financial needs of an

58. *Id.*

59. Jason Baruch, *Exit Sage Left, Enter Stage Right: Theatre Trends Over the Past 25 Years*, SENDROFF & BARUCH, LLP, <https://perma.cc/DS97-LFLK> (last visited Apr. 19, 2018).

60. Section 501 of the Securities Act defines an “accredited investor” as any person “whose individual net worth, or joint net worth with [their] spouse, exceeds \$1,000,000.” A non-accredited, sophisticated investor, as defined under Section 505, is any person whose net worth is below \$1,000,000 but who has “sufficient knowledge and experience in financial and business matters to [be] capable of evaluating the merits and risks of the prospective investment.” Of note, the 2012 JOBS (Jumpstart Our Business Startups) Act amended Rule 506 by adding a new Section 506(c), under which a company can use general solicitation or advertising to market the securities and still be considered a private offering. For a publicized private offering to qualify under Rule 506(c), however, all investors must be accredited. See U.S. Sec. and Exch. Comm’n, *Fast Answers: Rule 506 of Regulation D* (Oct. 6, 2014), <https://perma.cc/4AFN-V8W2>.

61. Steven R. Watts, *SEC Cracks Down on Unregistered Broker-Dealers in Private Offerings*, 42 SEC. REG. L. J. 69 (2014).

62. Internal punctuation omitted.

63. *Cornhusker Energy Lexington, LLC v. Prospect St. Ventures*, No. 8:04CV586, 2006 WL 2620985, at \*6 (D. Neb. Sept. 12, 2006).

64. Watts, *supra* note 61.

issuer, recommending or designing financing methods, involvement in negotiations, discussion of details of securities transactions, making investment recommendations, and prior involvement in the sale of securities.”<sup>65</sup> The finder/broker distinction is analyzed under a four-factor test, described below.

#### A. THE “BROKER-DEALER” TEST

In determining whether a person is a broker-dealer or a finder, the SEC considers four principal factors: whether the person (1) actively solicited investors, (2) advised investors as to the merits of an investment, (3) received transaction-based compensation, and (4) regularly participates in security transactions.<sup>66</sup> No one factor is dispositive, and a person need not meet all four of these factors to be considered a broker-dealer by the SEC. “A ‘yes’ answer to any of these factors indicates that registration may be required.”<sup>67</sup>

### V. APPLYING THE “BROKER-DEALER” TEST TO THE ACTIVITIES OF BROADWAY CO-PRODUCERS

#### A. CONDUCT THAT FALLS OUTSIDE THE SCOPE OF THE “BROKER-DEALER” DEFINITION

Not all Broadway co-producers actively bundle money from investors. Tony Award®-winning Broadway producer Barbara Whitman (*Fun Home* and *Fully Committed*) explains that co-producers often just write a check to cover their unit of the capitalization: “An awful lot of them just write a check. They are wealthy people who buy billing for one hundred twenty-five thousand dollars to two hundred fifty thousand dollars.”<sup>68</sup> Because these co-producers do not raise money from third parties, they fall outside of the scope of the “broker-dealer” definition.

Similarly, a grouping of investors might choose to form a syndicate, an “investment vehicle” that permits multiple individuals to co-invest under one collective name.<sup>69</sup> When a syndicate invests in a Broadway production, the production will generally make any financial distributions directly to that collective entity, which is then responsible for proportioning the distributions amongst the

65. *Cornhusker*, 2006 WL 2620985 at \*6.

66. Watts, *supra* note 61; *see also* Steve Ganis, Jeremy D. Glaser, & Jake Romero, *Using Finders to Assist in Financings Can Impose Significant Risks*, INSIGHTS: THE CORP. & SEC. L. ADVISOR, June 2011, at 18; In the Matter of David C. Sorrells, Respondent, Exchange Act Release No. 31265, 2014 WL 4792091 (Sept. 25, 2014) (finding that respondent violated Section 15(a) of the Exchange Act because he “(1) directly and regularly solicited current and prospective insurance clients for investments in Arete and the Snisky PIVs; (2) advised prospective investors on the specific details and merits of the investments; (3) received transaction-based compensation for bringing in money from investors; and (4) participated at key points in the investment chain.”).

67. Watts, *supra* note 61.

68. Interview with Barbara Whitman & Tom Casserly, Broadway Producers, in N.Y., N.Y. (July 26, 2016).

69. *See The Basics of Startup Syndicate Funding*, STARTUP XPLORE, <https://perma.cc/EV47-EZZP> (last visited Mar. 3, 2018).

syndicate's investors.<sup>70</sup> Because a lead producer will deal directly with an investing syndicate, no middleman exists to trigger broker-dealer registration requirements.<sup>71</sup>

### B. FACTOR (1): ACTIVE SOLICITATION

The first factor of the broker-dealer test asks whether the intermediary in a transaction for the sale of securities engaged in active solicitation of potential investors. The SEC generally defines "solicitation" in the context of broker-dealer regulation as "any affirmative effort by a broker or dealer intended to induce transactional business for the broker-dealer or its affiliates."<sup>72</sup> General solicitation includes, but is not limited to, "(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising."<sup>73</sup>

It is immaterial under the broker-dealer test whether the intermediary solicits potential investors or actual investors. In 2008, Brumberg, Mackey & Wall, P.L.C. ("BMW") considered entering into an agreement with Electronic Magnetic Power Solutions, Inc. ("EMPS") whereby BMW would help EMPS to raise funds to finance its operations and development in return for a percentage of the gross amount raised. Requesting a no-action letter concerning its conduct as an unregistered broker-dealer, BMW explained that it would introduce to EMPS only "individuals and entities 'who may have an interest' in providing financing to EMPS through investments in equity or debt instruments of EMPS."<sup>74</sup> The Division of Trading and Markets, however, advised that it was unable to assure BMW that it would not recommend enforcement action:

The Staff believes that the introduction to EMPS of only those persons with a potential interest in investing in EMPS's securities implies that BMW anticipates both "pre-screening" potential investors to determine their eligibility to purchase the securities, and "pre-selling" EMPS's securities to gauge the investors' interest. . . . [T]he Staff believes that your proposed activities would require broker-dealer registration.<sup>75</sup>

Often, experienced Broadway producers do not actively solicit investors, either actual or potential.<sup>76</sup> Already branded as industry insiders, these producers have circles of friends and colleagues who turn to the producers to signal their own

70. Interview with Barbara Whitman & Tom Casserly, *supra* note 68.

71. Interview with an experienced theatrical attorney who wishes to remain anonymous (Aug. 2, 2016).

72. ROBERT J. HAFT, ARTHUR F. HAFT & MICHELLE HUDSON, ANALYSIS OF KEY SEC NO-ACTION LETTERS § 9:18 (2017).

73. 17 C.F.R. § 230.502(c).

74. Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter, 2010 WL 1976174, at \*3 (May 17, 2010) (emphasis added).

75. *Id.*, at \*2.

76. Interview with anonymous theatrical attorney, *supra* note 71.

interest in investing in a Broadway show. Many other Broadway co-producers, however, do exhibit conduct that would probably meet the SEC's definition of active solicitation.

Some producers send mass e-mails describing investment opportunities to friends, colleagues, and other industry professionals who they may not even know personally: "Hey everybody, I'm working on this really great show . . . I saw it at NAMT<sup>77</sup> and signed up immediately. [Investment] units [start at] twenty-five thousand dollars—let me know if you're interested."<sup>78</sup> Others share posts on Facebook, visible to both friends and public groups, advertising opportunities to invest on Broadway. A search on Facebook using combinations of the terms "Broadway," "investment," "opportunity," and "producer" reveals many such examples of this practice:

Hey Y'all! I'm producing the Broadway Revival of Pump Boys and Dinettes starring Bo Bice! If you'd like to invest in Broadway, and attend opening night and afterparty (backstage tour included), or would like to see more information on it, please feel free to email me at [contact information omitted].<sup>79</sup>

An American in Paris is on Turner Classic Movies 2pm today ., [sic] if you are interested in investing in the new Broadway Musical (An American in Paris - The Musical), we are down to the last few shares (\$25,000) buy in... Call/text [contact information omitted] or email me here or at [contact information omitted] with your email address if interested or if any questions! (it's a Great Experience to make \$ investing/producing Broadway Musicals, plus the perks of opening night, Opening Night Cast Party, etc... [sic]<sup>80</sup>

If you haven't seen it yet, check out the awesome initial TVC teaser for The Visit Musical which opens on Broadway this March, starring the inimitable Chita Rivera! I'm incredibly excited to be part of the producing team and am happy to discuss further with anyone that might be interested in investing in the production. Drop me a line and say hi!<sup>81</sup>

This conduct likely meets the SEC's definition of "solicitation" and could therefore trigger broker-dealer registration requirements. Section 502(c) of the Securities Act does not enumerate e-mails and social media postings as examples of solicitation; nonetheless, the SEC has identified them as such. The SEC has singled out unregistered brokers for targeting investors via both individual e-mails<sup>82</sup> and mass e-mail campaigns.<sup>83</sup> And, in a recent case, the SEC charged an unregistered broker for advertising investment opportunities on LinkedIn.<sup>84</sup>

77. National Alliance for Musical Theatre.

78. Interview with Barbra Whitman & Tom Casserly, *supra* note 68.

79. FACEBOOK (Jan. 10, 2013) (posted in the OWU Class of 1998 group).

80. FACEBOOK (Nov. 2, 2014).

81. FACEBOOK (Feb. 18, 2015).

82. See *S.E.C. v. Helms*, No. A-13-CV-01036 ML, 2015 WL 6438872, at \*5 (W.D. Tex. Oct. 20, 2015) ("In support of this argument, Barrera offers no new evidence to rebut the emails and deposition testimony previously submitted by the SEC. This previously submitted evidence establishes . . . Sellers subsequently copied Barrera on . . . an email solicitation offering Moore a second investment opportunity, the "Vesta" portfolio (in which Moore/Vendetta never invested)."); see also *S.E.C. v.*

Further, although the JOBS Act amended Rule 506 to permit general solicitation in private placements, it did not waive broker registration requirements for such transactions. The SEC clarified this distinction in *In the Matter of Anthony Fields*:

Fields was a broker according to his own description—he described himself as an intermediary who introduced a buyer and seller and expected to receive commissions on transactions that occurred. The evidence of record contains examples of his attempts to broker transactions in instruments that he had advertised on social media. . . . Fields argues that he was not required to be registered as a broker because the contemplated transactions were private placements. *This argument confuses the exemption from registration of instruments that can be the subject of private placements with the requirement for a broker to be registered.* Accordingly, Fields violated Exchange Act Section 15(a)(1).<sup>85</sup>

### C. FACTOR (2): INVESTOR ADVICE

Factor (2) of the broker-dealer registration test asks whether the intermediary advised the investor as to the merits of the investment. The SEC has defined investor advice as discussions about “the advisability of investing in, or . . . reports or analyses as to, specific securities or specific categories of securities.”<sup>86</sup>

Rule 202(a)(11)-1 of the Investment Advisers Act of 1940 exempts from advisor registration “advice that is solely incidental to the broker-dealer’s business or account,” such as advice as to whether the investor “enter or to stay out of the market in general.”<sup>87</sup> However, any “recommendation” or “endorsement” of “specific securities” will constitute investment advice.<sup>88</sup>

Theatrical attorneys counsel managing producers to prohibit their co-producers from offering investors any information that the SEC might consider to be investor advice under the broker-dealer registration test: “The producer’s instructions to the co-producer are ‘Don’t give any projections other than the projections that we provide you with,’ and presumably the managing producer doesn’t continue to

Mapp, et. Al., Fed. Sec. L. Rep. P 99429 (Oct. 07, 2016) (“The Commission first alleges that Paxton violated Section 17(b) by forwarding one of Mapp’s promotional emails to a potential investor on July 23, 2011.”).

83. See *S.E.C. v. Alternate Energy Holdings, Inc.*, No. 1:10-CV-00621-EJL, 2014 WL 2515710, at \*1 (D. Idaho May 13, 2014) (“[T]he SEC alleges the Defendants used mass email distributions of offering documents called Private Placement Memoranda (“PPMs”) and other materials to solicit potential investors through supporters, paid promoters, and other finders; inviting them to forward the PPMs on to potential investors.”).

84. In the Matter of Anthony Fields, CPA d/b/a Anthony Fields & Assocs. & d/b/a Platinum Sec. Brokers, Release No. 474 (Dec. 5, 2012) (“LinkedIn is an online social network with a business to business (B2B) emphasis. LinkedIn has various discussion groups that users, such as Fields, can join. Such social media sites are an efficient way to reach potential investors. Fields advertised the availability of BGs and MTNs on LinkedIn and on two other B2B sites, TradeKey and E-2/Commerce, during 2010 and 2011. Fields’s profile on LinkedIn during 2010 and 2011 contained links to AFA’s and Platinum’s websites.”) (internal citations omitted).

85. *Id.* (emphasis added).

86. Donald F. Pooley, 1985 WL 52042, at \*1 (S.E.C. No - Action Letter Feb. 8, 1985).

87. Kevin Keogh, *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, BANKING & FIN. SERVICES POL’Y REP. 3 (June 2005).

88. The Inv. Archive, LLC, 2010 WL 2030233, at \*4 (S.E.C. No - Action Letter May 14, 2010).

work with anyone who they feel is not observing [those instructions].”<sup>89</sup> However, co-producers do not always follow such instructions:

You try as best you can [to regulate what a co-producer can and cannot say]. I personally try to bring in people who I feel will accurately represent the show. Many people are not able to control their co-producers that much . . . and we have had issues with people [exaggerating] their involvement in the show and the show’s [financial] prospects.<sup>90</sup>

Take, for example, the following Facebook solicitation:

It’s very rare to get an opportunity to invest & produce a future Broadway Hit Musical, we are bringing Anastasia to Broadway late next year, if you know anyone who has \$25,000 or more to invest or if you want to buy in, call/text me [contact information omitted]!!! A number of experts thought we could beat Hamilton for the Tony, but we will enter the race the following years to increase our chances which will lead to a longer and more Successful run.<sup>91</sup>

Here, the producer does not just advertise the existence of an investment opportunity; they also offer projections about the show’s commercial prospects, referring to it as a “future Broadway hit” that will likely enjoy a “long” and “successful” run. Although the producer likely considered their post an innocuous promotion, the SEC might read it as intending to educate prospective investors “as to the value of the securities involved,” which constitutes investment advice that may trigger broker-dealer registration requirements.<sup>92</sup> Any representation that a co-producer makes to a potential investor outside of the representations explicitly contained in the offering papers might qualify as investor advice under this second factor.

#### D. FACTOR (3): TRANSACTION-BASED COMPENSATION

Factor (3) asks whether the intermediary received “transaction-based compensation,” which is defined as a “commission” paid to the intermediary for effectuating a transaction.<sup>93</sup> In a 2010 no-action letter, the SEC opined that the receipt of transaction-based compensation alone, without any of the other three factors, “triggers the broker registration requirement.”<sup>94</sup> Although the Commission’s 2010 position is “neither legally binding nor persuasive,” it signals the importance of this third factor.<sup>95</sup>

89. Interview with anonymous theatrical attorney, *supra* note 71.

90. Interview with Barbra Whitman & Tom Casserly, *supra* note 68.

91. FACEBOOK (July 18, 2015).

92. Ganis et al., *supra* note 66, at 5.

93. *Cornhusker Energy Lexington, LLC v. Prospect St. Ventures*, No. 8:04CV586, 2006 WL 2620985, at \*6 (D. Neb. Sept. 12, 2006).

94. *S.E.C. v. Kramer*, 778 F. Supp. 2d 1320, 1341 n.51 (M.D. Fla. 2011).

95. *Id.*; see also *Landegger v. Cohen*, No. 11-CV-01760-WJM-CBS, 2013 WL 5444052, at \*5 (D. Colo. Sept. 30, 2013) (“Of these factors, some courts have also held that the transaction-based compensation factor, is one of the hallmarks of broker status.”).



Money-bundling Broadway co-producers are typically compensated post-recoupment from a production's adjusted net profits.<sup>96</sup> "Adjusted net profits are the weekly operating profits available for distribution to the producer and the investors after payment of net profits to third parties, such as stars, authors [and] underlying rights owners."<sup>97</sup> As a rule, adjusted net profits are split "50-50"<sup>98</sup> between the producers and investors.<sup>99</sup> "The money paid to the investors is divided pro rata and *pari passu* (at the same time) among them in accordance with the respective amounts contributed by each."<sup>100</sup> For purposes of example, if an investor invests one hundred thousand dollars in a production capitalized at one million dollars, they will be entitled to ten percent of the investor's share of adjusted net profits, equal to five percent of the total adjusted net profits. Similarly, the money payable to producers is usually divided pro rata in accordance with their respective amounts raised, after an off-the-top deduction of a "torchbearer share" payable to the lead producer or producers in consideration for their efforts in developing the project and managing the day-to-day operations (i.e., if a co-producer raises one hundred thousand dollars for a production capitalized at one million dollars, they will be entitled to ten percent of the producer's share of adjusted net profits, after the torchbearer's share has been deducted).<sup>101</sup> Sometimes, a producer will choose to allocate a portion of their adjusted net profits to an investor, often as a "kicker" to incentivize investor participation at a certain monetary level.<sup>102</sup>

The theatre industry is of the opinion that this form of producer compensation does not qualify as transaction-based compensation:

It would only be somebody who was inexperienced in the Broadway world who would propose to compensate a bundler with anything other than a share of adjusted net profits . . . . What you don't have in theater . . . is people who are paying bundlers a percentage of the money that they raised. . . . On the rare occasions when that has arisen, I've said, "Absolutely, you can do that if (1) it is disclosed and (2) the party that you're dealing with is a registered broker-dealer." What's the distinction between somebody who is getting paid on the basis of a classic commission vs. the arrangement that we have which is payment out of the producer's share of adjusted net profits? Whether it would hold up to scrutiny or not, what we've gotten ourselves comfortable with is the notion that whatever arrangement is being made with this bundler has no impact on investors. The securities laws are here to protect investors. No investor's capital contribution is being diminished by a fee that is being paid. . . .

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96. BREGGIO, *supra* note 39, at 167.

97. *Id.*

98. *Id.*

99. Here, the term "producer" refers to any individual or entity that bundles money for the production company, including the general partner or managing member of the company. The term "investor" refers to any individual or entity that directly contributes funds to the capitalization of the production company. An individual or entity that bundles a unit of the capitalization, part of which includes its own funds, will be considered both a "producer" and an "investor".

100. *Id.* (emphasis added).

101. Interview with Steven Chaikelson, *supra* note 51.

102. *Id.*

In this scenario, the gross proceeds are still the gross proceeds. . . . No harm, no foul.<sup>103</sup>

The theatre industry distinguishes producer compensation from transaction-based compensation because it is not taken off the top of the investor's capital contribution. Legal precedent, however, suggests that producer compensation out of a share of the adjusted net profits could, in fact, meet the SEC's definition of "transaction-based compensation."

First, federal courts have equated "transaction-based compensation" with a "commission,"<sup>104</sup> which Black's Law Dictionary defines as "a fee paid to an agent or employee for a particular transaction, usually as a percentage of the money received from the transaction."<sup>105</sup> Although this definition indicates that a "commission" usually takes the form of an off-the-top payment, it does not expressly limit the term to such.

Second, the underlying concern of "transaction-based compensation" is not that it will diminish an investor's capital contribution, but rather that it "represents a potential incentive for abusive sales practices that registration is intended to regulate and prevent."<sup>106</sup> If an intermediary is to receive a fee for effectuating a transaction, that intermediary may be incentivized to misrepresent the value of the security or securities involved, thereby increasing the likelihood that the investor actually invests. As such, the key inquiry regarding intermediary compensation is whether such compensation is tied to the transaction—i.e. compensation paid only if the transaction closes. The only form of intermediary compensation unlikely to trigger broker registration requirements is a fee paid to a finder solely for introducing a potential investor to an issuer, regardless of whether or not that investor actually invests.

A co-producer is compensated only if they actually effectuate the transaction. In fact, a co-producer share of the adjusted net profits will often increase based on the amount of money that the co-producer raises. Accordingly, producer compensation out of the producer's share of adjusted net profits will likely meet the definition of "transaction-based compensation" under factor (3) of the SEC's broker-dealer registration test.

#### E. FACTOR (4): REGULAR PARTICIPATION IN SECURITIES TRANSACTIONS

The final factor of the SEC's broker-dealer registration test asks whether the intermediary regularly participates in securities transactions. "The SEC is concerned that persons who have been barred from engaging in the purchase or sale of securities will attempt to operate as 'finders' in order to evade registration requirements. As such, a finder's prior experience in dealing securities . . . can trigger registration requirements. . . ."<sup>107</sup> "Regularity of participation has been

103. Interview with anonymous theatrical attorney, *supra* note 71.

104. *Cornhusker Energy Lexington*, 2006 WL 2620985 at \*6.

105. COMMISSION, Black's Law Dictionary (10th ed. 2014).

106. *Cornhusker Energy Lexington*, 2006 WL 2620985 at \*6.

107. Ganis et al., *supra* note 66, at 5.

demonstrated by . . . the dollar amount of securities sold . . . and the extent to which advertisement and investor solicitation were used.”<sup>108</sup> If an intermediary solicits an investment “on a single, isolated basis . . . such person might not be acting as a ‘broker’ or ‘dealer’ as these terms are defined in . . . the Securities Exchange Act of 1934.”<sup>109</sup> However, “if such activity is engaged in more often than on a single isolated basis,” broker-dealer registration may be required.<sup>110</sup>

When an individual or entity solicits investments for a single production, such conduct would be unlikely to equate to regular participation. Of note, in *Somerset Communications Group v. Wall to Wall Advertising*, the court found that an entity formed for the sole purpose of purchasing units in a *single* company, and issuing those units to investors, was not regularly participating in the market for securities.<sup>111</sup> If a producer, however, is actively engaged in the Broadway business, they might meet the participation threshold for broker registration. “Nobody does this for a living, but many people do it on a regular basis.”<sup>112</sup>

## VI. CONSEQUENCES OF USING AN UNREGISTERED BROKER

### A. LEGAL PENALTIES

An investor who purchases a unit of a production’s capitalization through an unregistered broker may be entitled to rescission of the investment agreement. Whereas Section 15(a) of the Exchange Act prohibits a broker from buying or selling securities without registering with the SEC, Section 29(b) (codified as 15 USC § 78cc (b)) provides a remedy for violations of 15(a):

Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation.

There exists judicial uncertainty as to the reach of Section 29(b). In *Zerman v. Jacobs*, the U.S. District Court for the Southern District of New York held that under 29(b), “only unlawful contracts may be rescinded, not unlawful transactions made pursuant to lawful contracts.”<sup>113</sup> Under the *Zerman* holding, an investor

108. *S.E.C. v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 12-13 (D.D.C. 1998) (internal citation omitted).

109. *Joseph McCulley Sales*, Fed. Sec. L. Rep. P 78,982 (S.E.C. No - Action Letter Sept. 1, 1972).

110. *Id.*

111. *Somerset Comm’n Group, LLC v. Wall to Wall Advert., Inc.*, No. C13-2084 JCC, 2016 WL 4063938, at \*1 (W.D. Wash. Jan. 28, 2016) (“[T]he only securities transactions properly before the Court are Somerset’s purchase of units in Fourpoints, and Somerset’s issuance of its own units to investors. This does not equal the ‘regularity of participation’ that would have required Somerset . . . to register as a dealer.”).

112. Interview with anonymous theatrical attorney, *supra* note 71.

113. *Zerman v. Jacobs*, 510 F. Supp. 132, 135 (S.D.N.Y. 1981), *aff’d*, 672 F.2d 901 (2d Cir. 1981).

cannot base a rescission right upon a broker's failure to register, provided that the investment agreement is itself lawful. Later courts, however, have narrowed this ruling,<sup>114</sup> and the American Bar Association Task Force Report on private placement broker-dealers suggests that the language in 29(b) is broad enough to offer investors a rescission right:

This section suggests that in any civil litigation an unregistered agent acting on behalf of the issuer will be compelled to return their commissions, fees and expenses; and that the issuer may justifiably refuse to pay commissions, fees and expenses at closing or recoup them at a later time. It also raises the question of whether the issuer can be compelled to repay these funds to an investor, since the unregistered broker-dealer is acting on behalf of the issuer.

The investor may also be entitled to return of his or her investment, since the purchase contract between the issuer and the investor is a contract which is part of an illegal arrangement with the unregistered financial intermediary, and that intermediary is engaged in the offer and sale of the security to the investor. The language to Section 29(b) is broad enough to permit such an interpretation.

Our research found little guidance on this type of case. Experience tells us that litigation involving unregistered broker-dealers or agents is often quickly settled. Furthermore, a reference to a state regulatory authority or the SEC will often produce compelling pressure for prompt return of the funds.<sup>115</sup>

Ultimately, an issuer who employs an unregistered broker to sell a security runs the risk of having to return the purchase price to the investor. And even if an investor does not demand rescission, use of an unregistered broker can expose the issuer to a civil fine or penalty,<sup>116</sup> and to enhanced SEC regulatory action in connection with future offerings, "for aiding and abetting the [intermediary's] violation of the SEC broker-dealer registration requirements."<sup>117</sup>

## B. UNSOPHISTICATED INTERMEDIARIES

An issuer also exposes itself to liability by using an unsophisticated intermediary unaware of SEC regulations. Of note, Section 10(b) of the Exchange Act prohibits issuers from using or employing "manipulative or deceptive devices in connection with the purchase or sale of securities."<sup>118</sup> "It is well established that an action may be brought under section 10(b) . . . against a stockbroker who states an opinion without a genuine belief in its accuracy, or with a reckless disregard for

114. See *Reg'l Properties, Inc. v. Fin. & Real Estate Consulting Co.*, 678 F.2d 552, 560 (5th Cir. 1982) ("Interpreting section 29(b) to render voidable those contracts that are either illegal when made or as in fact performed not only avoids these problems but also, in our view, most nearly comports with the language used in section 29(b).").

115. The Task Force on Private Placement Broker-Dealers, ABA Section of Business & Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 999 (2005).

116. *United States Sec. & Exch. Comm'n v. Collyard*, 154 F. Supp. 3d 781 (D. Minn. 2015).

117. *Id.*

118. *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 206 n.6 (3d Cir. 2001).

its truth or falsity.”<sup>119</sup> This principle applies to “forecasts and predictions” as to the expected value of a security being offered for sale.<sup>120</sup> For example, the Facebook solicitation reproduced in Section V(C), predicting that the new musical *Anastasia* will enjoy a long and successful run, might be found to violate Section 10(b) if a complainant can show that the producer made the prediction with “reckless disregard for its truth or falsity.” An issuer will be held secondarily liable for the fraudulent statements of a broker if the issuer had “general awareness” of the violation and “knowingly and substantially assisted” it.<sup>121</sup>

Fortunately for producers, liability under 10(b) is unlikely. “Predictions and statements of opinion generally cannot form the basis of a fraud claim,”<sup>122</sup> and under Second Circuit doctrine, “forward-looking recommendations and opinions are not actionable in securities fraud merely because they are misguided, imprudent or overly optimistic.”<sup>123</sup> Further, producers will typically guard against liability by including in the offering papers language providing that only express representations are actionable:

By executing this Agreement, each Investing Member represents and warrants to the Managing Member with full knowledge that the Managing Member and the Company intends to rely hereon, that Investing Member has not been induced to enter into this Agreement by any warranties, guarantees, promises, statements or representations, whether express or implied, except those that are expressly and specifically set forth in this Agreement, and that the Managing Member shall not be bound or liable in any manner by express or implied warranties, guarantees, promises, statements or representations pertaining to my investment, except as are expressly and specifically set forth in this Agreement.

## VII. CONCLUSION

Although responsible attorneys and producers are certain to include appropriate disclosures in theatrical offering papers and comply with blue sky filings, they rarely consider the requirement that intermediaries acting as broker-dealers register with the SEC. An experienced theatrical attorney who wishes to remain anonymous explains, “Nobody really wants the technically correct answer to the [broker-dealer] question, because that is how the theatrical financing business pretty much works these days, [and] nobody wants to hear that it is fraught with legal issues that might question that mode of operation.”<sup>124</sup>

Recognizing a willful ignorance on the part of theatre attorneys and producers, some in the industry contend that the SEC and New York Attorney General are unlikely to ever take regulatory action against Broadway producers,<sup>125</sup> as they have

119. *Filloramo v. Johnston, Lemon & Co.*, 697 F. Supp. 517, 521 (D.D.C. 1988).

120. *Id.*

121. *Hutto v. Texas Income Properties Corp.*, 416 F. Supp. 478, 482 (S.D. Tex. 1976).

122. *Morris Aviation, LLC v. Diamond Aircraft Indus., Inc.*, No. 3:09-CV-644-S, 2012 WL 3684760, at \*4 (W.D. Ky. Aug. 27, 2012), *aff'd*, 536 F. App'x 558 (6th Cir. 2013).

123. *In re Salomon Analyst AT&T Litig.*, 350 F. Supp. 2d 455, 467 (S.D.N.Y. 2004).

124. Interview with anonymous theatrical attorney, *supra* note 71.

125. Interview with John Pinckard, Theatre Producer, in N.Y., N.Y. (Feb. 13, 2017).

“bigger fish to fry.”<sup>126</sup> Might these regulatory bodies, however, shift their attention to the Great White Way?

In 2016, the Broadway blockbuster *Hamilton* opened, grossing nearly one hundred million dollars in its first year.<sup>127</sup> At this rate, *Hamilton*'s New York production could gross over a billion dollars in its first decade.<sup>128</sup> As shows like *Hamilton* demonstrate Broadway's potential to be a cash cow, the SEC might divert regulatory focus toward the industry.

Additionally, the Broadway industry has witnessed a number of fundraising scandals over the past few years. In 2012, a Long Island stockbroker defrauded producers of the Broadway-bound musical *Rebecca*, convincing them that he was raising four and one-half million dollars from investors who turned out to be phantoms.<sup>129</sup> The middleman was arrested and the show was never able to complete its fundraising for Broadway. And in 2016, an investor pulled his funds from the Broadway musical *Nerds* just weeks before it was intended to open,<sup>130</sup>

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126. The industry's disregard for the SEC extends all the way back to Broadway's "Golden Age." Take, for example, this letter that legendary Broadway producer Herman Shulmin wrote to Bernard Grossman, former President of the Federal Bar Association of New York, New Jersey & Connecticut and Chairman of the 1962 Symposium of the Committee on the Law of the Theatre:

In my experience, the S.E.C. is nothing more than . . . red tape, delays, more delays, nuisance and cost. And to what purpose? Who is being protected and from what? Certainly, the honesty of the producer is not guaranteed by these official requirements . . . .

As I understand the intention of Congress in passing the laws that created the S.E.C., it was to regulate the stock-selling activities which are so well-hidden in the devices of the public corporation. But nothing of this is involved in the limited partnership form which is the usual manner of doing business in the theatre. Moreover, and far more important, the amount of capital involved in the production of most plays is a tuppenny business, as against the vast amounts involved in the floating of stock corporations. The production of plays is for the most part an intimate affair, carried on within a comparatively small family of people motivated in general by an interest in the theatre, rather than an interest in getting rich. To equate the theatrical promotions with the debacle of Wall Street in 1929, from which the creation of the S.E.C. stems, is idiocy.

When the thing began, a committee of lawyers whose interests were chiefly in theatre, got together and considered whether it should accept the subservience to the S.E.C. They decided in favor of doing so. That was a great error. And now we are trapped in the years of precedence. I would like to be the heroic producer who would refuse to submit, but now the warnings of the lawyers against such an action are very alarming. . . . I wonder sometimes if it is not the essence of the legal character to look with joy upon the possibility of any process which promises more complexity, more red-tape, more paper work, rather than to strive for simplification? Am I being cynical?

Letter from Herman Shulmin to Bernard A. Grossman (Sept. 19, 1962), in FINANCING A THEATRICAL PRODUCTION 491 (Joseph Taubman ed., 1964).

127. Michael Paulson & David Gelles, *'Hamilton' Inc.: The Path to a Billion-Dollar Broadway Show*, N.Y. TIMES (Jun. 8, 2016), <https://nyti.ms/2k7GaoQ>.

128. *Id.*

129. Lorne Manly, *'Rebecca' Publicist Loses Round in Lawsuit Over Show's Travails*, N.Y. TIMES (May 12, 2015), <https://artsbeat.blogs.nytimes.com/2015/05/12/rebecca-publicist-loses-round-in-lawsuit-over-shows-travails/>.

130. Michael Riedel, *Spring on Broadway will be a bloodbath for new musicals*, N.Y. POST (Mar. 10, 2016), <https://perma.cc/HK3K-UGEW>.

leaving the lead producer unable to pay back creditors for funds already spent.<sup>131</sup> Each scandal of this kind increases the likelihood that Broadway investors and insiders agitate for regulatory change.<sup>132</sup>

Still, as Broadway shows become more and more expensive to produce, lead producers are unlikely to stop recruiting co-producers to raise or contribute portions of their capitalizations. So how can the industry avoid the drawbacks associated with this growing practice?

Veteran Broadway producer David Stone (*Wicked*, *Next to Normal*, *The 25<sup>th</sup> Annual Putnam County Spelling Bee*) suggests that co-producers will be unwilling to ever register as brokers with the SEC.<sup>133</sup> Registering as a broker-dealer is a complicated and expensive process that requires applicants to complete a test for membership demonstrating competence in securities activities and to pay annual membership fees.<sup>134</sup> However, Mr. Stone advises lead producers to instruct their co-producing partners to refrain from conduct that might trigger registration requirements. Most significantly, Broadway co-producers should (1) stop publicly soliciting investors, either through social media or via e-mail, and (2) avoid advising investors as to the value of the securities involved, specifically by making projections about a production's financial prospects.

In addition, lead producers should limit the aspects of the transaction in which co-producers can participate. When adjudicating the broker-dealer test, some courts have considered whether the intermediary participated at "key points" in the transaction.<sup>135</sup> An intermediary who negotiates the level of the investment, delivers offering papers, closes the deal, and/or transfers funds will be more likely to trigger registration requirements than a less involved intermediary.<sup>136</sup> As such, after finding a potential investor, a co-producer should do no more than introduce that investor to the general partner or managing member of the production company.

Finally, producers might consider alternative fundraising models to the dominant one described in this Note. In 2015, for example, Corey Schwitz and Stephen Santore—two theater professionals who first worked together at the advertising agency SpotCo—founded Standing Room Capital, an online platform to invest in Broadway shows.<sup>137</sup> Mr. Schwitz and Mr. Santore had the idea to start Standing Room Capital after the passing of the JOBS Act, which permits certain offerings to be solicited to the general public. Membership in Standing Room Capital cost two hundred and fifty dollars and was open only to accredited investors. After joining Standing Room Capital, members would be offered investment opportunities in Broadway productions and tours, at a minimum starting

131. Michael Riedel, *Money scandals roils Broadway's canceled 'Nerds'*, N.Y. POST (Mar. 25, 2016), <https://perma.cc/5EYQ-37VF>.

132. Interview with John Pinckard, *supra* note 125.

133. Interview with David Stone, *supra* note 11.

134. U.S. Sec. and Exch. Comm'n, *Guide to Broker-Dealer Registration* (Apr. 2008), <https://perma.cc/6NJT-ACBK>.

135. SEC v. Hansen, No. 83 CIV. 3692, 1984 WL 2413, at \*10 (S.D.N.Y. Apr. 6, 1984).

136. The Inv. Archive, LLC, 2010 WL 2030233, at \*4 (S.E.C. No - Action Letter May 14, 2010).

137. Andrew Gans, *Got \$2,500? New Online Investment Platform Will Let Theatre Fans Invest in Broadway Shows*, PLAYBILL (Aug. 3, 2015), <https://perma.cc/8Q8J-PR6Z>.

unit of two thousand and five hundred dollars. Standing Room Capital intended to bundle units from its member-investors and distribute profits proportionately.<sup>138</sup> In consideration for creating and managing the fund, Mr. Schwitz and Mr. Santore—who registered as brokers with the SEC—would take a twenty percent commission off the total profits before making returns to the investors. Mr. Santore cites logistical hurdles to explain his platform’s eventual closure.<sup>139</sup> The platform, however, offers a promising model for industry professionals hoping to circumvent the legal challenges associated with the current model of Broadway co-producing.

As every Broadway aficionado knows, “the show must go on,” and money-bundling Broadway co-producers have become essential players in raising the requisite capital to get a show from page to stage. If Broadway co-producers were required to register as brokers with the SEC, these individuals might—to the detriment of the entire industry—pull out of the fundraising game entirely. Still, with an increased awareness of federal fundraising requirements, the industry can self-regulate, to avoid the legal penalties of using unregistered intermediaries in the financing process.

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138. Interview with Corey Schwitz, Co-Founder of Standing Room Capital and Student at Columbia Business School, in N.Y., N.Y. (Aug. 2, 2016).

139. A group of Standing Room Capital members collectively invested in the national tour of *A Gentleman’s Guide to Love and Murder*. As such, the company is still in formal existence such that it can receive and make financial distributions. However, the company no longer operates its online platform, and the co-founders never developed the company as initially planned. *Id.*