

Legal Risk Management Tip
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BEWARE THE PITFALLS OF USING FINDERS

The ability of a fund manager or an entrepreneur to raise capital for their fund or company can be a critical component for the success of their venture. Fundraising can be quite challenging, so it is not surprising that those who are out raising funds will look favorably at friends, family members and business contacts who offer to bring investors to the table. These friends, family members and business contacts are seldom registered with the Securities and Exchange Commission (“SEC”) as broker-dealers and are generally referred to as “finders.” While the use of finders may be embraced as a smart supplement to other fundraising efforts of the fund manager or entrepreneur, a note of caution should be sounded. As discussed below, with very limited exceptions, the activities of a finder ordinarily would require the finder to be registered as a broker-dealer, and the consequences for failing to have the required registration can be severe, both for the unregistered finder and for the fund or company that engages them.

When Must a Finder Be Registered as a Broker-Dealer?

The determination of whether a finder’s activities require registration as or association with a broker-dealer is a fact specific inquiry that is made by examining the full range of facts and circumstances surrounding the finder’s activities. Section 3(a)(4)(A) of the Securities Exchange Act of 1934 (“Exchange Act”) defines a broker as “any person engaged in the business of effectuating transactions in securities for the account of others.” This is a very broad definition and can encompass many of the activities that a finder would undertake in trying to secure investors.

The SEC has historically considered a wide range of factors in determining whether a finder is “effectuating transactions in securities” and thus required to be registered as a broker-dealer. Prominent among them are the following five factors:

- whether such person participates in the negotiations surrounding the transaction;
- whether such person makes recommendations or gives advice concerning the transaction;
- whether such person receives transaction-based compensation in connection with the transaction;
- whether such person has engaged in previous securities transactions; and
- whether such person takes physical possession or control of the securities or funds to be exchanged in connection with the investment.

While the SEC has stated that the presence of any one factor does not, in and of itself, lead to a conclusion that a finder is engaging broker-dealer activities, the SEC has clarified that the presence of commissions or other transaction-based compensation represents one of the

hallmarks of being a broker-dealer¹ since it denotes a potential incentive for abusive sales practices that broker-dealer registration is intended to regulate and prevent. Therefore, the presence of transaction-based compensation is highly likely to be viewed as broker-dealer activity.

For example, in one no-action letter, a law firm requested assurance that the SEC would not initiate enforcement proceedings if the law firm, which was not registered as a broker-dealer, undertook certain limited activities to help an issuer raise funds.² The law firm informed the SEC that its activities as a finder would be limited to introducing the issuer to individuals and entities who “may have an interest” in purchasing the issuer’s securities and then step back and not assist further in the capital raising process. As compensation, the law firm would receive a percentage of the investment amount the issuer raised from the introductions. The law firm further assured the SEC that it would not: (a) engage in any transaction negotiations whatsoever on behalf of the issuer; (b) provide any potential investor with any information about the issuer which could be used as the basis for any funding negotiations; (c) have any responsibility for, nor make any recommendations concerning, the terms, conditions or provisions of any agreement providing funding; and (d) would not provide any assistance to any such contact or the issuer with respect to any transactions involving the financing. In denying the no-action request, the SEC, after noting that the introduction of potential investors “who may be interested in investing” implied certain pre-screening and pre-selling activities by the law firm, concluded that the receipt of transaction-based compensation would give the law firm a “salesman’s stake” in the financing transactions and would create a heightened incentive for the law firm to engage in sales efforts.

In addition to the prescreening activities and transaction-based compensation noted above, other broker-dealer activities an unregistered finder should avoid include: (a) actively soliciting potential investors; (b) advising potential investors about the relative risks and merits of an investment; (c) participating in the valuation or creation of the terms of the securities being sold or participating in negotiations between the issuer and the investor; (d) collecting or holding investor funds; (e) creating, reviewing or providing other assistance with respect to the agreement or other materials documenting the investment;³ (f) providing financing to an investor; (g) providing the issuer with assistance in the preparation and dissemination of offering materials; and (h) introducing the issuer to commercial banks or lawyers or other professionals to facilitate an investment.⁴

¹ See Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter, May 17, 2010 citing Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration, Securities Exchange Act Release No. 61884 (April 9, 2010) (“Indeed, the receipt of transaction-based compensation often indicates that such a person is engaged in the business of effecting transactions in securities.” (internal citation omitted)); and Letter from Catherine McGuire, Chief Counsel, Division of Market’s position that “the receipt of securities commissions or other transaction related [sic] compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of ‘broker’ or ‘dealer’ ... generally is required to register as a broker-dealer.” (internal citations omitted)).

² See Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter, May 17, 2010.

³ See Hallmark Capital Corporation, SEC No-Action Letter, June 11, 2007.

⁴ See Revocation of Prior No-Action Relief Granted to Dominion Resources, Inc., March 7, 2000.

In light of those restrictions, the question arises as to what activities an unregistered finder can engage in without being deemed to be “effectuating transactions in securities”? The answer, to the dismay of many fund managers and entrepreneurs is, not very many. Some will regard it as safe territory if the finder is limited to simply making an introduction in exchange for a flat fee or other non-transaction-based compensation. Even then, however, given the potential negative consequences of performing or engaging an unregistered finder, both the finder and the fund or company should proceed with extreme caution and engage an experienced securities attorney to assist in analyzing all of the surrounding facts and circumstances.

Consequences of Using an Unregistered Finder

Persons who act as unregistered broker-dealers in connection with providing finder services to a fund or company may subject themselves to potential civil and criminal liability under federal and state laws, including penalties, fines, suspension and disbarment. In addition, since Section 29(b) of the Exchange Act provides that contracts entered into in violation of the Exchange Act and its rules and regulations may be rendered void, the unregistered finder may not be able to enforce the fee agreement pursuant to which he or she was engaged as a finder.

While the consequences for the unregistered finder may be daunting, the impact on the fund or company who engaged the unregistered finder may be even more problematic. Consequences include, but are not limited to, the following:

- **Rescission Rights.** As noted, Section 29(b) of the Exchange Act provides that contracts entered into in violation of the Exchange Act may be rendered void. In the case of investors whose investments were arranged by an unregistered finder, Section 29(b) may be used to void the agreements underlying such investments. As a result, the investor is entitled to fully unwind the investment and receive a full refund of all funds invested. This alternative is rarely attractive to an investor if the value of the investment has increased over time. However, if the value of the investment has decreased, exercising what amounts to an inadvertently-granted put right becomes a very attractive way for the investor to recoup losses. It is easy to see that if a sufficient number of investors acquire rescission rights in this way, the fund or company may not have, and may not be able to obtain, sufficient funds to complete the rescission. As a result, such a rescission could pose an existential threat to the fund or company.
- **Aider and Abettor Liability.** Use of an unregistered finder may also subject the fund or company to civil and criminal penalties under Section 20(e) of the Exchange Act, which provides that anyone who provides substantial assistance to someone in violation of the Exchange Act “shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.” In this way, the fund or company becomes liable as if it had illegally performed broker-dealer activities. As a result, the fund or company could be subject to various sanctions from the SEC including fines, criminal sanctions and prohibition on further securities offerings.
- **State Law Compliance.** In addition, funds and companies should be aware of potentially violating state laws through the use of unregistered finders. Various state laws may

provide investors with rescission rights as well, even where the unregistered finder did not contract with such investors.

- Negative Publicity. Any fund or company utilizing the services of an unregistered finder also subjects itself to potential negative publicity from simply being associated with an SEC investigation and potential criminal conduct.

Proceed with Extreme Caution When Engaging Finders

Finding investors willing to invest in a fund or company can be a very challenging and time-consuming endeavor, regardless of overall market conditions. Assistance from finders can be, at first blush, a very attractive means to help fund managers and entrepreneurs reach their fundraising goals. However, given the constraints on permissible activities of unregistered finders, the inability to provide them with transaction-based compensation and the potentially severe negative consequences of using illegal finders, fund managers and entrepreneurs would be well served to avoid the temptation. If the use of unregistered finders is to be considered, experienced securities counsel should be engaged to carefully analyze the propriety of the proposed arrangement.

For more information on these and other considerations, please contact us at (619) 298-2880 or at info@jackolg.com.

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