Securities Alert

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Using Finders to Assist in Financings Can Impose Significant Risks on Your Company

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You have a great new idea and you need capital in order to build your new company. Unfortunately, finding venture capitalists or high net worth "angels" who may be interested in investing in your business is not an easy task. Like many entrepreneurs who find themselves in this predicament, the idea of retaining a "finder" to assist you in locating potential investors can look promising. However, using a finder who is not a registered broker/dealer can create significant risks for your company.

In this article, we provide a brief summary of liabilities and penalties that may result from the use of an unlicensed broker-dealer, as well as guidelines for companies considering using professionals to assist in fundraising. We also provide guidance to individuals or entities attempting to safely operate as finders. It is important to note, however, that the interpretation of the Securities and Exchange Commission (SEC) regulations is broad and often difficult to apply. We recommend that you consult with your legal counsel before retaining any individual or entity to assist in fundraising or acting as a fundraiser.

Potential Risks for Your Business

Using an unregistered broker-dealer to assist with the sale of securities may create a rescission right in favor of the purchasers of the securities, potentially requiring the issuing company to return the money it received for its shares, under both federal and California securities laws. Section 29(b) of the Exchange Act provides that every contract made in violation of the Exchange Act, including contracts for which performance under the contract is a violation of any of the Exchange Act provisions, shall be void as to "any persons who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract."

While Section 29(b) creates risk for the individual operating as the finder, potentially allowing the issuer company to claim its obligations to the finder under the finder's engagement agreement to be void, the language is broad enough that it can also be interpreted to void the contract for the sale of the securities to investors located through the use of the finder. If investors successfully assert this claim, they would have the right to demand that their purchase contract be rescinded and require the issuer company to return their funds. This potential rescission right can have a significant negative impact on a company's ability to raise funds in the future because under federal law the rescission right can be exercised until the later of three years from the date of issuance of the securities or one year from the date of discovery of the violation. In recent transactions for clients seeking venture capital financing, the potential of a rescission right in favor of prior angel investors in a company that used finders who were not registered broker-dealers has raised serious impediments to the closing of the venture financing.

In addition, many states also regulate the registration of broker-dealers. For issuers and purchasers

located in California, for example, a rescission right is explicitly available pursuant to California Corporations Code section 25501.5, enacted by the legislature in 2005, where securities are sold to or purchased from an unregistered broker-dealer. Section 25501.5 also provides that the purchaser can seek damages if he or she no longer owns the security, and gives the court discretion to award a plaintiff seeking rescission attorney fees and costs.

Even if rescission is not demanded by prior investors, the use of an unregistered broker-dealer in a prior transaction will create disclosure requirements in subsequent financings, acquisitions, or offerings. SEC filings require disclosure of compensation paid to finders in connection with an offering, as do many state blue sky filings. Such disclosure may dissuade future investors from investing and may prevent your legal counsel from being able to issue required legal opinions in connection with a subsequent financing. In addition, failing to disclose payments made to unregistered broker-dealers in connection with the sale of securities can expose a company to potential liability for fraud under Section 10b-5 of the Securities Act.

In March 2008, for example, the SEC announced the settlement of fraud charges brought against W.P. Carey & Co., as well as the company's chief financial and accounting officers, for failing to disclose, and later mischaracterizing, compensation paid to a broker-dealer in connection with issuances of securities.[1] The settlement, which included a number of other claims in addition to the failure to disclose, resulted in millions of dollars in fines, disgorgement, and interest, as well as a five-year ban preventing the former Chief Financial Officer (CFO) from serving as an officer or director of a public company. Given the overlapping nexus of state regulation, similar claims could potentially be brought by investors seeking rescission. Further, there is some risk that the failure to disclose the very fact that a finder is not registered as a broker-dealer might itself be characterized in regulatory enforcement or private litigation as a misleading omission that amounts to fraud.[2]

As the SEC steps up its enforcement of regulations requiring registration of broker-dealers, it is also worth noting that issuer companies who engage unregistered broker-dealers and finders may also find themselves subject to SEC action pursuant to Section 20(e) of the Exchange Act for aiding and abetting a violation.[3]

In addition, if a private fund manager is newly required to register as an investment adviser under the Dodd-Frank Wall Street Reform and Consumer Protection Act and engages a finder, then strict disclosure requirements about the solicitation arrangements will apply pursuant to the Investment Advisers Act of 1940 Rule 206(4)-3.

Finally, by utilizing a finder, an issuer company also runs the risk of eliminating potential securities registration exemptions under federal and state law, particularly if the company is not extremely vigilant in monitoring the activities of the finder. Actions by the finder, such as approaching unaccredited investors or engaging in general solicitation, can ultimately prevent the issuer from obtaining an exemption under Federal Regulation D or Section 25102 of the California Corporations Code.

Identifying Unregistered Broker-Dealers

Determining whether a finder is considered a broker-dealer under the Exchange Act can be difficult, but a number of factors provide guidance. The Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." [4] This definition is typically interpreted broadly, and includes such activities as providing advice regarding the value of securities, locating issuers, soliciting new clients, assisting in the structuring and negotiation of securities transactions, and disseminating quotes for securities.[5] Section 15(a)(1) of the Exchange Act provides that "[i]t shall be 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. Given the broad nature of the of the broker-dealer definition, some finders may not realize that their activities have triggered a registration requirement. Below is a list of questions you should ask in assessing

your risks if you are considering retaining a finder:

- ***Does the finder receive transaction-based compensation?***

Often finders will prefer to receive compensation based on a percentage of funds raised by the company. In addition, companies prefer to pay finders only if they are successful in helping to raise capital. However, this type of transaction-based compensation creates a substantial likelihood that the finder would be viewed as a broker-dealer and would be required to register because the SEC considers transaction-based compensation to be a key factor in determining if someone is acting as a broker-dealer.[6]

It is important to note that the amount of compensation, either objectively or in relative comparison to the finder's total income, is irrelevant for purposes of determining whether registration is required. Therefore the finder can be considered to be "in the business" of effecting transactions (as used in the definition of "broker" above) even if the transaction-based compensation is a small part of the finder's total income.[7]

The SEC has elected not to take action against the presumptive broker-dealers under circumstances where transaction-based compensation is not present.[8] In addition, the SEC has recently indicated that the use of finders may be allowed, even where such finder's compensation is transaction-based, where the party acquiring securities is purchasing 100% of the outstanding securities of a business as a going concern. The SEC staff issued a no-action letter to indicate that the staff would not recommend to the commission that the SEC undertake enforcement action with regard to Country Business, Inc. (CBI), where CBI represented (among other factors) that (1) it will have a limited role in negotiations between the seller and purchaser, will not advise either party, and will not assist the purchasers in obtaining financing; (2) the sale in question will be structured as a sale of 100% of either the assets or security interests of the business to a single purchaser, but only the sale of assets would be advertised; and (3) CBI's compensation will be "determined prior to the decision on how to effect the sale of the business, will be a fixed fee, hourly fee, a commission, or a combination thereof, that is based upon the consideration received by the seller, regardless of the means used to effect the transaction and will not vary according to the form of conveyance (i.e., securities rather than assets)."[9] While transaction-based compensation would typically trigger a registration requirement (as discussed above), the CBI no-action letter suggests that transaction-based compensation by unregistered finders is still permissible in limited circumstances in connection with an acquisition or merger, where the terms of such compensation are pre-set and not dependent upon the manner in which the transaction is effected and the finder is advertising a target company as a going concern, rather than securities.

- ***Does the finder engage in solicitation of potential investors?***

The solicitation of potential investors weighs in favor of requiring registration. However, whether an intermediary is engaged in "solicitation" can be a difficult determination because solicitation can take any number of forms. Generally, a solicitation can be any action that is designed to incentivize or persuade another person to purchase the security. Activities as general as newspaper advertisements or as targeted as individually-addressed e-mails may constitute solicitation.[10]

The SEC has recently indicated in a denial of a no-action relief that the introduction of investors "who may have an interest" in a securities investment implies "both 'pre-screening' potential investors to determine their eligibility to purchase the securities, and 'pre-selling' [the] securities to gauge the investors' interest."[11] Both the pre-screening and pre-selling are apparently broker-dealer functions requiring registration in the SEC's view.

- ***Does the finder provide advice or engage in negotiation?***

Providing advice, particularly with regard to the value of the securities involved, or assisting the

investor in negotiating the terms of the sale of the securities will bring the finder within the definition of a broker-dealer. This may also be the case even if the intermediary is performing a "due diligence" function of providing detailed information on the issuer to the investor. For an intermediary's participation to fall reliably outside the definition of a broker-dealer, the intermediary's involvement should not go beyond the "ministerial function of facilitating the exchange of documents or information."[12]

- ***Does the finder have previous securities sales experience or have a history of disciplinary action?***

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 and, in particular, any prior disciplinary action by the SEC, can trigger registration requirements even when other factors listed above are not present.[13]

Risk and Guidelines for Intermediaries Acting as Finders

Finders operating as unregistered broker-dealers may be subject to a number of penalties, the most typical of which is a permanent injunction barring such finder from participating in the purchase or sale of securities. However, the SEC has the power to impose more severe sanctions, such as disgorgement of funds and civil penalties. While historically such harsher penalties have generally been associated only with those cases in which fraud is also present, this is no longer the case. In April 2008, the SEC sanctioned Robert MacGregor, an employee of Duncan Capital who specialized in arranging private investments in public entities, for acting as a broker-dealer without proper registration.[14] The action against MacGregor was brought specifically in response to MacGregor's failure to register as a broker-dealer. The final judgment against MacGregor, absent a finding of fraud, not only barred MacGregor from associating with any broker or dealer for one year, it also required that MacGregor disgorge any "ill-gotten gains" that resulted from the transactions.

Furthermore, as noted above, finders may be unable to collect fees under their engagement agreements with issuers. In 2008, the Supreme Court of New York County in New York denied relief for an unregistered broker dealer who sued to collect fees owed under a contract with an issuer for brokerage services.[15] The fees owed under the contract were calculated as a percentage of the investment dollars raised with the finder's assistance. The court held that the agreement was void and rescindable because the finder was providing services associated with a broker-dealer, but was not a registered broker.

Summary

Particularly in a tight capital market, finding willing investors can be difficult and time- consuming. It is important to remember, however, that the long-term success of your business may be at stake if you choose to engage an unregistered broker-dealer. Transactions in which compensation is provided to an unregistered broker-dealer can make raising subsequent rounds of financing more difficult, make your business a less desirable target for acquisition, and potentially expose you and your company to penalties. If you are considering working with a finder, consultant, or other type of intermediary to assist in your fundraising activities, we suggest that you first seek the advice of corporate counsel.

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Endnotes

1 *See,* SEC Litigation Release No. 20501, also available at http://www.sec.gov/news/press/2008/2008-45.htm.

2 Torsiello Capital Partners v. Sunshine State Holding Corp., 2008 NY Slip Op. 30979, April 7, 2008.

3 As noted by the ABA, in most typical cases the SEC will urge registration and take no further action, provided that such request is complied with. However, where fraud or misrepresentation are present, the SEC generally brings multiple counts, "including violations of the registration provisions for the securities themselves as well as violating the requirement that a broker-dealer be registered." *Id.* at 36.

4 Securities Exchange Act of 1934 § 3(a)(4)(A).

5 *See,* SEC No-Action Letter re: InTouch Global, LLC, November 14, 1995.

6 *Supra* note 1, at 17, *citing* SEC No-Action Letter re: Mike Bantuveris, October 23, 1975 ("The staff noted that its opinion was 'based primarily on the fact that the consulting firm would . . . receive fees for its services that would be proportional to the money or property obtained by its clients and would be contingent upon such transactions in securities."). *See also,* SEC No-Action Letters re: Nemzoff & Co., LLC, November 30, 2010; Brumberg, Mackey & Wall, P.L.C., May 17, 2010; John w. Loofburrow Associates, Inc., June 29, 2006; Wolff Juall Investments, LLC, May 17, 2005

7 *Supra* note 1, at 17. *See also,* SEC No-Action Letters re: Herbruck, Alder & Co., June 4, 2002; Mike Bantuveris, October 23, 1975); John M. McGivney Securities, Inc., May 20, 1985; Richard S. Appel, February 14, 1983.

8 *See,* SEC No-Action Letters re: Putnam Investor Services, Inc., December 31, 2009; Goldman, Sachs & Co., January 17, 2007; TriNet Group, Inc., February 17, 2006; CommandTRADE, LP, December 28, 2005.

9 SEC No-Action Letter re: Country Business, Inc., November 8, 2006.

10 *Supra* note 1 at 19, *citing* SEC v. Schmidt, Fed. Sec. L. Rep. 93,202 (S.D.N.Y. 1971). *See also*, SEC No-Action Letters re: Nemzoff & Co., LLC, November 30, 2010; Hallmark Capital Corporation, June 11, 2007; Mike Bantuveris, October 23, 1975; Victoria Bancroft, August 9, 1987; and F. Willard Griffith, II, October 7, 1974.

11 SEC No-Action Letter re: Brumberg, Mackey & Wall, P.L.C., May 17, 2010.

12 SEC No-Action Letter re: Samuel Black, December 20, 1976. *Compare,* SEC No-Action Letter re: The Investment Archive, LLC, May 14, 2010 (relief granted where intermediary represented that it will not participate in negotiations between parties, assist investors with the closing of the transaction, or handle, receive or direct funds. *See also,* Goldman, Sachs & Co., January 17, 2007.

13 *Supra* note 1 at 20. *See also*, SEC No-Action Letter re: Rodney B. Price and Sharod & Assocs., November 7, 1982.

14 SEC Litigation Release No. 20535, April 23, 2008, *available at* http://www.sec.gov/litigation/litreleases/2008/lr20535.htm.

15 *See Supra* note 2.

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