Bloomberg Law Reports® Securities Law

Capital Raising Using Unregistered Finders and Financial Consultants

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Corporate clients generally are convinced that with sufficient funding their enterprises will succeed. Nevertheless, obtaining that capital often is elusive. In many cases, an enterprise is not sufficiently advanced for traditional sources of capital to be interested. Generally, these enterprises learn that they first must raise additional capital from friends and family or angel investors, and that after this initial round of funding an investment banker is in a much better position to assist with obtaining capital from more traditional sources. If friends, family, and angel funds are unavailable or inadequate, the entrepreneur often becomes desperate for funds and is susceptible to sales pitches from so-called "finders" or "financial consultants." These entities offer to raise capital for the enterprise in exchange for a percentage fee tied to the amount raised. The retainer agreement also frequently requires an up-front non-refundable “expense and due diligence deposit.”

Which Consultants and Finders Are Legitimate—and Which Are Not?

Although there certainly are legitimate financial consultants and finders who operate within the proper legal framework, a number of problems exist with respect to some of the less legitimate ones. The most unscrupulous of these simply will collect the up-front fee and never be heard from again. Others actually will attempt to raise capital. The problem is that these finders rarely are registered with the Securities and Exchange Commission (SEC) as "brokers" or with the appropriate state agency, such as the Florida Office of Financial Regulation (Florida OFR), as "dealers."[1] Section 3(a)(4) of the Securities Exchange Act of 1934, (Exchange Act), defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[2] Section 517.021 of the Florida Statutes defines a "dealer" as a person "who engages, either for all or part of her or his time, directly or indirectly, as broker or principal in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."[3] As a result, the consultant's or finder's activity of raising capital in exchange for a fee might render him a "broker" under federal law and a "dealer" under Florida law.

Securities laws are interpreted broadly to protect the public. The burden of proof is on the person claiming that he is not subject to registration to demonstrate facts that support that conclusion.

The High Cost of Hiring an Unlicensed Broker

Using the services of an unlicensed broker in a securities offering can have draconian consequences. First, the unlicensed broker could be the subject of enforcement actions by the SEC and the appropriate state regulatory authority. Second, in Florida, for example, the broker (as the issuer's agent) and the issuer he is representing are rendered jointly and severally liable in a rescission action (or a damage action if the securities have

been sold by the purchaser) by the purchasers of the securities. In fact, this joint and several liability extends to the issuer and the issuer's officers, directors, partners, and agents to the extent such persons participated or aided in making the sale.[4] A person performing a broker function has been held to be an "agent" of the issuer for purposes of the Florida Statutes.[5]

The possibility of rescission by the investor also exists at the federal level. Section 15(a)(1) of the Exchange Act requires that any person transacting business as a broker or dealer register with the SEC.[6] Some older authority indicates that failure to register might give rise to a private right of action against the broker under Section 15(a)(1), although modern authority generally rejects such a right.[7] Nevertheless, Exchange Act Section 29(b) provides that "every contract made in violation of [the Exchange Act] . . . and every contract . . . the performance of which involves the violation of . . . [the Exchange Act] . . . shall be void: (1) as regards the rights of any persons who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract . . . ."[8] Hence, the contract between the issuer and the unregistered broker-dealer clearly is voidable by the issuer, because the unregistered broker-dealer could not carry out his obligations under the contract without violating the Exchange Act.

The question that follows is whether the securities purchase contract between the investor and the issuer is voidable also. Some judicial authorities suggest that such a rescission right cannot be based upon solely the broker-dealer's failure to register because the purchase contract between the issuer and investor, itself, may not be illegal.[9] Under these authorities, the right to seek rescission under Section 29(b) turns on whether the violation of the Exchange Act is "collateral or tangential to the contract between the parties," or whether the violation alleged is "inseparable from the performance of the contract."[10] As noted in the American Bar Association's Report and Recommendations of the Task Force on Private Placement Broker-Dealers (Report): "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 in 29(b) is broad enough to permit such an interpretation."[11]

Also, where a broker-dealer's failure to register renders statements made in connection with the offer or sale of a security false or misleading, courts generally approve claims for rescission. "[A]n individual violates Section 10(b) [of the Exchange Act]—and therefore triggers Section 29(b)—when he or she employs manipulative or deceptive devices in connection with the offer and sale of securities."[12] Of course, the purchaser also must show that the failure to disclose the participation of the unregistered broker-dealer was done intentionally or recklessly to meet the scienter requirement of Section 10(b). Also, and as the Report notes:

> A consistent theme in the [SEC] proceedings against unregistered broker-dealers has been the lack of disclosure of compensation paid to such individuals or entities . . . [T]he failure to disclose [such] compensation in the presence of even a single non-accredited investor destroys the exemption for failure to meet the Rule 502 disclosure requirements.[13]

Arguably, the exemption is lost only with respect to the non-accredited investors entitled to such disclosure. Because accredited investors are not entitled to disclosure under Securities Act of 1933 (Securities Act) Rule 506 in the first place,[14] the failure to disclose illegal broker compensation potentially is not fatal to the exemption with respect to them. Securities Act Rule 508 states that if the issuer made a good faith effort to comply with Regulation D, a failure to comply fully is not fatal to the exemption to the extent that the "failure to comply did not pertain to [an exemption

requirement] directly intended to protect [that purchaser]; and [such] failure to comply was insignificant with respect to the offering as a whole. . . ."[15]

The loss of the Rule 506 exemption also has an effect on state regulation. Section 18(b)(4)(D) of the Securities Act preempts much of state law relating to registration of Rule 506 offerings.[16] However, if the Rule 506 exemption is lost, the offering likely is subject to state regulation. Most states follow the Uniform Securities Act, which conditions an exemption from registration only on paying commissions to registered broker-dealers.[17] In summary, to the extent Rule 506 is not available in the offering, state blue sky laws will not provide an exemption in those states, creating a rescission right.

The requirement of broker-dealer registration is designed to protect the investing public, and the sale of securities by unregistered broker-dealers undermines this public policy rationale. This fact, coupled with a showing that the failure to register may have rendered statements regarding the offering false or misleading, should help courts conclude that a private right of action under Exchange Act Section 29(b) should exist in transactions involving unregistered broker-dealers. Also, an issuer's simple failure to disclose that the broker-dealer is unregistered may be considered an omission of a material fact and give rise to a rescission right under state and federal anti-fraud provisions.

Finally, as noted above, numerous states extend rescission rights to the buyer in transactions involving unregistered broker-dealers. These state laws are distinct from the securities registration and exemption provisions and are not preempted by Section 18 of the Securities Act.

What Activities Confer Broker and Dealer Status?

Whether the person in question characterizes himself as a "finder" or a "financial consultant" is irrelevant in the various no-action letters rendered by the SEC staff (Staff). Although the no-action letters sometimes are inconsistent in their conclusions, several factors have emerged as particularly important in determining whether a consultant or finder must register as a broker-dealer:

1. Whether the person found investors for the issuer.
2. Whether the person merely introduced the prospect to the issuer or engaged in any formal negotiations between the issuer and a prospect concerning the price to be paid, the form of the transaction, or any other material term or condition of the transaction.
3. Whether the person provided advice or recommendations to a prospective investor with regard to the merits of the proposed transaction, including the likelihood of success of the issuer's activities.
4. Whether the person held any funds involved in the securities transaction.
5. Whether the person has engaged in other securities transactions in the past, and whether he intends to engage in such transactions in the future.
6. How the person is to be compensated in the transaction, i.e., commission, hourly rate or flat fee. As is explained below, transaction-based compensation is often an important consideration in determining whether a person is a broker-dealer because of the potential it may lead to abusive sales practices.

The following no-action letters illustrate the relative importance of the factors set forth above. Although federal authority primarily is cited below, state courts and securities administrators often look to federal authority for guidance in interpreting similar provisions of state law.

— Financial Consultants

The Staff, in *Benjamin & Lang, Inc.,*[18] stressed the importance of a financial consultant not acting as the issuer's agent in soliciting purchasers for a sale of securities on a negotiated basis, but instead limiting his activities to acting as the issuer's consultant in negotiations with *issuer-selected* purchasers.[19]

Similarly, in *Stamp Collector Associates, Inc.*,[20] a financial consultant was not required to register even though he was involved intimately in assisting the issuer in preparing a public offering and even though his fee (a $160,000 flat fee) was to be paid from the proceeds of the proposed offering.[21] The Staff focused on the fact that the consultant would not participate directly or indirectly in the sale of the securities and would have no part in finding or soliciting purchasers.[22]

Russell R. Miller & Co.[23] involved an entity created to identify acquisition prospects in the insurance industry.[24] Miller would be paid either an hourly fee or a percentage fee depending on the identity of the acquirer.[25] Miller's principal role following introduction of a prospect was to render advice to its client.[26] Miller did not participate in negotiations on behalf of the client, and was to play no part in determining whether the acquisition would be for cash, debt, or securities.[27] The Staff took a no-action position.[28]

In *Dominion Resources*,[29] a consultant advised the issuer regarding the terms of the offering; introduced the issuer to lawyers, brokers and underwriters; assisted in the preparation of disclosure documents; and participated in meetings with the offering team.[30] The consultant also would introduce the issuer to a commercial bank to act as the initial purchaser of the securities and as a standby purchaser if the securities could not be marketed readily by the underwriter.[31] In taking its no-action position, the Staff particularly noted that the consultant served only in an advisory capacity and could not bind the issuer.[32] Although payment of the consultant's fee was conditioned upon the closing of the financing, and although a public debt offering was contemplated, the Staff noted that payment of the fee was not based upon successful issuance of securities to the public or subsequent trades thereafter.[33]

Although the distinction that is drawn here is hard to understand—obviously, there would be no closing if the securities were not in fact sold to the public—the key appears to be that the consultant's activities were removed from the actual sales activity by the underwriters to the public.

In March of 2000, the Staff withdrew the no-action position taken in *Dominion Resources***,** stating that "[t]he staff no longer believes that an entity conducting the activity described in that letter would not have to be registered as a broker-dealer under Section 15 of the Exchange Act."[34] The Staff referred to some of the "finder" no-action letters as representing its current thinking with respect to broker-dealer status and the activities of consultants and finders.[35] The Staff particularly noted that Dominion would both participate in negotiations and introduce issuers to potential securities purchasers.[36]

— Finders

As is clear from *Dominion Resources*, and from the following no-action letters, if a finder locates a purchaser of securities (in the case of *Dominion Resources*, a bank) and also participates in the negotiation of the transaction, the Staff generally requires registration.

In *Davenport Management*,[37] the Staff refused to take a no-action position in a situation where a finder engaged in repeated finder activity; acted as an intermediary in the transaction; participated in negotiations; received compensation tied to securities transactions; and had direct contact with outside investors.[38] The Staff stated that such activity rendered the finder a "broker" within the meaning of Section 3(a)(4) of the Exchange Act.[39] In this author's experience, the proposed activities set

forth in *Davenport* track very closely the activities generally performed by finders.[40]

Birchtree Financial Services Inc.[41] involved the routing of commissions or other transaction-related compensation from a broker-dealer to an unregistered entity established and controlled by the broker-dealer's registered representatives.[42] The Staff refused to take a no-action position, noting that "the receipt of securities commissions or other transaction-related compensation is a key factor in determining whether a person or entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation . . . generally is required to register as a broker-dealer . . . ."[43]

The Staff took a no-action position in *Paul Anka*,[44] involving Mr. Anka's assistance in the offering for sale of limited partnership units in the Ottawa Senators hockey team.[45] Mr. Anka's involvement included furnishing the issuer with names and telephone numbers of persons with whom he had a pre-existing relationship and whom he believed might be interested in purchasing the units.[46] The Staff noted that Mr. Anka would not participate in negotiations between the issuer and the potential investor, solicit potential investors; make recommendations regarding prospective investments; participate in the advertisement or general solicitation of the partnership units; or participate in preparing the offering materials.[47] Finally, the Staff noted that Mr. Anka had not engaged in any offering previously and did not intend to do so in the future.[48] Under these circumstances, the Staff took a no-action position even though Mr. Anka was to be paid a ten percent commission of any units sold.[49]

Carl L. Feinstock[50] involved the payment of a commission to a finder who would put an issuer in contact with potential investors who were known to the finder.[51] The finder would not be involved in any negotiations between the issuer and the investors, attempt to value the investment, or give any advice to prospective investors regarding the issuer's proposed business.[52] The Staff noted that the finder had not engaged in any private or public offerings of securities previously and did not have a current intention of doing so beyond this transaction.[53] Based upon the above factors, the SEC took a no-action position.[54]

Conclusion

A few patterns emerge from these no-action letters:

1. If an entity is serving in a true financial consultant role in an acquisition, and if the target is obtained by the issuer, the consultant may advise his client regarding the value of the prospective target and help negotiate with the target.
2. If the entity is acting as a finder, i.e., has located prospects for the purchase of securities and introduced them to the issuer, generally the Staff will take a no-action position if the finder has no additional participation in the transaction other than the performance of ministerial activities. If the finder participates in the negotiation of the terms of the transaction, however, or advises the prospect as to the value and/or desirability of the proposed investment, the Staff almost always requires registration. Although in several cases commission-based compensation takes on particular prominence, generally that form of compensation is not in and of itself determinative.

In conclusion, there are instances in which financial consultants and finders can provide valuable services without the necessity of registration as a broker-dealer. These circumstances are limited, however, and in this author’s experience, the services offered by finders are generally too comprehensive to avoid the requirement of registration. As mentioned above, the fact pattern

in the *Davenport Management* no-action letter mirrors most closely the menu of services generally offered by such finders. Because of the severe ramifications of using an unregistered broker-dealer, counsel should review carefully any proposed participation of a finder or financial consultant in a transaction involving the sale of securities.

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The author would like to acknowledge the contributions of Summer Associate Scott Stevenson in the preparation of this article.

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1 Although Florida law is used as an example in this Article, many states require registration of "brokers" and "dealers" and have definitions of such terms similar to those used in the Exchange Act and Florida Statutes. Many states also provide for the rescission remedy discussed in this Article. *See, e.g.*, **CAL. CORP. CODE § 25501.5(a)(1)** (West 2011) (any person who purchases a security from an unregistered broker-dealer may bring an action for rescission or damages); **OHIO REV. CODE ANN. § 1707.43(A)** (West 2010) (providing that "every sale or contract for sale made in violation of [the registration statutes] is voidable at the election of the purchaser"); **WASH REV. CODE § 21.20.430(1)** (2011) (allowing investors to sue unregistered brokers to revert to the status quo); **MASS. GEN. LAWS ch. 110A, § 410(a)** (2010) (same).

2 15 U.S.C. § 78c(a)(4)(A) (2006).

3 Fla. Stat. § 517.021(6)(a)(1) (2010).

4 Fla. Stat. § 517.211(1) (2010).

5 *Arthur Young & Co. v. Mariner Corp.*, **630 So. 2d 1199**, **1204–05** (Fla. Dist. Ct. App. 1994).

6 15 U.S.C. § 78o(a)(1) (2006).

7 *See, e.g.*, *Goodman v. Shearson Lehman Bros., Inc.*, **698 F. Supp. 1078** (S.D.N.Y. 1988).

8 *Reg'l Props., Inc. v. Fin. & Real Estate Consulting Co.,* **678 F.2d 552**, **560** (5th Cir. 1982); *see also GFL Advantage Fund, Ltd. v. Colkitt,* **272 F.3d 189**, **201** (3d Cir. 2001).

9 *Slomiak v. Bear Sterns & Co.,* **597 F. Supp. 676**, **681–82** (S.D.N.Y. 1984) ("[U]nder § 29 of the Exchange Act, only unlawful *contracts* may be rescinded, not unlawful *transactions* made pursuant to lawful contract." (emphasis in original)); *Drasner v. Thomson McKinnon Sec., Inc.,* **433 F. Supp. 485**, **501–02** (S.D.N.Y. 1977).

10 *GFL Advantage Fund*, 272 F.3d at 201.

11 A.B.A. Section of Business Law, *Report and Recommendation of the Task Force on Private Placement Broker-Dealers*, *reprinted in* 60 BUS. LAW. 959, 999 (2005) [hereinafter ABA Report].

12 *GFL Advantage Fund*, 272 F.3d at **206** n.6.

13 ABA Report, *supra* n.11, at 972 (internal footnotes omitted).

14 *See* **17 C.F.R. § 230.506** (2010).

15 17 C.F.R. § 230.508 (2010).

16 15 U.S.C. § 77r(b)(4)(D) (2006).

17 UNIF. SEC. ACT § 202(14)(C) (2002).

18 SEC No-Action Letter to Benjamin & Lang, Inc. (Aug. 1, 1978).

19 *Id.*

20 SEC No-Action Letter to Stamp Collector Assocs., Inc. (Nov. 21, 1971).

21 *Id.*

22 *Id.*

23 SEC No-Action Letter to Russell R. Miller & Co. (Aug. 15, 1977).

24 *Id.*

25 *Id.*

26 *Id.*

27 *Id.*

28 *Id.*

29 SEC No-Action Letter to Dominion Res. Inc. (Aug. 22, 1985), *revoked by* **SEC No-Action Letter to Dominion Res. Inc. (Mar. 7, 2000)**.

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 SEC No-Action Letter to Dominion Res., Inc. (Mar. 7, 2000).

35 *Id.*

36 *Id.*

37 SEC No-Action Letter to Davenport Mgmt., Inc. (Apr. 13, 1993).

38 *Id.*

39 *Id.* (*citing* 15 U.S.C. § 78c(a)(4)(A)).

40 *See* **SEC No-Action Letter to John R. Wirthlin** (Jan. 19, 1999) (refusing to take no-action position where finder explained investment opportunities to clients, arranged meetings, and received transaction-based compensation); *see also* **SEC No-Action Letter to PRA Sec. Advisors, LP** (Mar. 3, 1993) (refusing to take no-action position where investment advisor was actively involved in negotiating terms of securities transactions).

41 SEC No-Action Letter to Birchtree Fin. Servs., Inc. (Sept. 22, 1998).

42 *Id.*

43 *Id.*; *see also* **SEC No-Action Letter to 1st Global, Inc.** (May 7, 2001).

44 SEC No-Action Letter to Paul Anka (July 24, 1991).

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.*

49 *Id.* The Commission also seems more likely to take a no-action position when the transaction involves the sale of business, as opposed to the sale of equity in an issuer to a number of investors. *See* **SEC No-Action Letter to Int'l Bus. Exch. Corp.** (Dec. 12, 1986) (finding that broker paid on commission who introduced parties to the sale of a business but performed no other tasks except ministerial activities did not have to register); *see also* **SEC No-Action Letter to Country Bus., Inc.** (Nov. 8, 2006) (reaching the same conclusion on similar facts); *cf. Edelstein v. Flanagan*, **620 So. 2d 1205**, **1206** (Fla. Dist. Ct. App. 1994) (finding that a real estate broker who aided in all-stock sale of business was not a "dealer" under Florida law).

50 SEC No-Action Letter to Carl L. Feinstock (Apr. 1, 1979).

51 *Id.*

52 *Id.*

53 *Id.*

54 *Id.*; *see* **SEC No-Action Letter to Charles H. Swanke** (May 6, 1980) (taking no-action position where finder took percentage-based

commission but did not handle money, make recommendations, or negotiate with parties); **SEC No-Action Letter to Colonial Equities Corp.** (Nov. 2, 1987) (taking no-action position where entity received percentage-based commission for referring investors but provided no hands-on assistance other than reviewing potential investors' biographical and financial questionnaires for completeness).