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INTRODUCTIONS FOR SALE:

FIVE FACTS AN ISSUER SHOULD CONSIDER BEFORE PAYING A FINDER'S FEE

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WHY FINDERS MAY NOT BE KEEPERS

For reasonable cost, simplicity and convenience, the appeal to a securities Issuer of a finder's fee for capital raised sounds tempting.

Hungry to raise capital, fledgling securities Issuers, however, may leap too quickly at promises for low-cost investor introductions by engaging unregistered finders[1] with uncertain expertise. Issuers seeking investor introductions by engaging finders are often conducting the sale of Non-Public Private Placement offerings based on an exemption from the registration requirements of Section 5 of the Securities Act of 1933 ("Securities Act"). Regulation D Rules 504, 505 and 506[2] provide exemptions from the registration requirements of the Securities Act, allowing some Issuers to offer and sell their securities without having to register the securities with the SEC.

Finders may be the capital raiser of choice for early-stage companies, or, as the U.S. Securities and Exchange Commission ("SEC") believes they may be unregistered broker-dealers. Finders raise capital for Issuers that might not otherwise have capital on their own or, more importantly, would not draw the attention of investment bankers, who by definition are licensed broker-dealers. Finders and those who employ them must be aware of the risks associated with their services and the requirements imposed on them by the federal securities laws. Issuers or individuals who intend to use a finder—or those engaged as one—must be aware that certain activities require registration, the lack of which may bring about serious consequences.

To be fair, the appeal to Issuers paying finder's fees was facilitated by the SEC back in 1991 when it drafted a No-Action Letter that allowed the Ottawa Senators Hockey Club to pay a finder's fee to entertainer Paul Anka to help the Club raise capital from investors. At that time, the former teen heart throb agreed to provide the Club a list of his personal contacts in exchange for a commission-like transaction fee based on what his contacts brought to the Club in terms of a capital investment in the organization.[3]

After the Paul Anka no action letter, in SEC v. Kramer, the SEC rejected a looser finder description, which, in contrast to providing a simple introduction, actually brought together parties for the purposes of a securities transaction. Such an arrangement did trigger the need for registration.[4] The SEC also issued a No-Action Request Denial Letter to Brumberg Mackey & Wall PLC[5] in which it appeared to reject

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[1] An Issuer raising capital through a private securities offering will often retain a finder to locate investors and possibly help negotiate the terms of the financing. It's fairly common for the Issuer to agree to pay the finder a transaction-based fee tied to the amount of money raised through the finder's efforts. Unfortunately, this seemingly simple arrangement can be a trap for the unwary.

[2] See Code of Federal Regulations §230.504, §230.505 and §230.506.

[3] See Paul Anka, SEC No-Action Letter dated July 24, 1991.

[4] S.E.C. v. Kenneth R. Kramer, et al., 778 F.Supp.2d 1320 (April 1, 2011).

[5] See Brumberg Mackey & Wall PLC, Denial of No-Action Request dated May 17, 2010.

the possibility that an unregistered finder can be compensated based on capital raised in a proposed transaction. The letter stated that in effect, a "salesman's stake" in the proposed transaction would create a heightened incentive which would require broker-dealer registration.

CHALLENGES AHEAD

Other challenges to finder fee transactions have touched on the role of technology in opening up more doors to transaction participants; the use and misuse of shell organizations and other sticking points. By allowing a transaction-based fee to be paid to Paul Anka, an unlicensed finder, the SEC opened the door to a kind of grey zone that colored outside the lines set down by the Securities Exchange Act of 1934 ("Exchange Act") and numerous state securities laws.

> **Simply stated, it is unlawful to "effect any transaction in, or induce or attempt to induce the purchase or sale of, any security" without first registering as a broker-dealer with the Securities and Exchange Commission (SEC) and applicable state regulators.[6]**

Registered broker-dealers must also be members of a self-regulatory organization-generally the Financial Industry Regulatory Authority (FINRA, formerly known as the National Association of Securities Dealers) and comply with SEC regulations regarding financial responsibility and market conduct.

In providing its rationale for its departure from the Exchange Act the SEC made clear that the author of the pop song "Diana" had a very limited involvement in the offering. Factors considered by the SEC included the following:

- Anka had a pre-existing relationship with investors;
- Anka had a reasonable belief that the investors were accredited;
- Anka did not advertise, endorse or solicit investors;
- Anka made no personal contact;
- Anka did not advise on valuation;
- Anka had never been a broker-dealer.

FINDER'S FEES HAVE A HIDDEN COST

Often Issuer's will want to use a "finder" to assist in the offer and sale of their securities offering. As discussed, generally a "finder" is someone who is not a licensed broker-dealer. The SEC and FINRA frown upon the use of finders and the payment of fees to finders. In certain states, the use of a non-licensed broker-dealer finder could result in a violation of that State's Blue Sky laws and loss of the securities registration exemption and may give rise to rescission rights for the purchaser. Accordingly, before engaging a finder to assist the Issuer in the offering, the Issuer should consult with its legal counsel. While in search for the capital needed to grow their respective businesses, Issuers should take a moment to consider these five facts about finder's fees before signing a contract or entering into some other type of arrangement with a finder.

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[6] See Securities Exchange Act of 1934 §15 Registration and Regulations of Brokers and Dealers.

FACT #1: THE ROLE OF "FINDER" IS PROBLEMATIC

Not just anyone can qualify as finder. Or can they?

The vagueness around defining what a finder is may prove worrisome for Issuers in a hurry to raise capital and meet potential investors. While SEC regulations do provide for a "finder exemption" from broker-dealer registration requirements, it is simultaneously narrowly defined and frustratingly vague.

Exchange Act Rule 3a4-1[7] provides a safe harbor from broker-dealer registration requirements for an associated person of the Issuer in certain limited circumstances if the following criteria are met:

- The finder must be a person who is a director, officer or employee of the issuer;
- The finder must have substantial duties other than capital-raising;
- Finally, the finder must not be compensated by an arrangement that depends on the success of the finder's securities sales efforts.

Distinguishing between what constitutes an introduction and a sales effort isn't clear. In general, the exception applies only if the finder's role is limited to introducing the parties or merely giving names to the Issuer. Any role in discussing the Issuer's capabilities may tilt the balance from finder to broker-dealer.

FACT #2: LACK OF TRANSPARENCY: QUALIFICATIONS UNKNOWN FOR UNREGISTERED FINDERS

As an Issuer will you require an individual be involved in effecting transactions in the securities subject to the offering or are mere introductions satisfactory? Without the legal and regulatory constraints and conditions of a formal contract, finders may unwittingly expose both the Issuer and the offering to, among other things, loss of certain regulatory exemptions.

FACT # 3: FINDER'S FEE TRANSACTIONS ARE REVERSIBLE

SEC finder's fee exemptions are not settled case law. Although the Paul Anka No-Action Letter has not been withdrawn by the SEC, there have been recent hints that the SEC staff would not reach the same conclusion today. To date, the SEC has yet to adopt a simplified registration process for finders. Without such clarity, finder's fee transactions can be challenged.

Additionally, such challenges in effect provide a put right to purchasers, looking to rescind a purchase solely because the Issuer completed a transaction without the services of a licensed broker-dealer. In the case of Berkeley Inv. Group,[8] for example, it was established that if an agreement cannot be

[7] See Securities Exchange Act Rule 3a4-1. Associated Persons of an Issuer Deemed not to be Brokers.

[8] See The SEC v. Unlicensed Broker/Dealers: The Good Bad, and The Ugly by William H. Caffee, White Summers Caffee & James, LLC Page 5 citing Berkeley Investment Group LTD v. Douglas Colkitt; Shoreline Pacific Institutional Finance, The Institutional Division of Finance West Group; National Medical Financial Services Corporation Appellant. 455 F.3d 195.

performed without violating the securities laws, that agreement is subject to rescission under Section 29(b) of the Exchange Act.

FACT #4: BROAD CONSEQUENCES FOR UNAUTHORIZED SECURITIES

Much can go wrong quickly if an Issuer colors outside of the lines where securities transactions are concerned.

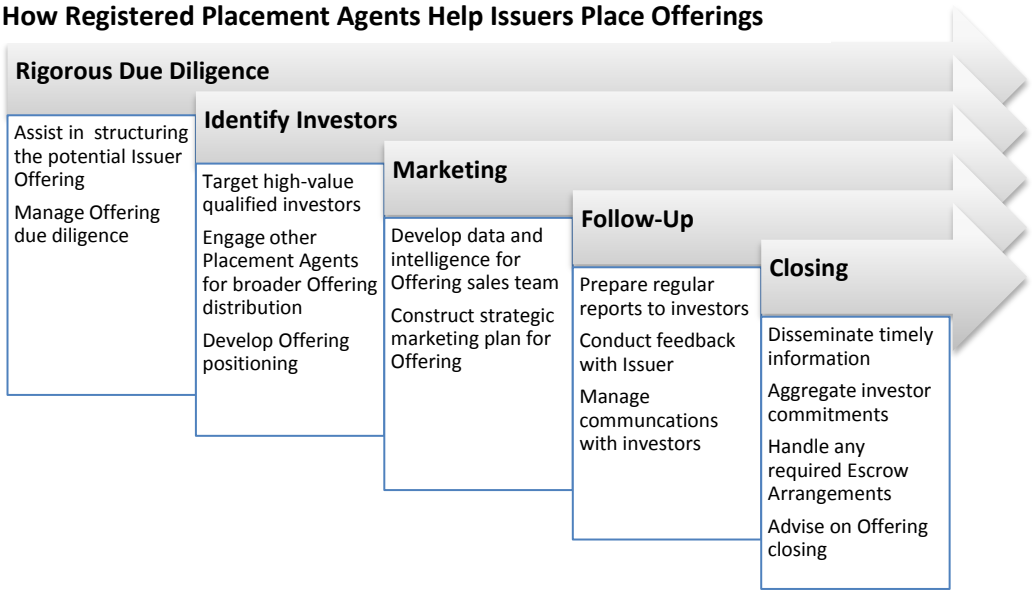
Issuers and finders face a raft of regulatory problems; including cease-and-desist orders, injunctions, civil penalties by both the SEC and State Securities Commissions and possible criminal referral. An unregistered finder acting on behalf of the Issuer may be compelled to return their commission, fee and expenses.

The SEC has determined these activities constitute actions of a broker-dealer –not a finder	
Receipt of transaction-based compensation	A person who receives transaction-based compensation in connection with a securities transaction is almost always deemed to be a broker-dealer.
Negotiation or advice	A financial intermediary involved in negotiations or who provides detailed information or advice to a buyer or seller of securities is likely to be deemed a broker-dealer.
Solicitation of investors	Solicitation is a factor that weighs in favor of finding a person to be a broker-dealer.
Previous securities sales experience or disciplinary action	Previous experience selling securities and/or discipline for violations of securities laws indicate that regulators will consider a person a broker-dealer.

Lastly, the SEC and State Securities Regulators could bring an enforcement action against the Issuer for, among other things, aiding and abetting the finder's violation or violating anti-fraud provisions by engaging in an illegal offering.

FACT #5: REGISTERED PLACEMENT AGENTS OF BROKER-DEALERS OFFER GREATER EXPERTISE

How Registered Placement Agents Help Issuers Place Offerings



There are tens of thousands of Issuers who may be too small to afford a dedicated marketing team and depend on the services of third-party marketers.

Fortunately, such firms are not limited to finders alone. Private Placement Agents, on the other hand, are registered as broker-dealers and can serve as external marketers for all types of Issuers in domestic, foreign, and emerging markets. Issuers include any of the following types of funding vehicles:

- Corporations;
- Private Equity;
- Venture Capital;
- Real Estate; and
- Hedge Funds.

These Private Placement Agents range from specialized divisions of large brokerage firms to small and mid-sized independent firms that are only in the Private Placement business. Legitimate Placement Agents are regulated by the SEC, FINRA and other Federal, State and international agencies and authorities.

Private Placement Agents have a range of qualifications, skills and capabilities that finders quite often lack, including:

- Both alternative asset class and general investment experience;
- Private equity buy-side and sell-side industry experience;
- Substantial and timely understanding of securities, markets and the economy;
- Prior relationships necessary to optimize the capital raising process;
- Capabilities for conducting thorough due diligence on an offering, its principals and strategy;
- Thorough vetting by SEC as registered broker-dealers and regulated by FINRA and various State Securities Commissions;
- Commitment to legal, ethical, and regulatory compliance;
- Qualified securities licensing according to their sales and supervisory responsibilities.

CONCLUSION

As an Issuer, is it worth it to your firm to count on introductions from unregistered finders to raise the capital needed to grow your business?

It might be.

As an Issuer, your firm has likely committed to a rigorous level of oversight on what these unregistered individuals are doing in the name of your firm. Even so, as an Issuer, your firm's finder's fee agreements may not be enforceable if challenged by an unhappy investor.

Without a clear statement from the SEC, both Issuers and finders need to exercise caution before proceeding in what is effectively a grey market in securities: permissible on the surface, yet not wholly legal. Generally, almost anything more than providing a name and contact information for a prospective purchaser of a security will be deemed to be "effecting" a securities transaction and require registration as a broker-dealer.

If your firm doesn't prefer to operate in the finder's fee grey zone and if qualified expertise is important to your business model, a registered Private Placement Agent may offer more to your firm. Registered Private Placement Agents, can help your firm minimize its exposure to transaction liabilities, while providing investors with a greater level of proven, authorized expertise and oversight relative to the merits of the underlying securities.

The opinions expressed in this paper are solely those of the author and do not represent those of any regulatory authority. These opinions should not be construed as any legal, financial or investment advice.

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COMPLIANCENOW.BIZ is a financial industry consulting firm dedicated to helping broker-dealer and advisor firms, both existing and aspiring, to keep abreast of ever-increasing compliance obligations, grow revenue, and expand their reach. The philosophy of the firm is grounded in experienced and creative business development consulting.

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