# Finders, weepers

## GPs should keep unregistered broker dealers away from deals.

By Edward M. Zimmerman, Scott Ring and Steven M. Hecht

Startup Inc., an early stage company, is seeking venture capital. The CEO's lack of contacts has led to difficulty in securing meetings with VCs. He meets Joe Shady, a finder. Shady talks up his Rolodex and offers access to "every VC worth contacting." Shady is so confident of his abilities that Startup need only pay Shady if the investment closes. The CEO enters into Shady's short agreement without bothering with the expense and delay of legal review. Shady starts dialing for dollars. Independently, the deal picks up momentum and other investors present term sheets. Startup, now on the verge of receiving venture, hires counsel. Counsel looks at Shady's agreement and rushes for the ulcer medicine (which counsel to early stage ventures should always keep nearby).

Why the acid indigestion? Because Shady is not a registered broker-dealer, which will taint the financing and potentially render it voidable. The CEO was far too generous with the fee structure and, worse, Shady's simple agreement contains a 24-month "tail," meaning any investment completed within 24 months after Shady's termination triggers Startup's obligation to pay both cash and equity - regardless of whether Shady generated the introduction! The investors now have three chief concerns: (1) how much of their capital will fund operations (as opposed to funding Shady), (2) will the deal be voidable under securities laws, and (3) what does this say about the judgment of the CEO they are about finance? What's more, finders often use a "magic Rolodex" of investors with whom they do not have a preexisting relationship, resulting in a "general solicitation" of the securities, severely jeopardizing the offering and the company.

This story is no mere hypothetical. We have been company or investor counsel more times than we would care to recall where we confronted these facts (or close cousins of them).

## The law on finders

A "finder" brings together a buyer and seller in M&A or other securities transactions. The line between "finders" and unregistered broker dealers is thin - we'd say "fine" but the SEC's fact-sensitive approach renders it difficult to divine the precise contours of that line. In fact, this area is so confusing that number one among the "Top Ten Securities Regulation Recommendations" in the Final Report coming out of the SEC's December 2003 forum on small business was a request to "address the regulatory status of finders."

Here's what we can glean from statutes, SEC No-Action letters (informal interpretive statements in response to given facts), cases, and commentators. According to Section 15 of the Securities Exchange Act, "any person engaged in the business of effecting transactions in securities for the account of others" must register with the SEC as a broker-dealer. Registered national securities associations and exchanges, in which membership is compulsory for all registered brokers, supervise broker activity. The SEC provides additional oversight of registered brokers through enforcing the federal securities laws and financial responsibility rules.

The finders exemption refers to the belief that independent businesspeople who do not "effect securities transactions," but rather "bring merger or acquisition-minded persons or companies together" without further involvement in the deal probably need not register as broker-dealers. Yet this exemption is often difficult to square with SEC pronouncements. For instance, harmonizing the SEC's December 2005 "Guide to Broker-Dealer Registration" with no-action letters and commentary, it appears that people who find investors in venture and M&A deals "even in a consulting capacity" probably have to register if they: (a) participate in important aspects of a securities transaction (soliciting, executing, negotiating, or structuring the deal), (b) receive transaction-based compensation (a fee contingent on the deal closing or increasing or decreasing based on deal size) or trailing fees, (c) value the securities being issued, (d) provide financing or handle the cash or securities at issue, or (e) otherwise engage in the business of effecting or facilitating securities transactions.

Other factors also heighten or diminish the likelihood of a broker-dealer registration obligation. For instance, finders in sales of the whole company are more likely to be exempt from registration than those involved in private placements. The "finder exemption" also seems more applicable where the business is a legitimate going concern as opposed to a shell.

## Anka facts

While no single factor uniformly determines the exemption's applicability, transaction-based compensation may be the factor that now comes closest to single-handedly requiring registration. The exception that proves this rule, lies in the remarkably narrow facts of a 1991 no-action letter involving Canadian singer/songwriter, Paul Anka. The SEC stated that it would recommend against enforcement where, a Canadian hockey team, sought to compensate Anka, who was a partner in the business, using transaction-based compensation for finding investors. Anka limited his involvement to identifying potential investors, each of whom Anka reasonably believed to be accredited. Apparently, and significantly, an earlier request for SEC no-action comfort in this matter indicated that Anka would make the initial contact; that request was revised. The SEC no-action letter is premised partially on the understanding that after supplying contact information, Anka exited the process, and only the company's executives would pursue prospective investors. Anka did not negotiate, recommend, advertise or solicit the investment. Nor did he assist in diligence or provide any financing or valuation services. Significantly, Anka had not served as a finder before and expressed an intent not to do so again.

Despite these narrow facts, commentators question whether the SEC would issue the same no-action letter today in light of recent SEC developments, including the SEC's surprising decision in 2000 to actually revoke a 1985 no-action letter regarding Dominion Resources, Inc., which involved transaction-based compensation.

## Ramifications of using unregistered broker dealers

When the finder is really an unregistered broker dealer, the SEC can: (i) enjoin the finder's activities, (ii) seek money penalties (including disgorgement), (iii) obtain cease-desist-orders, and (iv) refer the matter to the Justice Department for criminal prosecution. Additionally, courts have applied the Exchange Act to void finder agreements on the principle that contracts violating the Act are voidable.

Perhaps most alarming, when a company hires a finder to help with financing but the exemption proves inapplicable, the investors may have a rescission right, which entitles them to literally undo the deal and receive their money back plus interest.

Even if you successfully navigate the federal framework covering finders, you must then grapple with state laws, which are inconsistent and confusing. For instance, unlike a number of States, effective last year, California adopted legislation specifically granting investors a right to rescind a securities transaction completed via a finder. If Shady had shopped Startup to investors in California and a few other states, Shady and Startup would need to comply with the potentially contradictory rules in each.

What's the takeaway? We have a few recommendations to GPs in dealing with the problem of unregistered broker dealers:

**Diligence and professional advice.** Before investing, confirm that any broker in the deal is registered as a broker-dealer - visit the NASD's BrokerCheck at http://pdpi.nasdr.com/PDPI/ to see for yourself. Make sure that the company consulted an experienced lawyer familiar with both market terms and the risks and subtleties of engaging a finder and that the lawyer reviewed the broker's agreement.

**Just say no.** If the finder and the company have already signed an agreement before you have learned that the finder is not registered, consider walking away (or doing so until the finder and company have terminated their relationship without continuing obligations and with an express prohibition on the finder's ability to publicize in any way his involvement in the deal or that the company was his client).

**Cover your tails.** If investing into a company that has used a registered broker, regardless of what the engagement letter provides, condition the closing payment to that broker upon receipt of a release and termination from the broker, in which the broker represents that he is registered, acknowledges payment in full, and, if there is a tail, agrees in writing as to which specific entities he has contacted and for whom the tail will apply. Agreeing on the specifics of tail coverage avoids subsequent disputes.

Despite the SEC's prohibitions, a bastion of hope remains - numerous CPAs, lawyers, and executive search firms with broad connections within the venture space. Firms like Startup would be well advised to network their way to those points of entry into the investment world. But make sure that they don't seek transaction-based compensation or try to split fees with brokers (SEC no-action letters have prohibited splitting transaction-based fees with unregistered firms, even when split with a CPA firm). As members of private equity and venture funds, it is in your interest to encourage entrepreneurs to avoid succumbing to the enticements of hiring a success fee-based finder.

While there are no guarantees and the fact sensitive nature of this realm makes giving specific contract guidance difficult, for those who find themselves within the purview of the Paul Anka facts, at a minimum, the finder should represent in a contract that he complies with all of the elements set forth above in this article and agree not to 'effect the transaction' - ideally, the finder should also represent that he is a registered broker-dealer.

The earlier in the deal you, as the investor, can determine whether the finder is registered, the easier it will be for you and the company to avoid having the finder 'effect the transaction' and to evade the morass that the finder problem can become. ■

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