



Using Finders to Assist in Financings: Understanding the Risks Associated with Unregistered Broker-Dealers

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An Article discussing risks associated with the use of finders by early-stage companies to assist in locating potential investors. The Article lists questions that issuers and finders should ask to help determine whether a finder may be acting illegally as an unregistered broker-dealer. The Article also describes some of the risks faced by issuers and finders when a finder is deemed to be an unregistered broker-dealer, including risks arising from rescission rights, disclosure obligations and SEC sanctions.

For early-stage companies in need of capital, finding potential investors can be difficult and time-consuming, especially when conditions in the capital markets are tight. For many companies, using a “finder,” an individual or entity that identifies, introduces and negotiates with potential investors, to help locate potential investors may seem promising.

Companies should be aware, however, that there are risks involved in using finders, including risks arising from potential

violations of the SEC’s broker-dealer registration requirements. These risks are significant and, as investors become increasingly wary of the potential consequences, could threaten a company’s ability to raise capital in the future and its prospects for long-term growth and success.

Finders operating as unregistered broker-dealers also face significant risks, including the possibility of severe SEC sanctions.

This Article:

- Summarizes the main risks that issuers and finders face when a finder acts as an unregistered broker-dealer.
- Lists questions that issuers and finders should ask to help determine whether a finder is illegally acting as an unregistered broker-dealer.

This Article focuses primarily on US federal securities laws and certain state securities laws. Because state regulations on the issuance and sale of securities vary from state to state, this Article uses California, home to a large population of start-up companies and venture capital investors, for illustrative purposes only.

RISKS TO ISSUERS ASSOCIATED WITH USING UNREGISTERED BROKER-DEALERS

RISKS ARISING FROM INVESTOR RESCISSION RIGHTS

Using a person or entity that could be deemed to be an unregistered broker-dealer to assist with a sale of securities could create a rescission right in favor of the investors under US federal securities laws and the securities laws of California. If investors succeed in exercising their rescission rights, the issuer would be required to return the money it received from the investors for the purchase of its shares.

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Investor Rescission Rights under Federal Law

Section 29(b) of the Securities Exchange Act (Exchange Act) provides that any contract made in violation of any provision of the Exchange Act (including where performance of the contract would violate the Exchange Act) is void as to the rights of any person in violation of the relevant Exchange Act provision.

Section 29(b) is broad enough that it can be interpreted to void a securities purchase contract with any investor located through a finder that was acting in violation of the Exchange Act's broker-dealer registration requirement (see *Determining Whether a Finder is an Unregistered Broker-Dealer*). If an investor were to successfully assert this type of claim, it would have the right to:

- Demand that its securities purchase contract be rescinded.
- Require the issuer to return its funds.

Under federal law, this rescission right can be exercised until the later of:

- Three years from the date of issuance of the securities.
- One year from the date of discovery of the violation.

For companies that have used unregistered finders in the past, the risk of potential rescission rights under Exchange Act Section 29(b) in favor of past investors often raises significant obstacles to the closing of future financings. Because there is uncertainty as to how long these rescission rights can be exercised, the negative impact on future financings could linger for years.

Investor Rescission Rights under State Law

In addition to regulation under the Exchange Act, many states also regulate the registration of broker-dealers. State regulations related to unregistered broker-dealers vary from state to state, with some states providing rights to investor claimants beyond those provided under federal law. For example, under California law, a rescission right is available to purchasers located in California where securities are sold to or purchased from an unregistered broker-dealer (*Cal. Corp. Code § 25501.5*).

In addition to the rescission of the sale of securities and return of investor funds, Section 25501.5 also provides that:

- The purchaser can seek damages even if it no longer owns the securities in question.
- The court has discretion to award attorney fees and costs to a plaintiff seeking rescission.

RISKS RELATING TO DISCLOSURE OBLIGATIONS

Even if rescission is not demanded by past investors, the use of an unregistered broker-dealer in an earlier transaction creates disclosure obligations in related securities filings and may impact subsequent financings and acquisitions.

SEC filings required in connection with registered offerings and certain private placements, including registration statements and filings on Form D, require the issuer to disclose compensation paid to finders in connection with the offering, as do many filings

required under state blue sky laws. This type of disclosure about an unregistered finder could:

- Dissuade future investors from investing in subsequent financings.
- Prevent the issuer's legal counsel from being able to deliver required legal opinions in connection with any subsequent financing.

In addition, failing to disclose payments made to an unregistered broker-dealer in connection with a sale of securities could expose the issuer to potential liability for fraud under Rule 10b-5 of the Securities Act (Securities Act). For example, in March 2008 the SEC announced the settlement of fraud charges brought against W.P. Carey & Co. and its chief financial and accounting officers for failing to disclose, and later mischaracterizing, compensation paid to a broker-dealer in connection with issuances of securities (see *SEC Litigation Release No. 20501*). The settlement, which included several claims in addition to the failure to disclose, resulted in millions of dollars in fines, disgorgement of proceeds and interest payments, as well as a five-year ban preventing the former chief financial officer from serving as an officer or director of a public company. Fraud claims based on similar facts could potentially be brought by investors seeking rescission under state securities laws.

OTHER RISKS TO ISSUERS

As the SEC steps up its enforcement of broker-dealer registration requirements, companies that engage unregistered broker-dealers could also find themselves subject to SEC enforcement actions under Section 20(e) of the Exchange Act for aiding and abetting an Exchange Act violation (specifically, the finder's violation of the broker-dealer registration requirements).

In addition, an issuer that uses a finder also runs the risk of losing potential exemptions from securities registration requirements under federal and state securities laws that would otherwise be available to it. For example, if a finder engages in activities prohibited under Regulation D under the Securities Act or Section 25102 of the California Corporations Code, including approaching investors other than accredited investors or engaging in general solicitation, the issuer could become ineligible for the securities registration exemptions set out in those provisions. For more information on Regulation D, see *Practice Note, Section 4(2) and Regulation D Private Placements* (<http://us.practicallaw.com/8-382-6259>).

RISKS TO FINDERS ASSOCIATED WITH ACTING AS UNREGISTERED BROKER-DEALERS

Issuers are not the only parties at risk when a finder is deemed to be an unregistered broker-dealer. Intermediaries acting as finders are themselves subject to significant risks, including the risk of SEC sanctions.

RISKS ARISING FROM ISSUER RESCISSION RIGHTS

Issuer Rescission Rights under Federal Law

The rescission rights available under Section 29(b) of the Exchange Act also create significant risks for individuals or entities acting as finders. Specifically, an issuer could claim under Section 29(b) that its obligations to a finder under the finder's engagement agreement are void if the finder is acting in violation of the Exchange Act's broker-dealer registration requirement (see *Determining Whether a Finder is an Unregistered Broker-Dealer*).

In 2008, the Supreme Court of New York County, New York denied relief for an unregistered broker-dealer that sued to collect fees owed to it under a contract with an issuer for brokerage services (*Torsiello Capital Partners v. Sunshine State Holding Corp.*, 2008 N.Y. Slip Op. 30979 (April 7, 2008) (*Torsiello Capital*)). The court held that the agreement was void and rescindable because the finder was providing the type of services that require registration with the SEC as a broker-dealer without such registration.

Issuer Rescission Rights under State Law

Similar contract rescission rights may also be available under state law. For example, under Section 25501.5 of the California Corporations Code, a rescission right is available to issuers located in California where securities are sold to or purchased from an unregistered broker-dealer. A finder deemed to be acting illegally as an unregistered broker-dealer under state law could:

- Have its engagement letter with the issuer rescinded.
- Be barred from collecting the fees payable to it under its engagement agreement.

RISKS RELATING TO DISCLOSURE OBLIGATIONS

There is some risk that a finder's failure to disclose the fact that it is not registered as a broker-dealer could itself be characterized in regulatory enforcement proceedings or private litigation as a misleading omission that amounts to fraud on the issuer (see *Torsiello Capital*).

In addition, private fund managers newly required to register as investment advisers under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 are subject to strict disclosure requirements about any solicitation arrangements they enter into with finders (*Investment Advisers Act of 1940, Rule 206(4)-3*).

SEC SANCTIONS

A finder deemed to be acting as an unregistered broker-dealer may be subject to several different penalties under federal securities laws, the most typical of which is a temporary or permanent injunction barring it from participating in the purchase or sale of securities. However, the SEC has the power to impose more severe sanctions, including disgorgement of funds and civil penalties. Although historically these harsher penalties were generally only imposed in cases involving fraud, this is no longer the case.

In April 2008, the SEC announced sanctions against an employee of Duncan Capital LLC, who specialized in arranging private investments in public equity (PIPE transactions), for acting as a broker-dealer without proper registration (see *SEC Litigation Release No. 20535*). The SEC brought its action specifically in response to the employee's failure to register as a broker-dealer. The final judgment against the employee did not include any finding of fraud but:

- Barred him from associating with any broker or dealer for one year.
- Required that he disgorge any ill-gotten gains arising from the prohibited transactions.

DETERMINING WHETHER A FINDER IS AN UNREGISTERED BROKER-DEALER

Determining whether a finder may be deemed an unregistered 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 (*Exchange Act, Section 3(a)(4)(A)*). This definition is interpreted broadly, and encompasses activities including:

- Providing advice regarding the value of securities.
- Locating issuers.
- Soliciting new clients.
- Assisting in the structuring and negotiation of securities transactions.
- Disseminating quotes for securities.

(*InTouch Global, LLC, SEC No-Action Letter (November 14, 1995)*.)

Under Section 15(a)(1) of the Exchange Act, it is 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. For more information about broker-dealer registration requirements, see *Practice Note, US Broker-Dealer Registration: Overview* (<http://us.practicallaw.com/5-386-0339>).

Given the broad nature of the broker-dealer definition, some finders may not realize when their activities trigger a registration requirement.

Set out below are questions that issuers and finders should ask to help determine whether a finder may be deemed an unregistered broker-dealer.

DOES THE FINDER RECEIVE TRANSACTION-BASED COMPENSATION?

Finders often prefer to structure their compensation as a percentage of the funds raised by the company, while companies prefer to pay finders only if they are successful in helping to raise capital.

However, percentage commissions and other compensation arrangements that vary depending on the amount invested create a substantial likelihood that a finder would be viewed as a broker-dealer required to register with the SEC. In its no-action letters, the SEC has consistently treated transaction-based compensation as a key factor in determining whether a finder is acting as a broker-dealer (see, for example, *Mike Bantuveris, SEC No-Action Letter (October 23, 1975)*; *Nemzoff & Co., LLC, SEC No-Action Letter (November 30, 2010)*).

The amount of compensation, in absolute terms or relative to the finder's total income, does not dictate whether broker-dealer registration is required. Even if transaction-based compensation is only a small part of a finder's total income, the SEC may still consider the finder to be "in the business of effecting transactions in securities for the account of others" as that phrase is used in the definition of broker in Section 3(a)(4)(A) of the Exchange Act (see, for example, *Herbruck, Alder & Co., SEC No-Action Letter (June 4, 2002)*; *Mike Bantuveris, SEC No-Action Letter (October 23, 1975)*).

In contrast, the SEC has granted no-action relief to presumptive broker-dealers in several cases where other factors discussed in this Article were present but transaction-based compensation was not (see, for example, *Putnam Investor Services, Inc., SEC No-Action Letter (December 31, 2009)*; *Goldman, Sachs & Co., SEC No-Action Letter (January 17, 2007)*).

In one notable exception, the SEC indicated that a finder may not be required to register as a broker-dealer, even where its compensation is transaction-based, in the limited circumstances where the party acquiring securities is purchasing 100% of the outstanding securities of a business as a going concern and other factors are present (see *Country Business, Inc., SEC No-Action Letter (November 8, 2006)*). In the *Country Business, Inc.* (CBI) no-action letter, the SEC staff indicated it would not recommend an enforcement action against CBI where CBI represented, among other factors, that:

- CBI would:
 - have a limited role in negotiations between the seller and purchaser;
 - not advise either party; and
 - not assist the purchaser in obtaining financing.
- The transaction would be structured as a sale of 100% of either the assets or the equity securities of the business to a single purchaser, but only the sale of assets would be advertised.
- CBI's compensation would:
 - be determined before the decision on how to effect the sale of the business;
 - be a fixed fee, hourly fee, commission, or a combination of those, that would be based on the consideration received by the seller, regardless of the means used to effect the transaction; and
 - not vary according to whether the sale is achieved through a sale of assets or securities.

Though transaction-based compensation for an unregistered finder is often sufficient to trigger a broker-dealer registration requirement, the CBI no-action letter suggests that a very narrow exception exists where the transaction-based compensation is paid in connection with a transaction on terms mirroring those on which the SEC staff conditioned its no-action relief to CBI.

DOES THE FINDER ENGAGE IN SOLICITATION OF POTENTIAL INVESTORS?

Generally, solicitation of potential investors by a finder would suggest that it is acting as an unregistered broker-dealer. However, determining what activities constitute solicitation can be difficult because solicitation can take several forms. Generally, solicitation can be any action designed to persuade or incentivize another person to purchase a security. Activities as broad as general newspaper advertisements or as targeted as individually-addressed e-mails could constitute solicitation (see, for example, *SEC v. Schmidt, Fed. Sec. L. Rep. 93202 (S.D.N.Y. 1971)*; *Nemzoff & Co., LLC, SEC No-Action Letter (November 30, 2010)*).

In a 2010 no-action letter denying an applicant's request for relief, the SEC indicated that a finder's introduction of investors who may have an interest in a securities investment implies both:

- Pre-screening of potential investors to determine their eligibility to purchase the securities.
- Pre-selling the securities to gauge the investors' interest.

(*Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010)*.)

This no-action letter suggests that, in the SEC's view, both pre-screening and pre-selling are broker-dealer functions that would trigger the broker-dealer registration requirement.

DOES THE FINDER PROVIDE ADVICE OR ENGAGE IN NEGOTIATIONS?

Providing advice, particularly about the value of the securities involved, or assisting investors in negotiating the terms of a sale of securities brings a finder within the Exchange Act definition of broker. These activities may be problematic even if the finder is performing a due diligence function of providing investors with detailed information about the issuer.

For a finder's activities to fall reliably outside the broker-dealer definition, its involvement should not extend beyond the ministerial function of facilitating the exchange of documents or information (see, for example, *Samuel Black, SEC No-Action Letter (December 20, 1976)*).

DOES THE FINDER HAVE PREVIOUS SECURITIES SALES EXPERIENCE OR A HISTORY OF DISCIPLINARY ACTION?

The SEC is concerned that persons who have been barred from engaging in the purchase or sale of securities may attempt to operate as finders to evade broker-dealer registration requirements.



Reflecting this concern, a finder's experience dealing in securities and, in particular, any disciplinary action by the SEC, can trigger broker-dealer registration requirements even when certain other factors described above are not present (see *Rodney B. Price and Sharod & Assocs., SEC No-Action Letter (November 7, 1982)*).

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