

# INSIGHTS

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## SECURITIES OFFERINGS

### Using Finders to Assist in Financings Can Impose Significant Risks

*Many entrepreneurs are willing to pay a finder a share of the proceeds received from an investor found by the finder. Finders often seek a portion of any capital they raise. But both sides should tread carefully in structuring such arrangements because of the significant business, regulatory and litigation risks related to the broker-dealer registration requirements.*

**By Steve Ganis, Jeremy D. Glaser,  
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Over the past decade, tightening capital markets and technological advancements have made the use of “finders”—individuals and entities that identify, introduce, and negotiate with potential investors—more prevalent than ever. At the same time, the Securities and Exchange Commission (SEC) has shown an increased interest in transactions using finders as unregistered broker-dealers in violation of SEC regulations. As a result, investors who are considering making a potential

investment have become increasingly concerned about the inadvertent use of unregistered broker-dealers. Given these regulatory concerns, the use of finders, either in a current transaction or in connection with an earlier financing, can create time-consuming and expensive issues. It potentially can halt transactions and even create a rescission right among the business’s current equityholders, among other serious penalties and consequences.

### Potential Risks

Using an unregistered broker-dealer to assist with the sale of securities can create a number of significant risks to your business. In particular, using an unregistered broker-dealer for such a sale 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 Securities Exchange Act of 1934 (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

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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.

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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 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 10(b) of the Exchange Act and Rule 10b-5 thereunder.

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.<sup>1</sup> 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 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.<sup>2</sup>

As the SEC steps up its enforcement of regulations requiring registration of broker-dealers, it also is 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.<sup>3</sup>

In addition, if a private fund manager is newly required to register as an investment adviser under

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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 Rule 206(4)-3 under the Investment Advisers Act of 1940.

Finally, in using a finder, an issuer company 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, ultimately can prevent the issuer from obtaining an exemption under SEC Regulation D or Section 25102(f) 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 some guidance is available. Section 3(a)(4)(A) of the Exchange Act defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” This definition typically is 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.<sup>4</sup> 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 definition of what constitutes a broker-dealer, some finders may not realize that their activities have triggered a registration requirement. Below is a list of questions to consider when 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.<sup>5</sup>

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.<sup>6</sup>

The relative importance of the presence of transaction-based income as compared to other factors currently is being debated. In 2010, the SEC took a strong position suggesting that the receipt of transaction-based income, without more, would be sufficient to trigger broker-dealer registration requirements. “A person’s receipt of transaction-based income in connection with [effecting transactions in securities]” the Commission wrote, “is a hallmark of broker-dealer activity. Accordingly, any person receiving transaction-based compensation in connection with another person’s purchase or sale of securities typically must register as a broker-dealer. . . .”<sup>7</sup> However, on April 1, 2011, a United States District Court located in Florida dismissed a case brought by the SEC against Kenneth R. Kramer, rejecting the argument that the receipt of transaction-based income is, on its own, sufficient to trigger broker-dealer registration requirements.<sup>8</sup>

The *Kramer* court focused on a number of factors, finding that “Kramer’s conduct consisted of nothing more than bringing together parties to a transaction.”<sup>9</sup> While the court’s decision appears

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to give more leeway in granting and accepting transaction-based compensation, the sufficiency of such compensation to trigger registration requirements is far from a settled area. First, it remains unclear which circuit courts of appeals, if any, will adopt the District Court's reasoning in *Kramer*. Second, the facts and circumstances in *Kramer* appear somewhat unique. Third, the District Court in *Kramer* stressed in its decision that the conduct in question had occurred *before* the SEC staff issued certain no-action letters setting forth interpretations that arguably would have required broker-dealer registration. Regardless, Kramer's receipt of transaction-based compensation would have been taken into account and weighed in favor of registration had the SEC been able to establish the presence of any other factors.

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***The use of finders may be allowed, where the party acquiring securities is purchasing 100 percent of the outstanding securities of a business as a going concern.***

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In certain circumstances where transaction-based compensation is not present, the SEC has elected not to take action against the presumptive broker-dealers.<sup>10</sup> The SEC also 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 percent of the outstanding securities of a business as a going concern. In this regard, the SEC staff issued a no-action letter to Country Business, Inc. (CBI), where CBI represented (among other factors) that (1) it would have a limited role in negotiations between the seller and purchaser, would not advise either party, and would not assist the purchasers in obtaining financing, (2) the sale in question would be structured as a sale of

100 percent 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 would be "determined prior to the decision on how to effect the sale of the business, [would] 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 [would] not vary according to the form of conveyance (i.e., securities rather than assets)."<sup>11</sup>

Transaction-based compensation typically would trigger a registration requirement (as discussed above). However, 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. The terms of compensation related to an acquisition or merger should be pre-set and not dependent upon the manner in which the transaction is effected. In addition, the finder should be advertising a target company as a going concern, rather than an offer or sale of 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.<sup>12</sup>

The SEC recently has indicated in the denial of no-action relief to a law firm engaged in introducing potential investors to a company pursuant to a referral fee agreement, that the introduction of investors "who may have an interest" in a securities investment implies "both 'pre-screening'

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potential investors to determine their eligibility to purchase the securities, and ‘pre-selling’ [the] securities to gauge the investors’ interest.”<sup>13</sup> In the SEC’s view, both pre-screening and pre-selling apparently are broker-dealer functions requiring registration.

### **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 also may 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.”<sup>14</sup>

### **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.<sup>15</sup>

### **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.<sup>16</sup> 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 \$480,563 characterized as “ill-gotten gains” that resulted from the transactions and pay an additional \$174,552 in prejudgment interest and civil penalties.

Further, as noted above, finders may be unable to collect fees under their engagement agreements with issuers if they are not registered. 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.<sup>17</sup> 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 registered as such.

### **The Call for Reform**

In 2010, the American Bar Association reconvened its Task Force on Private Placement Broker-Dealers to address, among other issues, the finder problem. The Task Force originally was created in 1999 with the goal of alleviating problems faced by small companies in raising capital in private placements. The Task Force’s

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Report and Recommendations, originally issued in 2005 and re-issued on April 28, 2010, strongly emphasized the need for clarification and reform in this area. “There exists,” the Task Force wrote, “a major disconnect between the various laws and regulations applicable to securities brokerage activities, and the methods and practices actually in daily use by which the vast majority of capital is raised to fund early stage businesses in the United States.”<sup>18</sup> The Task Force found that small, early-stage companies often resort to using finders because of the scarcity of registered broker-dealers that are interested in small projects and able to broker such transactions at a price that is affordable to the issuer. The Report noted a “vast and pervasive ‘gray market’ of brokerage activity” creating problems for those involved in the issuance of securities at every step of the way.<sup>19</sup> Among other fundamental problems, the Task Force noted that the definition of “finder” is elusive and varies under the circumstances.<sup>20</sup> Moreover, the standards for enforcing the regulations have shifted over time, creating even greater uncertainty.<sup>21</sup>

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To address these problems, the Task Force recommended a multi-step process. First, the SEC should publish a clear statement of registration requirements, providing full reasoned analysis and taking into consideration the realities faced by early-stage companies in trying to raise capital. Second, for a period of time after clarifying the registration requirements, the SEC should cease making inquiries with respect to activities prior to the issuance of guidance. This, the Task Force reasoned, would make it easier for financial intermediaries, in light of the clarification

of broker-dealer guidelines, to come forward and register.<sup>22</sup> Third, in order to further encourage registration, the registration process should be streamlined to make the application cheaper and less time consuming, and state registration procedures should be made uniform. Finally, the Task Force noted that the time required to establish a broker-dealer, which can require up to six months, creates a substantial disincentive to voluntary compliance, as such delay may result in the applicant losing both staff and clients.

Collectively, the Task Force’s recommendations can best be summarized as an appeal to the SEC, asking that the Commission understand that given the important role that financial intermediaries play in our financing markets, a space needs to be carved out in which they can safely operate. The initial 2005 Report was accepted in principle by the SEC Division of Trading and Markets and was strongly endorsed by the 2006 report of the SEC Advisory Committee on Smaller Public Companies, as well as the North American Securities Administration Association. Notwithstanding the urgency of the problem and the general consensus regarding the need for action, reform in this area has been stalled by the troubled economy, among other things, and is unlikely to resurface until after the SEC has fully implemented its new rules and regulations under the 2010 Dodd-Frank Act.

## **Conclusion**

Particularly in a tight capital market, finding willing investors can be a difficult and time-consuming process for your clients. It is important to remember, however, that the long-term success of your client’s business may be at stake if they 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 the business a less desirable target for acquisition, and potentially expose the company or its principals to penalties.

## NOTES

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 American Bar Association, 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." Mary M. Sjoquist, et al., Report and Recommendations of the Task Force on Private Placement Broker-Dealers (*ABA Task Force*), A.B.A., 36 (April 28, 2010).
4. See, SEC No-Action Letter re: InTouch Global, LLC, November 14, 1995.
5. *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
6. *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.
7. Brumberg, *supra* note 5.
8. *S.E.C. v. Kramer*, 2011 WL 1230808 (M.D. Fla.), April 1, 2011.
9. *Id.* at 14.
10. 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.
11. SEC No-Action Letter re: Country Business, Inc., November 8, 2006.
12. *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.
13. SEC No-Action Letter re: Brumberg, Mackey & Wall, P.L.C., May 17, 2010.
14. 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.
15. *Supra* note 1 at 20. See also SEC No-Action Letter re: Rodney B. Price and Sharod & Assocs., November 7, 1982.
16. SEC Litigation Release No. 20535, April 23, 2008, available at <http://www.sec.gov/litigation/litrelases/2008/lr20535.htm>.
17. See *supra* note 2.
18. See *supra* note 3, at 1.
19. *Id.*
20. *Id.* at 7.
21. *Id.* at 10.
22. *Id.* at 49.

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