Jon S. Liland
Direct dial: 603.643.9070
Fax: 603.643.3679
jliland@sheehan.com

Practice Areas

Securities and Venture Capital

Good Company

Use of Unregistered 'Finders' in Securities Transactions

Tuesday, February 02, 2010

The last year has been a trying one for many entrepreneurs-- tight credit markets, newly-cautious banks and the overall slowdown in the economy have left many growing companies without access to the sources of capital that they had previously relied upon to fund their operations. These constraints have hit early-stage companies especially hard, with more companies and would-be entrepreneurs chasing fewer dollars available from venture capital funds and angel networks.

When looking for additional capital, many companies consider working with third parties who offer to find investors and to serve as an intermediary between the company as an issuer of securities and potential investors. Such intermediaries often refer to themselves as “finders,” “business brokers,” “investment facilitators,” “investment consultants” or even “specialized investment bankers”, and their backgrounds vary from individuals with interesting rolodexes (celebrities, former politicians, and retired corporate executives) to bankers, venture and investment fund professionals, and other experienced securities market professionals.

The services offered by such intermediaries (referred to herein as “finders”) range from simply providing a list of potential investors culled from the finder’s rolodex, to more substantive roles, including soliciting potential investors with whom the finder may or may not have a pre-existing relationship, providing advice regarding the structure or valuation of the transaction, negotiating one or more substantive terms of the transaction, or assisting the potential investors in locating financing.

Before engaging a finder, however, the prospective issuer must carefully discuss with counsel the finder’s credentials, the nature of the proposed relationship and the compensation to be paid to the finder. Most finders, especially those who are paid based on a percentage of the amounts invested or based on the outcome or size of any transactions resulting from their assistance, are required under applicable federal and state laws to be registered as broker-dealers with the Securities and Exchange Commission (the “SEC”), state securities regulators and the Financial Industry Regulatory Authority (“FINRA”). Many finders are not appropriately registered, however.

Unfortunately, it is a harsh reality that a finder’s failure to be appropriately registered poses far more significant risks for the company issuing the securities than for the finder. Anecdotal evidence indicates that many entrepreneurs are not aware of these risks, and most unregistered finders clearly have little incentive to discuss them.

Regulation of Finders
Under Section 15(a) of the Securities Exchange Act of 1934 (the “1934

Act"), any person acting as a "broker" must be registered with the SEC; the same is true under the New Hampshire Uniform Securities Act (RSA 421B:1 *et seq.*, referred to herein as the "NHUSA") and most other state securities laws. According to the 1934 Act, a "broker" is "any person engaged in the business of effecting transactions in securities for the account of others."

Although at first blush the statutory language appears relatively simple, it provides little guidance as to what activities constitute acting as an unregistered broker in the context of a given securities offering or business sale. However, the guidance available from recent court decisions, SEC no-action letters and comments by SEC staff members indicate that the activities of finders must be very limited to avoid a violation of the statute, and it appears that over time the permitted scope of action for an unregistered finder has become narrower and narrower.

There are multiple factors that will be taken into account by regulators and courts in determining whether an unregistered finder is acting as a broker, each of which should be carefully considered by a company that is considering using a finder. These are:

- Active solicitation of potential investors by the finder;
- Advice to potential investors regarding the merits of the investment;
- Involvement of the finder in the negotiation of the terms of any sale of stock or other securities;
- Involvement of the finder in the valuation or terms of the securities to be sold;
- Provision of financing for any participant in the sale;
- Previous involvement of the finder in other sales of securities or businesses;
- Previous discipline of the finder for violations of the securities laws; and
- Receipt of transaction-based compensation for the finder's services, including compensation based on a percentage of transaction value or "success fees."

Of the above factors, there are a few which seem to carry a great deal of weight with regulators and the courts when they assess whether a person is acting as an unregistered broker-dealer. The most important of these, and most common, is the receipt of transaction-based compensation. Regulators believe that such compensation gives the finder a "salesman's stake" in the transaction, and could therefore lead to the kind of abuses that broker-dealer registration and regulation is intended to prevent.

Similarly, prior involvement of the finder in securing investors for securities transactions or the expectation of the finder that he or she will be involved in similar future transactions as part of the finder's business is likely to be highly relevant to regulators. This is especially true if the finder or any of its agents has been disciplined previously for a violation of the securities laws. Previous discipline alone would most likely lead to a determination that the actions of a finder in connection with a sale of securities required registration as a broker-dealer. The regulators are loathe to permit 'bad actors' to participate in securities transactions in any capacity without the protections that registration affords.

Avoiding transaction-based compensation and finders with a history of engaging in securities transactions is not enough, however, to avoid the requirement of registration. If anything, recent decisions by courts and regulators appear to indicate that anyone involved in finding investors for securities issuers in return for compensation can be held to be acting as an unregistered broker, with dire consequences for both the finder and the issuer of the securities involved.

Consequences to Issuers of Using an Unregistered Broker

The consequences to an issuer of using a finder that is an unregistered broker can be severe. In the worst case

scenario, the issuer could find itself the target of enforcement action by the SEC or state securities regulators, facing civil penalties, restrictions on future investment activities, and possibly prosecution for aiding and abetting the security law violations of the finder.

However, from a practical perspective, it is more likely that the negative consequences of the use of an unregistered broker will not stem from enforcement action, but instead will arise in the context of a dispute with investors or when the issuer is planning its next issuance.

Simply put, the use of an unregistered broker in connection with an issuance of securities is a violation of the securities laws, including the 1934 Act, which means that any contract entered into in connection with such issuance is void. In other words, purchasers of securities sold in the offering in which the finder was involved would have the right to rescind their purchase and have their investment returned to them, with interest. This right of rescission would apply to any purchaser in the transaction, and not just those purchasers located by the finder. The issuer would have no assurances that any investor who is or later becomes dissatisfied with the direction of the company would not exercise the right of rescission.

Additionally, use of an unregistered broker will also call into serious question the validity of the registration exemptions most commonly used in private placements under both state and federal law. For example, New Hampshire's limited offering exemption under NH RSA 421-B:17(II)(a)(2) explicitly cannot be used if compensation is provided to any unregistered finder. With regard to federal securities regulations, the exemption provided by Rule 506 would most likely not be available because the activity of the finder could constitute a proscribed general solicitation.

Loss of the applicable exemptions would not only render the issuance in question illegal and give rise to potential civil and criminal claims, it could also curtail the future use of similar registration exemptions, require the issuer to disclose to purchasers in all subsequent transactions the fact that the issuer previously issued securities in violation of the securities laws, and create accounting problems due to the need to account for the rescission rights of investors.

The Bottom Line
Any issuer contemplating the use of a third party 'finder' in connection with the sale of securities should first find out whether that third party is registered as a broker-dealer with the SEC, the applicable state regulators, and FINRA. If this information is not provided by the finder at the start of serious discussions, then it can easily be found online. If the finder in question is not registered, then the issuer should strongly consider either forgoing the finder's assistance altogether, or consulting with counsel to determine whether the finder's activities or the transaction itself can be structured in a way to minimize the likelihood that they will later be found to have acted as an unregistered broker-dealer. In this case, it is very important to bring experienced securities counsel into the discussions as early as possible-- certainly before the relationship with the finder has been documented or the finder has provided any information regarding prospective investors. Otherwise, the consequences could be both severe and long-lasting for the issuer.

This article is intended to serve as a summary of the issues outlined herein. While it may include some general guidance, it is not intended as, nor is it a substitute for, legal advice. Your receipt of Good Company or any of its individual articles does not create an attorney-client relationship between you and Sheehan Phinney Bass + Green or the Sheehan Phinney Capitol Group. The opinions expressed in Good Company are those of the authors of the specific articles.