

## The Risks of Engaging Unregistered Finders in Securities Offerings

Many start-up and small-cap companies seeking to raise capital employ “finders” to assist in locating and introducing qualified investors. However, in light of increased enforcement activity by the SEC and many state securities commissioners aimed at unregistered broker-dealers, issuers should be mindful of the risks associated with using finders to obtain capital. Failure to do so could result in severe monetary penalties and other negative consequences, not only for finders, but also for issuers and their senior executives, and other agents who employ them.

Federal and state securities laws prescribe a comprehensive regulatory scheme for any person or entity engaged in the business of effecting transactions in securities for the account of others. Whether a person characterizes himself as a finder is irrelevant in the analysis of the securities administrators.

Unregistered broker-dealer activity can arise in the context of a private securities offering where persons not registered as broker-dealers act as bankers, consultants, advisers or finders. In these instances, the SEC has taken the position that finders who are engaged in such activities and fail to become associated with a registered broker-dealer have denied investors the protections of regulatory oversight and firm supervision.

While the consequences to an unregistered broker-dealer can include both civil and criminal penalties and potential bars from participating in the securities industry, issuers who employ such persons also face adverse consequences. For example, under federal and many

state securities laws, investors may have the right to rescind their investment in an issuer’s securities on the basis that they were materially misled by not being informed that the finder was not a registered broker-dealer. Some states may also permit investors to seek monetary damages from the issuer. Moreover, issuers that engage unregistered broker-dealers may be barred from future private placements under Regulation D, which is an important element in confirming an exempt offering.

There is no bright-line rule for determining whether a finder “effects” a transaction in securities and has therefore acted as an unregistered broker-dealer. Instead, the SEC and state securities regulators typically employ a facts and circumstances analysis. Under this approach, finders who merely open up their contact lists and make introductions to potential investors have not been required to register as broker-dealers. In contrast, those who take on incremental responsibilities in connection with an offering often tip the analysis toward the need to register.

Activities which have been found to create a presumption that a finder is acting as a broker include:

- Soliciting prospective investors for an offering of securities;
- Offering or providing advice or recommendations with respect to the merits of an offering of securities, or the likelihood of success of the issuer’s business activities;
- Negotiating the price or other material terms of an offering of securities;
- Assisting the issuer with the preparation of offering documents;
- Distributing offering or sales materials or other related financial data;
- Handling or assisting in the transfer of investor funds in a securities offering;
- The payment of transaction-based compensation (i.e., compensation that is based on the size or success of the securities transaction); and
- Previous involvement, the frequency of involvement and possible future involve-

ment in the sale of securities.

While any one or more of the activities outlined above may lead a regulator to scrutinize a particular private placement offering for possible unregistered broker-dealer activity, the existence of transaction or success-based compensation is one of the two activities that are most likely to draw regulatory scrutiny and result in the classification of a finder as a broker-dealer.

Although early no-action letters to the SEC did not prohibit percentage-based commissions for successful introductions absent any of the other activities outlined above, in a recent no-action request the SEC determined that the receipt of compensation directly tied to the success of investments in an offering gave a finder a “salesman’s stake” in the offering, therefore heightening the incentive for the finder to engage in sales efforts, which, in turn, required broker-dealer registration. As such, the most cautious compensation route for issuers and finders today is to provide a fixed fee for the finder, regardless of the outcome of the offering or the success of the finder in introducing investors. Unfortunately, this is not a possible alternative for many early-stage companies.

The second most scrutinized factor is the finder’s prior involvement in securities offerings. This provides evidence as to whether the finder is “engaged in the business” of effecting securities transactions. However, a finder’s prior experience and success in raising capital is often a critical factor in an issuer’s willingness to pay a flat fee that is not based upon success. Without a successful prior track record, a finder is unlikely to be retained.

In conclusion, any issuer contemplating engaging an unregistered finder to assist with a private placement of securities should carefully consider the compensation scheme paid to such finder, the activities of the finder in connection with the offering, and the interactions of such finder with potential investors. In most cases, it may be more prudent to limit the individuals or entities engaged in the solicitation of potential investors to those that are registered broker-dealers. ■



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