What's In A Name?
Protecting Your Securities Offering Through The Use Of Exempt "Finders"

By: John Cleary[1]

Despite record amounts being invested in private equity funds, emerging growth companies will always struggle to find investors willing to write checks. Few entrepreneurs have sufficient personal contacts to fully fund a deal, so they use "placement agents" to assist them in finding accredited and sophisticated investors. Because start-up companies typically seek less than $5 million in capital to fall within an exemption from registering the offering with the Securities and Exchange Commission (SEC), very few registered placement agents will be interested in a deal that size. As a result, many early stage companies enlist the services of well-connected individuals who make introductions and open up their contact lists for a fee. These individuals are called "finders."

The problem is these "finders" may be acting as unregistered broker-dealers. The National Association of Securities Dealers, Inc. (NASD), as well as federal and state regulatory agencies, highly regulate the activities of broker-dealers. Until recently, most private placements involving unregistered finders ran little risk to the finder or the issuer. The risks were largely academic because in most cases investors could not claim a private right of action against the finder or the issuer. In 2005, however, the California legislature enacted a statute that drastically altered the risk exposure for companies and finders in transactions involving California residents or California issuers.

Corporations Code section 25501.5 gives investors the right to rescind a transaction when an unregistered broker-dealer procures the investment. If the investor no longer holds the securities, he or she may sue for damages. Pursuant to its authority under an amendment to Code of Civil Procedure section 1029.8, the court may award attorney's fees, costs and treble damages up to $10,000.

Section 25501.5 is a pernicious arrow in the quiver of plaintiffs' lawyers representing investors who want their money back. As a result, companies seeking to attract venture capital have wisely reconsidered their use of finders. If not doing away with finder arrangements entirely, they have tailored their arrangements so as to ensure their finders fit within a very narrowly tailored exemption from registration.

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The Exemption From Broker-Dealer Registration for Finders

Section 15 of the Securities Exchange Act of 1934, as amended, defines a "broker" as any person engaged in the business of effecting transactions in securities. Section 15(c)(6) makes it unlawful for a person not registered as a broker-dealer to effect any transaction in securities. California's "blue sky" securities laws essentially restate the federal law. Corporations Code Section 25004 defines a broker-dealer as any person engaged in the business of effecting transactions in securities in California. Under Section 25210, any person acting as a broker-dealer must be licensed by the Department of Corporations unless they are otherwise exempt.

Finders argue they are not "effecting transactions" in securities, and therefore are not acting as broker-dealers, when they facilitate investments. Finders and issuing companies have support for this position in a 1991 SEC no-action letter wherein the SEC blessed a "finder's exemption" for persons that merely open up their contact lists or make introductions to potential investors. In the letter (Paul Anka, July 24, 1991), the SEC found it important that the finder merely furnished his contact list of accredited investors and did not negotiate or offer advice in the financing. Although the SEC looked askance at the compensation arrangement where the finder was paid a percentage of the money he raised, it noted he had not previously arranged investments and agreed he would not do so in the future.

California case law and interpretive guidance from the Commissioner of Corporations also address the issue of finders. In each instance,[2] the finder's exemption has been narrowly construed to only include those persons who introduce investors to the issuing company. If the finder engages in any activity beyond swapping names, he or she is in violation of securities laws as an unregistered broker-dealer.

Based on available authority, several issues must examine several issues before engaging a finder. Each issue is relevant to whether a finder will be deemed an unregistered broker-dealer for purposes of regulatory action or liability under section 25501.5. However, none of these factors, either alone or together, are dispositive of the issue. The SEC and the California Department of Corporations (not to mention aggressive plaintiffs' attorneys) look at each situation on a case-by-case basis.

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[2] Lyons v. Stevenson, 65 Cal. App. 3d 595, 600-606 (1977); Evans v. Riverside International Raceway, 237 Cal. App. 2d 666, 675-76 (1965); Commissioner's Opinion No. 81/1C (Jan. 19, 1981).

1. Is the Finder Providing Services Other Than Simple Introductions?

Black's Law Dictionary, Sixth Edition, defines a finder as "an intermediary who contracts to find, introduce and bring together parties to a business opportunity, leaving ultimate negotiations and consummation of business transactions to the principals." A person loses his or her finder status by taking any role, however minor, in the ultimate sale of the securities.[3] The finder's involvement must start and stop with making introductions.

Issuers must ensure the finder is not involved in presentations to investors, negotiation of transactions, structuring of deal terms and similar activities. Other activities that will render a finder non-exempt include:

- providing advice or recommendations about the merits of a particular transaction.
- providing assistance to investors in completing the purchase agreement, subscription agreement or other documentation.
- providing financing to any investor for purchase of the securities.
- providing assistance to the issuer in drafting or distributing any material including financial data or sales materials.
- introducing the issuer to commercial banks, lawyers or other professionals to facilitate the financing.
- handling the funds or securities involved in the transaction.

The more information and assistance the finder gives to investors or the issuer, the less likely he or she will maintain exempt status. The finder's exemption is predicated on the finder merely introducing the issuer to potential investors or handing over his or her list of contacts. Even arranging meetings between the issuer and prospective investor will jeopardize the exemption.[4] Both issuers and finders are well-advised to ensure the scope of engagement is clearly and conspicuously committed to writing and followed in practice.

2. Does the Finder Regularly Engage in the Business of Facilitating Investments?

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[3] Henry Goppelt, SEC No-Action Letter, June 2, 1974.

[4] Mike Bantuveris, 1975 SEC No-Act. LEXIS 2, 158 at 1-2 (Oct. 23, 1975); *see also* May-Pac Management Corporation, 1973 SEC No-Act. LEXIS, 1, 117 at 1, 3-4 (Dec. 20, 1973).

As the SEC first made clear in the Paul Anka no-action letter, the regularity of a finder's activity is crucial to the determination of whether he or she is acting as a broker-dealer. Nothing is more certain to blow the finder's exemption than engaging a person who regularly, or even more than once, acted as a finder for a fee.

Individuals who profess to be "professional finders" may be successful in raising money, but they will put that money at risk and expose the company to the potential of regulatory action, fines, fees, penalties and myriad other bad things. If an issuer is looking for a proven product, the only safe bet is to employ a registered broker-dealer or placement agent.

3. Is the Finder's Compensation Fixed or a Percentage of Money Raised?

Perhaps no factor is more important when engaging a finder than compensation. Companies usually engage finders for the sole purpose of raising money, and do not engage them to provide financial or other consulting services. As a result, issuers usually pay finders a transaction fee based on the amount of capital he or she is responsible for bringing to the company, usually paid in either securities or cash (or a combination of both) as a percentage of the money raised (usually 5% to 10%). The Paul Anka no-action letter and California authority could not be clearer that success-based compensation is the primary characteristic of broker-dealer activity.

The safest course is to pay the finder a fixed fee regardless of the outcome of his or her efforts. However, this poses a practical challenge to the start-up company raising money precisely because it lacks operating capital. One solution is to guarantee the finder a fixed fee payable at the close of the financing. This way, the finder's compensation will not jeopardize the exemption and the offering as a whole.

Still, practicality may require a success-based compensation arrangement. After all, the finder by necessity must not have experience or a reputation as a rainmaker. With a guaranteed fee, the issuer could be on the hook for a substantial fee that is not justified or earned. Provided the other elements of the finder exemption are intact, success-based compensation by itself may not blow the exemption. However, until a California court renders an opinion on the issue, the better counsel is against using success-based compensation with finders.

The Consequences of Using an Unregistered Finder

Using an unregistered finder to help fund a deal poses significant risks to both parties involved. The issuer will face regulatory action by the SEC and state authorities, and may face private actions by investors for damages or to rescind their investments. In addition, using an unregistered broker-dealer will call into question any Regulation D private placement exemption from registration of the offering.[5] It will also jeopardize future efforts to raise capital. Some regulators have at least informally advised issuers that the use of non-exempt finders will render the company liable as aiders and abettors of securities law violations under Section 20(e) of the Securities Exchange Act of 1934. For emerging growth companies planning to tap the public markets, these issues will at best be spoilers during the road show presentations to large banks.

If a finder's activities do not fall within the exemption from registration, his or her agreement with the issuer will be wholly unenforceable in court. As a result, the finder has no real way to enforce payment by the issuing company and may not be compensated for his or her services. In addition, non-exempt finders are susceptible to civil and criminal penalties under both federal and state law.

The Department of Corporations Has Proposed a Limited Registration System for Finders

In September 2006, the California Department of Corporations invited comments to address whether it should adopt a limited registration system for finders and private placement broker-dealers.[6] In doing so, the Department recognized that the strict scrutiny of broker-dealers may not make sense for those whose activities are generally limited to receiving success-based compensation in private placement offerings. The Department specifically noted that "[t]he Commissioner has concerns that the current approach with respect to finders and private placement broker-dealers may unduly impede capital formation and jobs creation in California."

The Department invited public comment until December 28, 2006, and is expected to issue guidance by mid-2007.

[5] *See, e.g.*, Fed. Sec. L. Rep. (CCH) § 42,131; Sec. 359-f2 (d).
[6] Department of Corporations, Invitation for Comments PRO 31/06 (Sept. 13, 2006).