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THE RISKS OF USING "FINDERS" TO RAISE CAPITAL

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Raising investment capital for a business isn't easy in this climate and most entrepreneurs are willing to take any help they can get. Few entrepreneurs have sufficient personal contacts to fund an offering and when they are not an attractive candidate for the venture capital market, they enlist the services of well-connected individuals who make introductions and open up their contact lists. These individuals who act as intermediaries in the capital raising process are called "finders."

The problem is these "finders" may be acting as unregistered broker-dealers. The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), as well as state regulatory agencies highly regulate the activities of broker-dealers. In the past, private placements involving unregistered finders ran little risk to the finder or the issuer. The SEC rarely investigated or pursued finder arrangements, and sought enforcement only when the unlicensed match-making occurred in connection with much more significant wrongdoing.

This has changed. Over the past 18 months, the SEC has actively pursued investigation and enforcement actions for violation of the broker-dealer laws as they relate to unregistered finders. In addition, in this current economic climate where investors in private placements have seen their investments sour, or at best their path to liquidity shut down, investors are

JOHN P. CLEARY

bringing private actions against issuers to rescind their investments.

California Corporations Code Section 25501.5 gives investors the right to rescind a transaction when an unregistered broker-dealer procures their 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.

As a result of the civil and regulatory exposure, companies seeking to attract private capital have wisely reconsidered their use of finders. If not doing away with finder arrangements entirely, they have tailored their arrangements to ensure their finders fit within a very narrowly-tailored exemption from registration.

The "Finder's Exemption" From

Broker-Dealer Registration

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 issuers have historically relied on a 1991 SEC no-action letter (*Paul Anka, July 24, 1991*) to support this position. In the *Anka* no-action letter, the SEC blessed a "finder's exemption" for persons that merely open up their contact lists or make introductions to potential investors. 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, the finder's exemption has been narrowly construed to exclude most capital raising efforts by unregistered finders.

Based on available authority, several issues must be examined 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. The determination is not a balancing test of these factors. Rather, violation of one of these factors will render the finder arrangement illegal.

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. 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. Even arranging meetings between the issuer and prospective investor will jeopardize the exemption. 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?

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

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, penalties, litigation and a myriad of other consequences. If an issuer is looking for a proven finder, the only safe action is to employ a registered broker-dealer or placement agent.

3. Is the Finder's Compensation Dependent on Success in Raising Capital?

It is a common misperception among entrepreneurs and finders that the payment of a fee in cash or equity is acceptable if the finder merely makes introductions. This is wrong. It is a myth perpetuated by entrepreneurs and finders who have not been caught.

It is verboten to pay a finder a fee based on the amount of capital he or she is responsible for bringing to the company. SEC no-action letters post-*Anka* and recent guidance from the SEC could not be clearer that success-based compensation is the primary characteristic of broker-dealer activity. Whenever the finder will be compensated based on success in raising capital, he or she has the "salesman's stake" characteristic of a broker. In the SEC's view, it is this "salesman's stake" that creates the risk of unscrupulous activity and the need for the regulation and oversight that broker-dealer registration provides.

I have heard countless proposals from entrepreneurs and consultants seeking to avoid the success-based compensation prohibition. The most common would involve hiring the finder as a "consultant" and paying him a "consulting fee" for unspecific business purposes, payable if and when the company achieves a certain funding threshold. No matter how the arrangement is structured, if the fee is tied to the finder's activity in raising investment capital, and he would not have received the fee absent his success in doing so, then it is not permissible.

The safest course is to pay the finder a fixed fee regardless of the outcome of his or her efforts (for example, the finder receives a $10,000 fee for making the introduction regardless of whether the investor purchases shares). This of course requires the assumption of some risk on the part of the entrepreneur in the event the introduction does not lead to an investment. If practicality requires a success-based compensation arrangement, the only solution is to have the finder affiliate with a registered broker-dealer, essentially becoming a "back office" entity. For smaller transactions, this is not a realistic solution because the finder would have to pass the relevant licensing exams, find a firm willing to undertake supervisory duties over his activities and he certainly would have to share a portion of the fee with the supervising firm.

The Consequences of Using an Un-

registered 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. Using an unregistered finder will call into question reliance on the Regulation D private placement exemption and because Section 25501.5 allows investors to rescind investments procured through the use of unregistered finders, the funds raised will be at risk during the statute of limitations period. The contingency created through the rescission right also causes accounting troubles. Finally, if the investors demand a legal opinion to close the transaction, the issuer will also have a hard time convincing counsel to issue one.

Using an unregistered finder will also jeopardize future efforts to raise capital. A common sanction sought by the SEC against issuers utilizing unregistered finders is to bar the issuer from conducting Regulation D offerings in the future. This, of course, could have a lethal effect on a start-up company dependent on private capital. In addition, 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 in the future, these issues will at best be spoilers during the road show presentations to large banks.

The consequences to the finder also are severe. 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 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.

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