



# Finders for Raising Capital in Private Placements—Risky Bet

Startups and mature companies frequently turn to third parties – such as friends or former colleagues – to identify and negotiate with investors. These third parties often seek compensation for their efforts. This arrangement can have consequences for all involved parties, as the intermediary may in fact be acting as a broker-dealer.

Under Section 15(a)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”), it is unlawful for any broker or dealer to “effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security” unless such broker-dealer is registered with the SEC.[1] The Exchange Act defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.”[2] The Act defines a “dealer” as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”[3] Given the breadth of these definitions, the SEC looks to a variety of factors, expanded upon below, to determine whether a party is in fact acting as a broker or dealer.

While some exemptions and exceptions exist, broker-dealers generally must: (1) register with the SEC; (2) apply for membership in an SRO, such as FINRA; and (3) apply for broker-dealer registration with each state in which they plan to do business. Brokers-dealers that fail to fulfill these obligations can face severe penalties, including fines, disgorgement, criminal liability, and investor rescission.

## **Determining Broker-Dealer Status:**

The SEC employs broad, fact-dependent tests to identify unlicensed broker-dealer activity. Broker activity will likely be found where an individual: (1) participates in the solicitation, negotiation, or execution of securities transactions; (2) receives transaction-based compensation contingent on the value or success of securities transactions; (3) is otherwise engaged in the business of effecting or facilitating securities transactions; or (4) handles investor funds or securities.[4] Dealer activity is commonly attributed to persons or entities that: (1) hold themselves out as being willing to buy and sell securities on a continuous basis, or (2) originate securities that they may buy and sell.[5] Note that these factors are non-exhaustive and offered only as a guide.

## Manner of Compensation:

The SEC’s no-action and interpretive letters offer clarity on the practical implementation of these tests. In reviewing these materials, it becomes clear that the nature of compensation is the paramount consideration. The SEC has referred to transaction-based compensation as the “hallmark” of broker-dealer activity. Thus, “any person receiving transaction-based compensation in connection with another person’s purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer.”[6] Even one instance of transaction-based compensation may be enough for a finding that a person was in fact, “engaged in the business” of broker activity, and thus subject to registration.[7]



It is also apparent that these tests are sensitive and it is easy to trigger the registration requirement. For instance, the SEC is not particularly concerned with the substantiality of one's broker-dealer activities, having warned that one cannot avoid registration "merely because his securities activities are only a small part of his total business activities, or merely because his income from such activities is only a small portion of his total income." [8] The quantity or nature of the securities is also of little import. The sale of one share of stock is sufficient and the securities involved may be public or private. Further, limited partnership interests in a typical private investment fund are "securities," with the private investment fund as the "issuer." [9]

#### **Limited Exemptions, Exceptions:**

There exist limited conditions under which one may conduct broker-dealer activity without registering. In its "Guide to Broker-Dealer Registration" the SEC explicitly identifies five exemptions: (1) "associated persons" of a broker-dealer [10]; (2) intrastate broker-dealers [11]; (3) broker-dealers that limit their business to excluded and exempted securities [12]; (4) issuers and associated persons of issuers; and (5) foreign broker-dealers [13]. Based on a few SEC no-action letters, some believe that a "finder's exemption" exists, under which merely introducing potential sellers and buyers may not require registration. The SEC has been reluctant to create a "finder's exemption." The issuer's exemption and so-called finder's exemption generate the most uncertainty and are further discussed below.

#### Issuer's Exemption:

Entities issuing securities (issuers) are generally not required to register with the SEC, as issuers are not considered "brokers" or "sellers." [14] However, this does not apply to the personnel of a company who routinely engage in the business of effecting securities transactions for the company, such as general partners, employees, and other related persons seeking investors in the company.

Given the impracticality of this arrangement, the SEC established a safe harbor for employees or associates of issuers. The safe harbor covers officers, directors, employees, and partners of the issuer, and, if the issuer is a partnership, officers, directors, employees, and partners of the general partner of the issuer, who meet the following key conditions: the person (1) must primarily perform substantial duties for the issuer aside from those connected to securities; (2) may not participate in a securities offering more than once in a year; and (3) may not receive transaction-based compensation in connection with the sale of securities. [15]

While theoretically useful, this exemption is practically very limited. The conditions – particularly, that an unregistered individual may only participate in one offering per year – diminish its impact. Issuers must be cautious in using this exemption, as investors may rescind any purchases induced by unregistered individuals acting outside the scope of the exemption.

#### Finder's Exemption:

Based on a few SEC no-action letters from the early 1990s, many believe that an uncodified "finder's exemption" exists. [16] Under the so-called finder's exemption, which has not been explicitly adopted by the SEC, merely introducing potential sellers and potential buyers may not require broker-dealer registration. The exemption is extremely limited with respect to the level of engagement by the finder that may be permissible without registration. Depending on a number of factors, persons who find investors for issuers, even in a "consultant" capacity, may need to register. The factors include whether:



(1) the finder participates in the solicitation, negotiation, or execution of the transaction; (2) compensation is related to the outcome or size of the transaction; (3) the finder is otherwise engaged in the business of effecting securities transactions; and (4) the finder handles securities or funds of others.[17] The presence of any one of these conditions, even in isolation, may trigger the registration requirement.

The SEC focused on the compensation and solicitation factors in a 2010 denial of no-action request involving a finder arrangement. Brumberg, Mackey & Wall (“BMW”) sought to enter into an agreement with Electronic Magnetic Power Solutions (“EMPS”) under which BMW would help EMPS raise funds. BMW would introduce to EMPS individuals and entities who “may have an interest” in providing financing to EMPS. In return, EMPS would pay BMW an amount equal to a percentage of the gross amount EMPS raised as a result of BMW’s introductions.[18]

The SEC was disturbed by the fact that BMW would be evaluating who “may have an interest” in investing. The SEC reasoned that BMW would need to both “pre-screen” potential investors to determine their eligibility to purchase securities and “pre-sell” EMPS’s securities to gauge investor interest. These activities clearly fell within the confines of “solicitation.”[19] The payment arrangement was equally repugnant, as it gave BMW a “salesman’s stake” in the proposed transactions.

In one notable exception, the SEC authorized an arrangement in which the finder, Country Business, Inc. (“CBI”), would potentially be receiving transaction-based compensation. The SEC’s determination was based on the unique circumstances of the transaction and speaks to the narrow implementation of the “finder’s exemption.” In taking its no-action position, the SEC highlighted that: (1) CBI was to have a limited role in negotiations between buyer and seller, and would not advise either; (2) the selling company was a “small business,” as statutorily defined; (3) the transaction would be structured as a sale of 100% of either the assets or the equity of the seller to a single purchaser, but only the sale of assets would be advertised; (4) CBI’s compensation would be determined before the decision on how to effect the sale, and would not vary according to whether the sale was achieved through a sale of assets or securities; and (5) CBI would not help purchasers obtain financing.[20]

While seemingly promising for finders, the above SEC determination has been interpreted very narrowly. A transaction-based compensation arrangement for an unregistered finder would likely be permissible only when connected to a transaction with terms mirroring those on which the SEC conditioned its no-action relief to CBI.[21]

### **Consequences of Unregistered Broker-Dealer Activity:**

The ramifications of failing to register as a broker-dealer when required, or using the services of an unregistered broker-dealer, are severe. They include rights of rescission by investors under federal and state law; potential fines, disgorgement, injunctions, and suspensions of securities activity; reputational risks in the marketplace; and potentially losing the ability to rely on Regulation D and other exemptions from securities registration requirements.[22] These penalties can be imposed even absent evidence of fraudulent conduct.

To understand the risks, consider the recent SEC enforcement action against Ranieri Partners, a private equity firm, its Senior Managing Director Donald Phillips, and William Stephens, an independent



consultant hired by the firm to find potential investors for its funds. Stephens was not a registered broker-dealer, and was paid a fee equal to one percent of all capital commitments that he facilitated.

Finding that Stephens actively solicited investors on behalf of the funds, the SEC concluded that Stephens had violated Section 15(a) of the Act by failing to register. Ranieri Partners was at fault for failing to adequately oversee Stephens' actions, while Phillips willfully aided and abetted Stephens' violations.

As a consequence, Stephens was permanently barred from the securities industry and was required to pay disgorgement and pre-judgment interest in excess of \$2.8 million. Ranieri Partners paid a civil monetary penalty of \$375,000, while Phillips paid a civil penalty of \$75,000 and was suspending from acting in a supervisory capacity in the securities industry for 9 months.[23]

### Conclusion:

Attempting to profit from the sale of third party securities as an unregistered "finder" or other outsider is a treacherous endeavor. The same can be said for issuer use of unregistered finders. This assertion is buttressed by the SEC's recent crackdown on unregistered broker-dealers in the context of private securities offerings.[24]

Unregistered parties seeking to facilitate securities transactions should carefully review the SEC's registration triggers. They should never receive transaction-based compensation, such as commissions, contingency fees, bonuses, or other remuneration tethered to deal outcome. They should not advise any party, solicit or vet purchasers, or participate in deal negotiations. Finally, recall that fraud is not a required condition for SEC enforcement. Thus, even well intentioned actors can face severe consequences.

[1] They are also subject to regulations set forth by self-regulatory organizations ("SROs"), and the states in which they do business.

[2] Exchange Act, § 3(a)(4)(A)

[3] Exchange Act, § 3(a)(5)(A)

[4] <http://www.sec.gov/divisions/marketreg/bdguide.htm#I>

[5] In its "Guide to Broker-Dealer Registration," the SEC provides a more extensive list of questions: (1) Do you advertise or otherwise let others know that you are in the business of buying and selling securities?; (2) Do you do business with the public?; (3) Do you make a market in, or quote prices for both purchases and sales of, one or more securities?; (4) Do you participate in a "selling group" or otherwise underwrite securities?; (5) Do you provide services to investors, such as handling money and securities, extending credit, or giving investment advice?; (6) Do you write derivatives contracts that are securities? See <http://www.sec.gov/divisions/marketreg/bdguide.htm#II>

[6] <http://www.sec.gov/divisions/investment/noaction/1995/intouchglobal111495.pdf>

[7] Broker-Dealer Regulation: New Developments and Continuing Practical Concerns Regarding Registration Requirements for Business Brokers, “Finders,” and Other Financial Intermediaries, May-June 2014. Stephen Wink, Dana G. Fleischman, and Brett M. Ackerman.

[8] <http://www.sec.gov/divisions/investment/noaction/1995/intouchglobal111495.pdf>

[9] <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.22922.13.pdf>

[10] “Associated persons” are individuals who work for a registered broker-dealer. Although associated persons usually do not have to register separately with the SEC, they must be properly supervised by a currently registered broker-dealer. Associated persons may not (1) engage in securities activities outside the supervision of their broker-dealer, or (2) receive commission income on behalf of a registered representative.

[11] A broker-dealer that conducts all of its business in one state does not have to register with the SEC. To qualify for this *very* narrow exception, all aspects of all transactions must be done within the borders of one state. Even information posted on the Internet that is accessible by persons in another state would be considered an interstate offer that would require registration.

[12] A broker-dealer that transacts business *only* in commercial paper, bankers’ acceptances, and commercial bills does not need to register with the SEC.

[13] The full “Guide to Broker-Dealer Registration” is located at:  
<http://www.sec.gov/divisions/marketreg/bdguide.htm#II>

[14] The SEC has commented that “the Act has customarily been interpreted not to require the issuer itself to register as either a broker or a dealer” because the issuer is not effecting transactions for the account of others, nor is it engaged in the business of both buying and selling securities for its own account. See: <http://www.proskauer.com/files/uploads/broker-dealer/Summary-Rule-3a4-1-Safe-Harbor-for-Sales-Securities-by-Officers-Employees-other-Associated-Persons-of-Issuer.pdf>

[15] <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.22922.13.pdf>

[16] See *Paul Anka*, SEC No-Action Letter (July 24, 1991). The SEC granted no-action relief to an individual who, in one instance only, provided a list of names and telephone numbers of potential investors and received a success fee in return. This was the individual’s only involvement in securities transactions.

[17] <http://www.lexology.com/library/detail.aspx?g=b3fc9cc9-822b-4a29-938b-b48278adece4>

[18] *Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010)*.

[19] Note that finder activities needn’t extend this far to constitute solicitation. Solicitation can be any action designed to persuade or incentivize another person to purchase a security, including general newspaper advertisement or individually addressed emails. See, for example, *SEC v. Schmidt*, *Fed. Sec. L. Rep.* 93202 (S.D.N.Y. 1971); *Nemzoff & Co., LLC, SEC No-Action Letter (November 30, 2010)*.

[20] *Country Business, Inc., SEC No-Action Letter (November 8, 2006)*.

[21] *Using Finders to Assist in Financing: Understanding the Risks Associated with Unregistered Broker-Dealers*; Steve Ganis, Jeremy Glaser, Jake Romero; 2011.



[22] <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.22922.13.pdf>

[23] Broker-Dealer Regulation: New Developments and Continuing Practical Concerns Regarding Registration Requirements for Business Brokers, “Finders,” and Other Financial Intermediaries, May-June 2014. Stephen Wink, Dana G. Fleischman, and Brett M. Ackerman.

[24] <http://www.lexology.com/library/detail.aspx?g=b3fc9cc9-822b-4a29-938b-b48278adece4>