FINDERS' FEES: FOLKLORE AND FACT ON REGULATION

The capital markets are heating up, and as a result we are seeing increased interest in raising private capital for early-stage and private equity transactions. Because the private capital market is so inefficient, the use of "finders" to secure capital is increasing.

FINDER FOLKLORE

In the course of advising clients and reviewing proposed "finder" engagement agreements, we often hear folklore, or possibly wishful thinking, about the laws that apply to using agents to raise capital. This folklore typically takes the form of "finders" (i.e., persons who raise capital for a fee) and issuers (i.e., companies raising money), and assumes that the regulation of securities broker-dealers does not apply where a party seeking debt or equity funds hires a finder to introduce investors to the issuer. Often the documentation describes these activities as "consultation," as opposed to classic broker-dealer activities, but the fundamental relationship is the same: The finder is paid to bring investors (which may include lenders) to the issuer.

Confusion as to the law in these situations is dangerous for all parties to the transaction … .

As is almost always the case, this folklore is incorrect. Confusion as to the law in these situations is dangerous for all parties to the transaction, including the issuer, the finder, and in certain instances, the investor.

BROKER-DEALER LAW

The law is relatively simple. A "broker" means any person in the business of effecting transactions in securities for the accounts of others. If a person is compensated, either directly or indirectly, in connection with his or her participation in a securities transaction, that person is likely a broker and subject to the filing requirements and regulations under the Securities Exchange Act of 1934 as amended (the "Exchange Act") and, potentially, state laws regulating securities brokers. Section 15(a) of the Exchange Act provides that it is unlawful for any unregistered broker or dealer to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security.

If a person is compensated, either directly or indirectly, in connection with his or her participation in a securities transaction, that person is likely a broker and subject to the filing requirements and regulations under the Exchange Act and, potentially, state laws regulating securities brokers.

An exception to these requirements is available for employees of an issuer who occasionally sell the issuer's securities but primarily perform other duties for the issuer, whose compensation is not based either directly or indirectly on transactions in securities, and who meet certain other requirements.

Prior to 2010, there was a degree of informal comfort from the SEC staff that broker-dealer registration may not be required for a finder simply introducing interested investors to an issuer, assuming the finder did not participate in the negotiations or otherwise have anything to do with the sale of securities. In 2010, however, the SEC staff took a much more conservative position in a letter to a law firm that was seeking a referral fee arrangement for introducing an issuer to investors:

> [T]he Staff believes that the receipt of compensation directly tied to successful investments in [the issuer's] securities by investors introduced to [it] by [the finder] (i.e., transaction-based compensation) would give [the finder] a "salesman's stake" in the proposed transactions and would create heightened incentive for [the finder] to engage in sales efforts. Accordingly, the Staff believes that your proposed activities would require broker-dealer registration.

Hedge Funds

Specifically, our dealings with investment adviser clients who offer hedge funds reveal that the SEC is taking a hard look at the sales practices of these funds. Payment of solicitation fees is permissible only if the investment adviser and the finder follow Rule 206(4)-3 of the Investment Adviser Act of 1940 and the solicitation is for individually managed accounts. Interests in an investment fund are securities in their own right, and payment of finders' fees to unlicensed persons when raising capital for a fund will cause the SEC staff to question whether the arrangement involves payment of commissions to an unlicensed broker.

Private Equity Funds

Many firms that manage private equity funds are now required to register as investment advisers or report to the SEC. As a result, it is likely the SEC will be looking into sales practices related to those funds. As with interests in hedge funds, interests in private equity funds are securities that are subject to broker-dealer rules. Recent changes to SEC forms require registered investment advisers to private funds to identify each person that the fund compensates for marketing. This disclosure requirement gives the SEC a tool to identify opportunities for enforcement efforts against the payment of finder fees to persons not licensed as broker-dealers.

Risk All Around

Whether the nature of the activity of an unlicensed broker is questioned by a regulator or a disgruntled investor, the consequences can be severe. An unregistered finder who has violated the Exchange Act may face SEC sanctions as well as the loss of any fee. Specifically, Section 29(b) of the Exchange Act provides in part that any contract made in violation of any provision of the Exchange Act or of any rule or regulation thereunder shall be **void** in regard to the rights of (1) any person who, in violation of any such provision, rule, or regulation, made or engaged in the performance of any such contract and (2) any person who, not being a party to such contract, acquired any right under the contract with actual knowledge of facts by which the making or performance of that contract was in violation of any such provision, rule, or regulation. The maximum reach of this section is unclear, but it certainly allows the issuer to void the contract with the finder and likely would allow an investor to void an investment contract with the issuer that retained an unlicensed finder.

Even the investors themselves may be at risk.

Numerous securities laws, both state and federal, give investors rights to recover their investments if anyone who sold the investments materially misled the investors or omitted any information that makes the provided information materially misleading. An investor could argue that both the finder and the issuer misled the investor by not informing the investor about the protections that broker-dealer licensing is intended to provide, and omitting the fact that the finder is not licensed. Even the investors themselves may be at risk. Where some investors choose to stay in a deal, and others want out, those investors who stay in are at risk that the issuer may find itself burdened by claims for rescission by the other investors.

Additionally, Section 21C of the Exchange Act allows the SEC to issue a cease and desist order requiring not only the cessation of the unlawful activity but also that the violating person comply with the terms and conditions and within the time specified in the SEC order. The SEC may also obtain a court order to enjoin a violation of the Exchange Act and may seek civil penalties.

A knowing violation of the Exchange Act is a criminal offense and may lead to fines or imprisonment. Although it is probably unlikely that the typical finder arrangement would lead to criminal prosecution, the broker-dealer licensing issue may provide a more direct route for a criminal case when an investment involves other questionable practices.

CONCLUSION

Most "finders" are ethical people who perform a valuable service of matching opportunity with capital. It is important, however, that the issuer confirm that the finder is a registered broker-dealer or, if the finder is not registered, that the issuer determine that the intended activities do not require registration. This complex and highly regulated area makes it imperative for clients to be wary of simple fixes intended to structure around the requirement that most finders need to be registered broker-dealers.

ADDITIONAL INFORMATION

For more information, please contact:

Glenn E. Morrical
216.696.3431
glenn.morrical@tuckerellis.com

Jennifer W. Berlin
216.696.5482
jennifer.berlin@tuckerellis.com

Robert M. Loesch
216.696.5916
robert.loesch@tuckerellis.com