

## FUND FORMATION & INVESTMENT MANAGEMENT ALERT

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### Unregistered Finders: A Trap for the Unwary

The struggling economy and the tight credit market have made many companies turn to third-party intermediaries to help them raise capital or sell all or part of their business. Private funds are also increasingly looking to intermediaries for assistance in identifying potential sources of funding. These intermediaries, sometimes called “business brokers” or “finders” and referred to generically in this memorandum as “finders,” often tout their long lists of industry connections and extensive experience in facilitating transactions or fund raising. Companies and funds should think twice about engaging a finder without proper due diligence, however. Many finders should be – but are not – registered as broker-dealers with the Securities and Exchange Commission (the “SEC”). A company or fund that hires a finder that is not properly registered with the SEC may be unwittingly subjecting itself to future risks and liabilities, including the risk that investors or other parties to a transaction facilitated by the unregistered broker-dealer could later unwind the transaction.

### Determining Whether a Finder Should be Registered as a Broker-Dealer with the SEC

Any broker or dealer that effects the purchase and sale of securities is required by the Securities Exchange Act of 1934, as amended (the “Exchange Act”), to be registered with the SEC or, if a natural person, to be associated with a registered broker-dealer. A “broker” is broadly defined under the Exchange Act as “any person engaged in the business of effecting transactions in securities for the account of others.” Because of the breadth of these provisions, finders can inadvertently find themselves within their purview even if they are not selling or handling securities.

Registered broker-dealers must become members of a self-regulatory organization, such as the Financial Industry Regulatory Authority (“FINRA”), and are subject to the SEC’s rules regarding financial responsibility and conduct. This extensive regulation and oversight is intended to impose standards of professional conduct on and reduce abusive sales practices by broker-dealers. It also makes registration with the SEC time-consuming, expensive and, oftentimes, cost-prohibitive for finders.

A limited exception to the broad broker-dealer registration requirements has been recognized for finders who have argued that registration is not necessary because their role in securities transactions is limited – for example, to introducing willing buyers and sellers – and that they are not “effecting transactions in securities.” However, the contours of the so-called “finders exemption” are unclear. Indeed, there is little case law and the No-Action Letters that have been issued on the subject are highly fact-specific and cannot be relied upon as precedent.

In its Guide to Broker-Dealer Registration, the SEC states that a finder may be required to register as a broker-dealer if any of the following hallmarks of broker-dealer activity are present:

- Participation of the finder in important parts of a securities transaction, including soliciting, negotiating or executing the transaction.

- Compensation of the finder that depends upon, or is related to, the outcome or size of the transaction.
- A history of the finder effecting or facilitating securities transactions.
- The finder handling the securities or funds of others in connection with securities transactions.

The SEC further notes that the act of finding investors for companies issuing securities or for venture capital firms or finding buyers or sellers of businesses, even in a consulting capacity, may be sufficient to require registration as a broker-dealer.

While no single factor is dispositive in determining whether a finder is considered a broker-dealer, the SEC has made clear in its No-Action Letters that it considers the manner in which a finder is compensated to be a critical factor in the analysis. Presumably, the reason for this focus is that if a finder's compensation is tied to whether a transaction occurs (a "success fee") or the dollar value of a transaction (a "percentage-based commission"), there may be an inherent incentive for the finder to engage in abusive sales practices to effect the transaction.

### **Potential Consequences of Using an Unregistered Broker-Dealer**

Many believe that the consequences of a broker-dealer failing to properly register fall on the unregistered broker-dealer only. This is simply not the case. A broker-dealer's lack of registration will certainly subject the broker-dealer to fines and penalties under federal and state law and make it difficult for the broker-dealer to enforce any related fee arrangements. The consequences, however, may be even more problematic for the company or fund that engages the unregistered broker-dealer.

Section 29(b) of the Exchange Act renders void any contract made in violation of the Exchange Act or its rule and regulations. Arguably, this provision gives the parties to a transaction arranged by an unregistered broker-dealer a right to void the transaction agreements and unwind transactions that have previously closed. In other words, an investor that purchases securities may have the right to unwind the purchase if the company or fund that issues those securities subsequently fails just because the purchase was arranged by an unregistered broker-dealer.

In addition, the use of an unregistered broker-dealer in a transaction could cause a company or fund to lose any exemption from the registration requirements of the Securities Act of 1933, as amended (as well as from applicable state law qualification requirements), it may have relied upon in that transaction. Accordingly, the company or fund may have a difficult time obtaining a legal opinion from its counsel in connection with that transaction or a future transaction. It also may subject a company or fund to civil and criminal penalties, including pursuant to Section 20(e) of the Exchange Act on the theory that the company or fund aided or abetted the unregistered broker-dealer. Additionally, the use of an unregistered broker-dealer may lead to accounting issues because of the contingency arising from any rescission right of investors and disclosure issues in a subsequent public offering. Finally, the SEC may bar the company or fund from conducting private placement offerings in the future, thereby risking its ability to raise capital.

## **State Law Registration Requirements**

Registration of broker-dealers is no longer solely the domain of the SEC. Increasingly, states are imposing their own set of registration requirements on finders and broker-dealers. Registration requirements, and the implications for failing to register, vary by state. Accordingly, a state-by-state analysis of applicable securities laws must be undertaken. Illinois, for instance, requires the registration of “business brokers,” even if the business broker would have been exempt from registration as a broker-dealer under federal law. While many state statutes (including the Illinois statutes) provide for fining finders for failing to register, other states go further. For example, California law provides that any person who purchases a security from, or sells a security to, an unlicensed broker-dealer may bring an action for rescission of the sale or purchase or, if the security is no longer owned by the party, for damages.

## **Disconnect between Law and Practice; Recent Developments**

Because the law does not clearly delineate what activities can be undertaken by unregistered broker-dealers, the practice in this area varies considerably. Oftentimes, finders are not registered with the SEC, even when the law suggests they should be. In fact, a “major disconnect” between the law applicable to securities brokerage activities and the practice by which the “vast majority of capital is raised to fund early stage businesses in the United States” has been noted by a task force of the American Bar Association. Many proposals for reform have been advanced as a result of this disconnect, including a vastly simplified registration scheme for finders. Movement on these reform proposals has been slow, however, and, unless and until adopted, companies and funds should be wary of hiring finders not properly registered with the SEC even if they see others doing so.

Indeed, there are indications that regulators may be becoming more stringent in their enforcement of the broker-dealer registration rules. In 2000, the SEC revoked the no-action assurance it had previously granted to Dominion Resources, Inc. In its 2000 No-Action Letter, the SEC noted that because of technological advances and other developments in the securities markets, more and different types of persons were becoming involved in the provision of securities-related services and that the SEC had recently taken a more restrictive view of the finders’ exemption. Additionally, Form D, as amended effective September 15, 2008, requires companies to disclose fees paid to finders, which will make policing these activities far easier for regulators.

More recently, on June 19, 2009, the SEC announced a settlement of an administrative proceeding against Ram Capital Resources, LLC (“Ram”) and its two principals for acting as unregistered brokers. Between 2001 and 2005, Ram and its principals engaged in the business of identifying and soliciting investors, a majority of which were hedge funds, to participate in PIPE offerings. Ram also played a role in structuring and negotiating the terms of these PIPE offerings. The investors compensated Ram by paying it a percentage of the gross amount invested and, in most instances, allocated to it a certain percentage of any warrants received in connection with the investment. In characterizing the violation as “willful,” the SEC noted that the principals of Ram “knew or were reckless in not knowing that Ram’s compensation structure for its services required Ram to register as a broker-dealer.” This settlement is unique in that the only basis for the proceedings against Ram and its principals appears to be the failure to register as a broker-dealer. Few, if any, enforcement proceedings had been initiated by the SEC up until this point unless the failure to register was

accompanied by fraud or some other form of misconduct.

### **The Take-Away: Proceed with Caution**

Companies and funds should be confident prior to engaging a finder that the finder is either registered with the SEC and under applicable state securities laws or that the SEC and applicable state securities regulators will not view the finder as an unregistered broker-dealer. A company or fund can quickly determine whether a finder is registered with the SEC by consulting the list of registered broker-dealers maintained by FINRA on its website.

If a finder is not a registered broker-dealer, a company or fund should consider consulting with an attorney for assistance in determining whether registration is required and the risks in proceeding without registration. There are steps a company or fund can take to minimize risk when engaging an unregistered broker-dealer, including by:

- Researching the finder's history of involvement in securities transactions.
- Excluding the finder from negotiating or making recommendations regarding the transaction and carefully delineating the scope of the finder's engagement in an agreement with the finder.
- Limiting the finder's compensation to a flat or hourly fee that is not contingent on the success of the transaction.
- In M&A transactions, proceeding with an asset sale rather than a sale of the underlying stock.

Given the lack of clarity regarding the registration requirements for finders, companies and funds should proceed with extreme caution when engaging a finder. What may appear to be a good way to identify sources of funding or a willing buyer could result in a company or fund unintentionally assuming long-term risks and liabilities.

If you have any questions regarding this Alert, please call Michael B. Gray (312-269-8086) or any other attorney at Neal, Gerber & Eisenberg LLP with whom you regularly work.

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