FINDERS MAY NOT BE KEEPERS: TRAPS FOR THE UNWARY IN AWARDING TRANSACTION-BASED COMPENSATION

Smarter Way to Cross Blog Archives
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The CEO of an emerging technology company Acme Corp. calls you on a proposed Regulation D offering. Like many companies in this space, Acme is long on brains but short on capital. The CEO just *knows* that there *must* be a deep-pocketed, farsighted investor that will launch Acme into the tech stratosphere alongside Alphabet and Facebook. The CEO has recently met Mr. X at a trade conference. Mr. X touts an impressive rolodex that seems chock-full of eager investors on the lookout for hidden gems. In return, Mr. X demands a "finder's fee" equal to 1.5% of the total amount invested in Acme by his contacts. The CEO thinks this seems like a win-win on paper, but what are the legal implications of such an arrangement?

What does the law say?

Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires that all persons engaged in "broker" or "dealer" activity must register with the SEC unless an exemption is available. In general, a "broker" is any person "engaged in the business of effecting transactions in securities for the account of others" and a "dealer" is any person "engaged in the business of buying and selling securities for such person's own account." Based on established SEC staff guidance, activities that (alone or in combination) may be deemed to confer "broker" status include:

- soliciting investors to enter into securities transactions (including private transactions);
- assisting issuers in structuring prospective securities transactions or helping issuers to identify potential purchasers of securities;
- participating in the negotiating process or otherwise bringing buyers and sellers of securities together; and
- receiving compensation contingent on the success of a securities transaction or based on the value of a securities transaction.

In a 2013 speech, David Blass, the Chief Counsel for the SEC's Division of Trading and Markets remarked that the SEC *has consistently viewed transaction-based compensation as the "hallmark" of broker dealer activity.* Thus, based on the SEC's longstanding view, Mr. X must be a registered broker-dealer (i.e. licensed with a

brokerage firm) to lawfully be paid a "success fee" that is contingent on investments made in Acme. Mr. X may be licensed on his own or may be associated with an existing brokerage firm.

Is there a "Finder's Exemption"?

There is some lore about a "finder's exemption" that, believe it or not, originates from classic Canadian crooner Paul Anka. The SEC gave Anka no-action relief that permitted him to receive transaction-based compensation in exchange for providing a list of names and telephone numbers of possible investors (with no further contact or involvement in the transaction). However, the SEC has since reversed this position and has since indicated that such a letter would not be issued today. Nevertheless, it spawned a longstanding area of misunderstanding in US securities law over the existence of a "finder's exemption" There have also been advocates in the securities bar promoting a "broker-dealer lite" registration procedure that could be used by such finders to "cleanse" such activities. The SEC has never in fact issued such a regulation.

In January, 2014, the SEC did provide no-action relief from broker-dealer registration for M&A brokers engaged in activities related to the purchase or sale of a privately-held company. However this exemption appears to be narrowly tailored to circumstances where, among other things, (i) the M&A broker does not have the ability to bind a party to an M&A transaction and will not provide financing or handle funds in connection with the transaction, (ii) the M&A broker does not assist in forming the buying group, (iii) the buyer will, upon completion of the business, control the company and actively operate the company or business conducted with the purchased assets (the buyer cannot be a passive buyer) and (iv) there is no public offering involved in the M&A transaction.

Another recent regulatory change approved by the SEC involves a more permissive framework for corporate financing firms meeting the requirements of a new "Capital Acquisition Brokers" category. Such firms, if registered appropriately with FINRA, can advise issuers concerning their securities offerings and act as a finder with respect to institutional investors but not to accredited investors more generally.

A Risky Proposition:

Perhaps Acme feels that the risk of dealing with an unlicensed broker lies with the unlicensed broker. While this may be the case for broker-dealer regulations in some jurisdictions, it is not the case in the United States. When this issue has been litigated, some courts have accepted the payment of such fees, but recent SEC enforcement actions indicate risk to both the issuer and the unlicensed finder even where there are no allegations of fraud or other misconduct.

Furthermore, Section 29(b) of the Exchange Act provides that contracts made in violation of the Exchange Act may be voidable concerning the "rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract." Thus, if a sale of securities is effected through an unregistered broker-dealer, investors may have the dreaded "recission right" – essentially a right for investors to "put" back their investments to the issuer. In 2012, the SEC discovered that Neogenix, a public biotech company, had used unregistered finders in its late stage financings. The SEC required Neogenix to disclose its potential liability to investors with rescission rights, and the resulting impact on its financial statements led Neogenix into bankruptcy.

The Short Answer:

If Mr. X is not registered as a broker-dealer, there is risk to the company itself (not just Mr. X) in providing transaction-based compensation for soliciting investors. The risk is heightened in a Reg. D offering because of the required Form D filing that must be made post-closing:

- Item 12 of the Form requires the disclosure of each person who received sales compensation in connection with the offering, including the CRD[1] number of each such recipient.
- Item 15 of the Form requires disclosure of the total amounts of the sales commissions and finder's fees (or best estimate thereof), which may include non-cash compensation. It will be quite obvious to the SEC if sales commissions have been paid to an unlicensed broker: sales commissions or finder's fees will be disclosed in the form, but no recipient CRD number will be entered! One can be fairly certain that regulators will closely examine such Form D disclosures in enforcement proceedings.

To avoid the unpleasant consequences outlined above, Acme should ask Mr. X flatly whether he is a U.S. registered broker / dealer and for his CRD number. If he is not, Mr. X should avoid the "broker" activities enumerated above and limit his involvement with Acme to outside consulting services. Moreover, his remuneration should be a flat consulting fee that is not contingent on the amount raised in the offering.

Note that this blog post only discusses the legal implications of this arrangement under the federal securities laws of the United States. Each state also has its own broker-dealer regulatory regime that may be implicated by such an arrangement.

[1] This is an identification number unique to each U.S. registered broker-dealer.