"Finders Agreements In A State Of Flux"
By Dario de Martino and Jason Canales

07-13-11

In light of today's depressed capital markets, an increasing number of companies and funds are seeking the advice of third-party intermediaries for the purpose of raising capital or selling all or part of their business. These intermediaries, sometimes known as "finders," normally have access to a wide ranging network of financial sources and often offer to facilitate fund raising in exchange for a fee.

The current legal framework does not clearly define what activities can be undertaken by finders and often finders are not registered with the U.S. Securities and Exchange Commission, even when they should be. Regulators are becoming more stringent in their enforcement of the broker-dealer registration rules and in light of the major disconnect between the current legal framework and the practices by which capital for early stage companies is raised, we believe more regulations are about to be promulgated.

This article examines the reasons why companies should carefully consider engaging a finder and what potential pitfalls unregistered broker-dealer activities may trigger under federal and New York state laws.

Whether a Finder Should Be Registered as Broker-Dealer with the Security and Exchange Commission and Related Federal Securities Law Implications

The federal securities laws generally govern whether a finder must register as a broker-dealer, or conduct its activities in association with a registered broker-dealer. Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act") broadly defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

Section 3(a)(5) of the Exchange Act defines "dealer" as "any person who engages in the business of buying and selling securities for his own account, through a broker or otherwise." Section 15(a)(1) of the Exchange Act provides that 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 or dealer is registered with the SEC.

In addition, registered broker-dealers must become members of the Financial Industry Regulatory Authority, which imposes standards of professional conduct in order to insure among other things that abusive sales practices are drastically reduced.

It has been argued that there should be a limited exception for finders who do not effect transactions in securities, and limit their role to merely introducing willing buyers and sellers.

However, there is little case law on the subject and the SEC no-action letters addressing this matter are fact-specific and often do not constitute reliable precedent. [1]

In a no-action letter the SEC staff explained: "[A]n intermediary who did nothing more than bring merger- or acquisition-minded people or entities together and did not participate in negotiations or settlements between them probably would not be a broker in securities and not subject to the registration requirements of Section 15 of the Exchange Act; on the other hand, an intermediary who plays an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally would be deemed to be a broker and required to register with the Commission." [2]

In the April 2008 SEC "Guide to Broker-Dealer Registration," the SEC stated that a finder may be required to register as a broker-dealer if any of the following factors are present:

- Participation in important parts of a securities transaction, including soliciting, negotiating or execution of the transaction;
- Compensation for participation in the transaction depends upon, or is related to, the outcome or size of the transaction or deal;
- A prior engagement in the business of effecting or facilitating securities transactions; and
- Handling the securities or funds of others in connection with securities transactions.

There is no dispositive factor in determining whether a finder is considered a broker-dealer. However, the SEC has made clear in its most recent no-action letters that it gives significant importance to the manner in which a finder is compensated: if a finder's compensation is correlated to whether a transaction occurs ("success fee") or the dollar value of transaction ("percentage-based commission"), there may be an inherent incentive for the finder to engage in abusive sales practices to effect the transaction.

In a no-action letter dated May 17, 2010, addressed to the law firm of Brumberg Mackey & Wall PLC ("BMW"), the SEC makes clear that "[a] person's receipt of transaction-based compensation in connection with [effecting a transaction in securities, or inducing or attempting to induce the purchase or sale of securities] is a hallmark of broker-dealer activity." [3] There, BMW sought to enter into an agreement with a certain company to raise funds to finance its operations and development.

More specifically, "BMW would introduce to [the company] individuals and entities who 'may have an interest' in providing financing to [the company] through investments in equity or debt instruments of [the company]. In return, [the company] would pay BMW an amount equal to a percentage of the gross amount [the company] raised as a result of BMW's introductions."

Despite the fact that BMW was engaged principally in the practice of law, did not engage in the practice of securities law and was not engaged in any activities involving securities, the SEC found that BMW's "proposed activities would require broker-dealer registration" since (1) the "introduction to [the company] of only those persons with a potential interest in investing in [the

company] implies that BMW anticipates both 'pre-screening' potential investors to determine their eligibility to purchase the securities, and 'pre-selling' [the company's] securities to gauge the investors' interest" and (2) since the staff believed that "receipt of compensation tied to successful investments in [the company's] securities by investors introduced to [the company] by BMW (i.e., transaction-based compensation) would give BMW a 'salesman's stake' in the proposed transactions and would create heightened incentive for BMW to engage in sales efforts."

Clearly, regulators are becoming more stringent in their enforcement of the broker-dealer registration rules. In light of the major disconnect between the current legal framework and the practices by which capital for early stage companies is raised, more regulations are about to be enacted.

As further example of the tightening of the application of the current regulations, on June 19, 2009, the SEC entered into a settlement of an administrative proceeding against Ram Capital Resources LLC ("Ram") and its two principals for acting as unregistered broker Ram, and its principals engaged in the business of identifying and soliciting investors to participate in private investments in public companies ("PIPE"). [4]

Between 2001 and 2005, Ram through its two principals engaged in the business of identifying and soliciting investors, a majority of which were hedge funds to participate in PIPEs. 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.

Ram did not limit its activities to introducing potential interested parties but also played a role in structuring and negotiating the terms of these PIPE offerings. For example, the principals often drafted and distributed to issuers and investors the initial term sheet outlining the terms of the PIPE offering; moreover, they advised whether the offering should be structured as a convertible debt offering or a common stock offering and continued to remain involved in the offering by negotiating the terms of the relevant documents, including the securities purchase agreement.

The SEC noted that although 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," at no point in time did they register while engaging in the conduct alleged therein. As a result of the conduct described above, the SEC found that RAM "willfully" violated Section 15(a) of the Exchange Act.

The SEC deemed appropriate to impose sanctions pursuant to Sections 15(b) and 21C of the Exchange Act and ordered, among other things: (1) the two principals to be suspended from any association with any broker or dealer for a period of 12 months; and (2) penalties of about $538,000 per principal.

This settlement is unique in the way the SEC proceeded against Ram based on the mere failure to register as a broker-dealer. Only few, if any, enforcement proceedings had been initiated by the SEC unless such failure to register was accompanied by fraud or some other form of misconduct.

It is also worth nothing that Form D, as amended effective September 15, 2008, requires companies to disclose fees paid to finders, and therefore makes it easier for regulators to reveal abusive practices.

Federal Case Law

In SEC v. Kramer[5], the U.S. District Court for the Middle District of Florida stated: "The distinction between a finder and a broker, however, remains largely unexplored, and both the case law and the Commission's informal, 'no-action' letter advice is highly dependent upon the facts of a particular arrangement."

According to the court, "the Commission's proposed single-factor "transaction-based compensation" test for broker activity … is an inaccurate statement of the law .... As this order exhaustively explains, an array of factors determine the presence of broker activity. In the absence of a statutory definition enunciating otherwise, the test for broker activity must remain cogent, multi-faceted, and controlled by the Exchange Act."

New York Law

New York law recognizes a finder as "someone who finds, interests, introduces and brings parties together for a business transaction that the parties themselves negotiate and consummate." [6] As one court has explained, "[f]inders find potential buyers or sellers, stimulate interest and bring parties together. Brokers bring the parties to an agreement on particular terms."[7]

For a finder to recover under a finder's agreement there must be a causal relation between the introduction of the parties and the ultimate conclusion of the transaction. [8] Moreover, courts have consistently required that the finder show more than his services was a necessary "but-for" condition, and prove a continuing connection between the finder's service and the ultimate transaction. In addition, some courts have directed the payment of a finder's fee in situations where the consummation of the transaction at issue flowed not directly from the finder's initial introduction, but indirectly from a chain of introductions initiated by the finder.

Potential Pitfalls

A finder acting as a broker-dealer not only triggers fines and penalties under federal and state law and makes it difficult for the broker-dealer to enforce any related fee arrangements but can also have consequences over the company 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. Therefore, any investor that purchases securities may have the right to void the purchase agreement and claim that the funds be returned just because the purchase was arranged by an unregistered broker-dealer.

In addition, the use of an unregistered broker-dealer could cause a company to lose the exemption from registration requirements of the Securities Act of 1933 it may have relied upon

in that transaction and most importantly, lose the ability to raise capital in the future since the SEC may ban the company from conducting private placement offerings in the future.

Finally, the SEC may seek an injunction to enjoin the finder's activities, issue a cease-anddesist order following notice and a hearing, and may, although unlikely, refer the matter to the government for criminal prosecution.

Conclusion

Given the lack of clarity of the current legal framework and the recent tendency of the regulators to apply registration rules more stringently, companies should proceed with extreme caution when engaging a finder.

If a finder is not registered as broker-dealer, a company or fund should consider, among other things: (1) the finder's role overall and ferret out whether it will be restricted to merely bringing two parties together or whether the finder will participate in negotiating and structuring the transaction; (2) the finder's history of involvement in securities transactions; and (3) the finder's compensation and whether it is a flat fee or contingent on the success of the transaction.

If a finder is not a registered broker-dealer, a company should consider consulting with an attorney and therefore avoid assuming unintentional long-term risks and liability.

Jason Canales *is an associate in the New York office of Moses & Singer.* **Dario de Martino** *is an associate in the New York office of Gersten Savage.*

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

Endnotes:

[1] One of the only ways to maybe guarantee that regulatory action will not be taken against a "finder" is by requesting and obtaining a no-action letter from the SEC prior to engaging in a particular transaction.

[2] See Henry C. Coppelt d/b/a May Pac Management Co., 1973-1974 Fed. Sec. L. Rep (CCH), paragraph 79,814

[3] Citing, Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration, Securities Exchange Release Act Release No. 61884 (April 9, 2010) ("Indeed, the receipt of transaction-based compensation often indicates that such a person is engaged in the business of effecting transactions in securities) and Letter From Catherine McGuire, Chief Counsel, Division of Market Regulation, to Thomas D. Giachetti, Stark & Stark, regarding 1st Global, Inc., (May 7, 2001) (reiterating the staff's position that "the receipt of securities commissions or other transaction related [sic] compensation is a key factor in determining whether a person or an entity is acting as a 'broker' or 'dealer.' Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of 'broker' or 'dealer', generally is required to register as a broker-dealer."

[4] The SEC instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934.

[5] See SEC v. Kramer, No. 8:09-cv-455-T-23TBM (M.D. Fla. Apr. 1, 2011).

[6] See Moore v. Sutton Resources Ltd., 1998 *4 (S.D.N.Y. 1998) (citing Northeast General Corporation v. Wellington Advertising Inc., 82 N.Y.2d 158, 163, 604 N.Y.S.2d 1 (1993).

[7] See Train v. Ardshiel Assoc. Inc. 635 F. Supp. 274, 279 (S.D.N.Y. – 1986), aff'd without opinion, 805 F.2d 391 (2d Cir. 1986).

[8] See Moore v. Sutton Resources Ltd 1998 WL 67664, *4; see also Simon v. Electrospace Corp., 28 N.Y.2d 136, 142, 320 N.Y.S.2d 225, 229 (1971); Edward Gottlieb Inc., v. City & Commercial Communications PLC, 200 A.D.2d 395, 606 N.Y.S.2d 148, 150 (1st Dept 1994); Karelitz v. Damson Oil Corp., 820 F.2d 529, 531 (1st Cir. 1987) (Breyer, J.) (Applying New York law).

Jason Canales
New York, N.Y.

Reprinted with permission from the "July 13, 2011" edition of "Law360" Copyright © Portfolio Media, Inc. Content may not be shared or redistributed in any fashion without the express permission of Portfolio Media. For inquiries regarding rights and reprints, please contact reprints@law360.com.

MOSES & SINGER LLP

Disclaimer

Viewing this or contacting Moses & Singer LLP does not create an attorney-client relationship.

This is intended as a general comment on certain developments in the law. It does not contain a complete legal analysis or constitute an opinion of Moses & Singer LLP or any member of the firm on the legal issues herein described. This contains information that may be modified or rendered incorrect by future legislative or judicial developments. It is recommended that readers not rely on this general guide in structuring or analyzing individual transactions or matters but that professional advice be sought in connection with any such transaction or matter.

Attorney Advertising

It is possible that under the laws, rules or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.

Copyright © 2011 Moses & Singer LLP
All Rights Reserved