USING A "FINDER" – A PRACTICAL GUIDE

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Chicago, Illinois
October 10, 2017

When an early stage company is in need of capital and cannot obtain bank financing, finding potential investors can be difficult. Typically, the entrepreneur will first look to friends and family and later to angel investors (if available) or to other potential investors. Before embarking on raising capital (regardless of whether equity or debt) from investors, it is important for the company's directors and executive officers to understand that regardless of who the prospective investors are and regardless of whether the investors will invest in stock of the company or debt (promissory note, etc.), such a capital raising offering involves the offer and sale of the company's securities and the offering is regulated by the U.S. Securities and Exchange Commission ("SEC") and securities laws and its laws, rules and regulations and the laws of each state where the company's securities will be offered and sold. Strict compliance with such laws, rules and regulations is important because the company's directors and executive officers will be jointly and severally liable in a rescission action brought by the purchasers of the securities in the event the offering fails to comply with such laws.

Under the U.S. securities laws, the offer and sale of securities by the company can only be done legally by an offering of securities that is either registered with the SEC (and applicable state securities laws) or made in compliance with one of the various exemptions from the SEC's securities registration requirements. The company's directors and executive officers should be aware that the term "securities" is very broadly defined by the SEC and case law and includes stock, bonds, promissory notes, limited partnership interests, limited liability company interests, bonds, promissory notes, convertible notes, investment contracts, etc.

Raising capital from investors regardless of whether done pursuant to a registered securities offering or an exempt securities offering, is expensive, time consuming and will require the attention of the company's directors and executive officers to avoid violating such laws. In a registered securities offering, the company will incur substantial accounting and legal fees in connection with the registration process without any assurance that it will successfully raise any funds from investors and the company will be required to have its financial statements audited by a qualified independent public accounting firm. An exempt securities offering is typically much less expensive than a registered offering and the process is shorter than a registered securities offering but as with a registered securities offering there is no assurance that the company will successfully raise any funds from investors. For these reasons, many companies elect to raise the capital in reliance on one of the SEC's (and state) exempt offerings (e.g., a private placement, an intrastate offering, Regulation A offering, a crowdfunding offering, etc.). An exempt offering will also require the time and attention of the Company's directors and executive officers.

Regardless of whether the company engages in a registered offering or an exempt offering, it will become apparent to the company's directors and executive officers that raising capital from the sale of the company's securities is not easy, success is not assured, it is time consuming, it is a separate

and substantially different business from the company's core business, and requires skills and experience that the company's directors and executive officers may not possess. For these reasons, the company's directors and executive officers may want to engage a registered securities broker-dealer firm to assist the capital raising effort. However, such broker-dealer firms are typically very selective in taking on engagements and when evaluating the potential engagement they will look to, among other factors, the success and experience of company's management team, the nature of the business, the company's desired valuation, the size of the proposed offering, the prospects for the company's growth potential and the risks regarding the company's industry. Accordingly, the company's directors and executive officers may find it time consuming and difficult to try to attract a registered broker-dealer firm to accept the engagement. As a result, many companies turn to working with a finder (also sometimes called a financial consultant, a "Finder") to assist in the company's capital raising effort. A Finder is a person or firm that assists a company in raising capital from investors. Typically, a Finder is not registered as a broker-dealer under the Securities Exchange Act of 1934 (the "Exchange Act") and for that reason, the use of a Finder may complicate and possibly jeopardize the status of the company's offering as being exempt from the securities registration requirements. Therefore, it is prudent for the company's directors and executive officers to be aware of and understand the risks involved with using a Finder.

Under the Exchange Act, a broker is defined as "any person engaged in the business of effecting transactions in securities for the account of others" and a dealer is defined as a person that is "engaged in the business of buying and selling securities … for such person's own account," but excludes a person that buys and sells securities for its own account, but not a part of a regular business. These definitions are interpreted broadly by the SEC and the courts to protect the public. In particular, the definition of broker is the one that creates the most problems for Finders because it encompasses activities including: selling securities for companies to investors in public offerings and **exempt offerings**, providing advice regarding the value of securities, locating companies, soliciting new clients, assisting in the structuring and negotiation of securities transactions, disseminating quotes for securities. Section 15(a)(1) of the Exchange Act, provides that it is unlawful for any broker or dealer to induce or attempt to induce the purchase or sale of any security unless such broker or dealer is registered with the SEC. It is important that the burden of proof is on the person claiming that he is not required to register as a broker-dealer. The federal and state securities laws have no formal definition of a Finder. Case law, SEC interpretations and SEC no-action letters are the sources for guidance as to whether a Finder's activities will require the person to register as a broker-dealer.

Impact of Using a Finder on the Status of the Securities Offering Exemption

Under the federal and state securities laws, the company bears the burden of establishing that its securities are sold in compliance with those securities laws. This means not only compliance with the securities registration requirements or compliance with requirements of the particular exemption from the securities registration requirements, but also compliance with the offering process and manner of the offering, including whether the securities are offered/sold through a registered broker-dealer or directly by the company's directors and/or executive officers (who are exempt from the broker-dealer registration requirements). For this reason, if the company decides to use an unregistered Finder, it is prudent that the company take precautions to limit the services to be

performed by such Finder so the Finder does not run afoul of the SEC's broker-dealer registration requirements and thereby result in the loss of the intended offering exemption.

If it is subsequently determined that the services performed by the Finder would have required the Finder to register as a broker-dealer, the offering will have not complied with the "offering process". In such an event, if the offering was intended to be conducted in reliance on one of the SEC's securities registration exemptions, the intended exemption will not be available for that offering and the offering will have been made in violation of the applicable securities laws. The SEC may seek a civil injunction or monetary penalties, and refer the matter to the United States Attorney for criminal prosecution. Additionally, the purchasers of securities sold in an offering that is not exempt due to the failure of the Finder to register as broker-dealer, will have a right to bring a rescission action against the company and its directors and executive officers. Furthermore, the company and its directors and executive officers will have no post-offering means of protecting subsequent investments made by investors from such rescission claims that could arise from the prior unregistered, non-exemption securities offering and in such event the capital invested by subsequent investors would be available to pay the rescission demands of the earlier investors rather than to fund the company's business purposes. Also, this risk would need to be disclosed to the subsequent investors before they invest. Further these rescission risks will continue until the applicable statute of limitations period has expired. Accordingly, when a company uses a Finder, the company is at risk of having conducted an illegal sale of securities and the Finder is at risk that it violated the SEC's broker-dealer registration requirements, both of which may also give rise to the investors for a claim for rescission under the applicable laws.

Limiting the Services to be Performed by a Finder

There are no hard and fast rules as to what services or activities may be performed by an unregistered Finder without violating broker-dealer registration requirements. Conventional wisdom is that a Finder who does nothing more than provide the name and phone number of a potential purchaser is the only person sure to be a Finder that is not required to register as a broker-dealer. Any activity beyond that can raise issues that the Finder is acting as an unregistered broker-dealer. Given the broad nature of the broker-dealer definition, some companies may not realize when the activities of the Finder will trigger the broker-dealer registration requirement.

A review of SEC no-action letters discussing this indicates that the SEC considers the following factors determinative:

- *Receipt of transaction-based compensation*. A Finder who receives transaction-based compensation (a commission or some form of compensation that varies in size or type based upon the amount of resulting investment) in connection with a securities offering is almost always deemed to be a broker-dealer.

- *Negotiation or advice*. A Finder that is involved in negotiations or who provides detailed information or advice to a buyer or seller of securities is likely to be deemed a broker-dealer.

- *Solicitation of investors*. A Finder who solicits investors is likely to be deemed a broker-dealer.

- *Previous securities sales experience or disciplinary action*. A Finder who has previous experience selling securities and/or has been disciplined for violations of securities laws are factors that will cause the Finder to be considered a broker-dealer. The regulators do not want the Finder exception to allow past violators to operate in the securities industry and compromise investor protection.

However, it is important to understand that the SEC has repeatedly stated that none of these factors is dispositive.

While no single factor is considered dispositive in determining whether a Finder is considered an unregistered 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.

The SEC broadly interprets activities that qualify as engaging in a securities transaction and therefore such activities are restricted to only the company's directors and executive officers and registered broker-dealers. Activities such as recommending the purchase of securities, negotiating terms of a securities offering or purchase, performing due diligence, attending meetings where the merits of a proposed investment are discussed, providing valuations, and handling the funds of others have all been found to require a Finder to register as a broker-dealer. In addition, a Finder who accepts a fee for introduction of capital more than once may be "engaged in the business" of effecting securities transactions and hence engaging in activities that are restricted only to a registered broker-dealer.

Other factors considered to be typical of a Finder acting as a broker that requires the Finder to be registered include:

- Assisting in structuring the transactions;
- Engaging in "pre-selling" the issuance to gauge the level of interest;
- Engaging in "pre-screening" potential investors to determine their eligibility to purchase securities;
- Conducting or assisting with the sale of securities;
- Disseminating quotes for securities or other pricing information;
- Actively soliciting or finding investors;
- Distributing private placement memoranda, subscription documents, and due diligence materials to potential investors;
- Advising on portfolio allocations to accommodate an investment; and
- Providing analyses of potential investments.

Based on the foregoing, it would be prudent for any company that intends to engage an unregistered Finder to assist in the capital raising effort to enter into a written agreement with the Finder that will itemize those activities that the Finder **will not** be authorized to perform (which are activities available only to registered broker-dealers). Specifically, such agreement should provide that:

- The Finder will only make introductions to suitable, accredited investors;

- The “Finder” will not solicit or pre-screen investors;
- The Finder will not provide advice about the merits of particular investment opportunity;
- The Finder will not receive a commission (based on the amount of money raised) from the company or the investor and will only receive compensation that is not based upon the amount of money raised from investors (a non-contingent fee and/or a nominal flat fee to cover administrative costs);
- The Finder will not participate the structuring the investment or in any negotiations between company (including its directors, executive officers, promoters, etc.) and prospective investors;
- The Finder will not directly assist the company or investors with the completion of any transaction;
- The Finder will not handle funds or securities involved in completing a transaction;
- The Finder will not present information regarding the company or the offering to potential investors; and
- The Finder should not hold itself out as providing any general securities-related services.

Such an agreement should also include representations, warranties and covenants and indemnification by the Finder in favor of the company against losses arising out of any violations of applicable federal and state securities laws by the unregistered Finder or the breach of any of the representations, warranties or covenants and a covenant that the unregistered Finder will not take any action or perform any services under the agreement that will require it to register as a broker-dealer.

If you have any questions regarding the use of finders, or capital raising in general, please contact the Jerold N. Siegan at (312) 560-7228 or jerry@jnsieganlaw.com. Jerry is the founder of J.N. Siegan & Associates, a boutique business law firm in Chicago, Illinois. He specializes in the areas of corporate, businesses, transactions and securities law matters. He has substantial experience in advising clients in numerous transactions, including entity formation and governance, mergers and acquisitions, public and private offerings of debt and equity securities and representation of public companies in connection with their ongoing disclosure requirements under the federal securities laws.

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