July 10, 2014

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Emerging Business Program

Use Caution When Using Finders to Help Raise Capital

By: Daniel H. Peters

The ability to raise capital from investors is critical to the success of most emerging businesses. Founders of early stage companies often look to enlist their networks and employees to assist in that effort, in many cases seeking to compensate such individuals for their efforts. What on the surface may seem to be a simple and sensible proposition—"help me find investors from whom I can raise capital, and I'll reward you with a commission"—can turn into a legal nightmare with a far reaching impact if the company uses a finder or solicitor who is effectively acting, but not registered, as a broker. Emerging businesses should proceed with caution when employing and compensating such individuals who may help to reel in investors.

When is a person considered to be acting as a broker in connection with an investment round? U.S. securities laws generally consider any person that effects transactions in securities to be acting as a broker-dealer, requiring that person to be registered with Financial Industry Regulatory Authority (FINRA). Becoming a registered broker-dealer involves a costly and extensive process, and subjects the individual or organization to significant federal and state regulation. In recent years, the Securities and Exchange Commission (SEC) has signaled an increased aggressiveness in defining the scope of activities that may lead to a broker determination. A person may be viewed to be acting as a broker-dealer in connection with a securities transaction if that person:

- Participates in important aspects of the transaction (e.g., by soliciting, executing, negotiating or helping to structure the deal);
- Recommends, values or otherwise provides advice regarding the securities;
- Receives transaction-based compensation, such as a commission or fee contingent on the deal closing or based on the size of the investment;
- Handles funds or securities in the transaction; or
- Regularly engages in the business of effecting or facilitating securities transactions.

As regulators will focus on the substance of any finder arrangement rather than the form it takes, emerging companies using finders should not expect to avoid a violation simply by re-characterizing the relationship. For example, merely structuring it as a consulting arrangement will not likely succeed in insulating the relationship from regulatory scrutiny.

What are the consequences? The negative consequences of using a person to help raise capital who is determined to be an unregistered broker can be significant. A company doing so could face government enforcement action and monetary penalties. Moreover, investors may be entitled to rescind the deal and receive a refund of their investments. In addition to the financial hardship that a rescission and refund might place on an emerging business, a serious misstep in early-stage financing could cripple the company's ability to obtain additional capital in a future round. The individual acting

as a broker could also be subject to fines and other penalties, which may include disgorgement of his or her fee. Any company engaging in a finder arrangement should also be aware of all applicable state laws, as each state has its own set of laws and regulations addressing broker-dealers in the context of investment transactions.

How can emerging businesses lawfully use finders and employees to solicit investors? Contrary to what some may believe, no general "finder's exemption" is recognized under which a company can safely pay to a finder compensation that is related to the outcome or size of an investment. A company engaging in a financing round, whether by issuing stock or debt, is offering securities. In order to lawfully engage persons to act as finders, an emerging business should ensure that such persons limit the scope of their activities to only effecting introductions and should not make investment recommendations to potential investors or participate in the negotiation of the deal terms. The company should not pay to a finder any fee that is contingent on the success or size of the capital raising transaction, regardless of whether the fee is payable in cash or equity. Any compensation to a finder should be payable irrespective of the success of the investment transaction.

The SEC has a "safe harbor" rule protecting people associated with a company that is offering securities in an investment transaction. This exemption to the standard broker-deal registration requirement may apply to allow the company's officers or employees to assist in soliciting investors without being required to be registered broker-dealers. However, such persons may not receive transaction-based compensation, such as a commission contingent on the deal closing or based on the size of the investment. To qualify for the safe harbor, an officer or employee must also:

- Not have previously been determined to be a "bad actor" within the securities industry;
- Not have been a registered broker within the last year, and must not be associated with a broker or dealer during the transaction;
- Primarily perform a job for the company other than assisting with raising capital; and
- Not participate in the company's securities offerings more than once in any 12-month period.

It is important to note that recent cases have seen federal courts challenging the SEC's aggressive posture regarding broker-deal determinations in the context of finder arrangements. The decisions indicate that a finder may in certain circumstances be able to receive transaction-based compensation—for example, when a finder's involvement is solely limited to introducing a potential investor to the company. However, because the SEC and the federal courts do not yet appear to be in harmony on the matter, entrepreneurs should tread carefully when using finders to raise capital.

Founders of emerging businesses often need help to identify and attract sources of capital, and can and should rely on their networks to do so. However, many entrepreneurs engaging a finder or employee to assist with a capital raising transaction anticipate a compensation arrangement that could in fact violate securities laws and have significant adverse consequences. Emerging businesses should use caution and obtain competent legal advice before entering into any arrangement with a person that proposes to find and introduce investors to the company, whether that person is a third party consultant or an employee. Failing to do so may put the brakes on the company's ability to successfully raise needed capital.

For more information on the matters discussed in this *Locke Lord QuickStudy,* please contact the author:

Daniel H. Peters | 213-687-6778 | dpeters@lockelord.com