withersworldwide

New Guidance on Broker-Dealers vs. Finders

21 MAY 2010

David Guin
PARTNER | US

CATEGORY:
ARTICLE

As the economy begins to recover from a severe recession, new companies are being formed and existing companies are trying to grow their businesses. With bank credit still scarce, many companies turn to "finders" to help identify potential investors. Finders are generally defined as intermediaries who help locate investors but who do not register with the SEC as broker-dealers under the Securities Exchange Act of 1934 (the "Exchange Act").

Registering as a broker-dealer is expensive, time-consuming and subjects the broker-dealer to SEC regulatory oversight; thus, there are many reasons why an intermediary seeks to be categorized as a finder rather than as a broker-dealer. However, companies that use intermediaries to assist in the sale of securities must be extremely cautious when working with a finder who may be required to register as a broker-dealer under the Exchange Act. In addition to the reputational risks to a company associated with such a mistake, contracts entered into in violation of the Exchange Act and its rules and regulations are subject to being deemed void.

Therefore, if a purchaser of a company's securities uses an unregistered broker-dealer, the purchaser may be able to void the purchase and seek rescission of its investment in the company.

The SEC has not provided a bright line test to distinguish between a finder and a broker-dealer. Instead, rather than identify any dispositive factors, the SEC has generally performed an analysis that considers multiple criteria, including:

1. Whether the intermediary's compensation is success- or transaction-based;

2. Whether the intermediary participates in negotiations between the issuer and purchaser;

3. Whether the intermediary has a history of involvement in securities transactions; and

4. Whether the intermediary handles the securities of others in connection with securities transactions.

On May 17, 2010, the SEC issued a No-Action Letter that provides additional guidance regarding the finder/broker-dealer distinction. A prospective finder requested no action from the SEC regarding its potential engagement by a corporation to assist in the acquisition of funding. Under the proposed referral fee agreement, the finder would receive success-based compensation tied to a percentage of the amounts raised from contacts identified by the firm as being interested in investing in such corporation. In its request for no action, the firm stated that it would not (i) engage in negotiations on any party's behalf, (ii) provide its contacts with any information about the corporation, (iii) be involved with or make recommendations about any financing agreements reached by the parties, or (iv) assist with any transactions involving the financing.

Although the finder's role was proposed to be limited, the SEC pointed to two reasons why the firm would need to register as a broker-dealer. First, the fact that the firm would only be making a limited number of introductions suggested to the SEC that the firm would be "pre-screening" potential investors and "pre-selling" the corporation's securities in an effort to make sure that the investors were both eligible for and interested in the transaction. Second, and perhaps more critically, the firm's success-based compensation arrangement suggested to the SEC that the firm would have a "heightened incentive" to engage in sales efforts. Based on those two factors, the SEC expressed its belief that the firm's activities would require it to register as a broker-dealer.

Given the SEC's recent guidance, both "finders" and companies that work with them must continue to be wary of SEC enforcement and the other consequences of engaging in activities related to the sale of securities without broker-dealer registration. Such persons should first consider obtaining legal advice regarding the structuring of the finder relationship as a way of minimizing potential risk.

Authors

David Guin

PARTNER | NEW YORK

Corporate

+1 212 848 9870

david.guin@withersworldwide.com