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The Payment Of Finders' Fees- An Ongoing Discussion

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Introduction

As a recurring topic, I discuss exemptions to the broker-dealer registration requirements for entities and individuals that assist companies in fundraising and related services. I have previously discussed the no-action-letter-based exemption for M&A brokers, the exemptions for websites restricted to accredited investors and for crowdfunding portals as part of the JOBS Act and the statutory exemption from the broker-dealer registration requirements found in Securities Exchange Act Rule 3a4-1, including for officers, directors and key employees of an issuer. I have also previously published a blog on the American Bar Association's recommendations for the codification of an exemption from the broker-dealer registration requirements for private placement finders. I've included links to each of these prior articles in the conclusion to this blog.

A related topic with a parallel analysis is the use of finders for investors and investor groups, an activity which has become prevalent in today's marketplace. In that case the investor group utilizes the services of a finder to solicit issuers to sell securities (generally convertible notes) to the investment group. These finders may also solicit current shareholders or convertible note holders to sell such holdings to a new investor or investor group.

Most if not all small and emerging companies are in need of capital but are often too small or premature in their business development to attract the assistance of a banker or broker-dealer. In addition to regulatory and liability concerns, the amount of a capital raise by small and emerging companies is often small (less than $5 million) and accordingly, the potential commission for a broker-dealer is limited as compared to the time and risk associated with the transaction. Most small and middle market bankers have base-level criteria for acting as a placement agent in a deal, which includes the minimum amount of commission they would need to collect to become engaged. In addition, placement agents have liability for the representations of the issuing company and fiduciary obligations to investors.

As a result of the need for capital and need for assistance in raising the capital, together with the inability to attract licensed broker-dealer assistance, a sort of black market industry has developed, and it is a large industry. Neither the SEC, FINRA or state regulators have the resources to police this prevalent industry of finders. The fact is that there are thousands of unlicensed finders that operate openly, and even advertise their services, making it impossible for practitioners to convince small issuers that they should not utilize the services of these groups. As the saying goes, if everyone is doing it and doing it openly, it must be okay – but it is not okay.

As discussed further in this blog, I would recommend a regulatory framework that includes (i) limits on the total amount finders can introduce in a 12-month period; (ii) antifraud and basic disclosure requirements that match issuer responsibilities under registration exemptions; and (iii) bad-actor prohibitions and disclosures which also match issuer requirements under registration exemptions.

SEC Advisory Committee on Small and Emerging Companies' Recommendations

The SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") has once again made recommendations to the SEC regarding the regulation of finders and other intermediaries in small business capital formation transactions. The Advisory Committee previously submitted recommendations to the SEC on September 23, 2015.

By way of reminder, the Advisory Committee was organized by the SEC to provide advice on SEC rules, regulations and policies regarding "its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation" as related to "(i) capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization; (ii) trading in the securities of such businesses and companies; and (iii) public reporting and corporate governance requirements to which such businesses and companies are subject."

The newest recommendations of the Advisory Committee are almost in the form of a plea to the SEC to recognize this very important issue and take some action, any action. The entire recommendation of the Advisory Committee is that the SEC do as follows:

"The Commission take action in the near future to provide certainty in the context of finders and platforms involved in primary and secondary securities transactions. The range of potential options includes compliance or enforcement efforts, rulemaking, or coordination with the states. Even staff guidance such as Q&A's as to what constitutes broker-dealer activity would be tremendously helpful."

In support of its recommendations, the Advisory Committee noted that:

- Identifying potential investors is one of the most difficult challenges for small businesses trying to raise capital;
- There is significant uncertainty in the marketplace about what activities require broker-dealer registration. Companies that want to play by the rules struggle to know in what circumstances they can engage a "finder" or platform that is not registered as a broker-dealer.
- For years, many interested parties have urged the SEC and its staff to take steps to address this ambiguity. As one recent example, in 2015, this Committee recommended that the Commission "take immediate intermediary steps to begin to address issues regarding the regulation of intermediaries in small business capital formation transactions…."; and
- The Committee is disappointed that the SEC has not taken actions to help to address these concerns despite repeated and long-standing requests.

Previously, on September 23, 2015, the Advisory Committee made the following four recommendations:

- The SEC take steps to clarify the current ambiguity in broker-dealer regulation by determining that persons that receive transaction-based compensation solely for providing names of or introductions to prospective investors are not subject to registration as a broker under the Exchange Act;
- The SEC exempt intermediaries on a federal level that are actively involved in the discussions, negotiations and structuring, and solicitation of prospective investors for private financings as long as such intermediaries are registered on the state level;
- The SEC spearhead a joint effort with the North American Securities Administrators Association (NASAA) and FINRA to ensure coordinated state regulation and adoption of measured regulation that is transparent, responsive to the needs of small businesses for capital, proportional to the risks to which investors in such offerings are exposed, and capable of early implementation and ongoing enforcement; and
- The SEC should take immediate steps to begin to address this set of issues incrementally instead of waiting for the development of a comprehensive solution.

At the time of its recommendations in 2015, the Advisory Committee noted that:

> Small businesses account for the creation of two-thirds of all new jobs, and are the incubators of innovation, generating the majority of net new jobs in the last five years and continuing to add more jobs;
>
> Early-stage capital for these small businesses is raised principally through private offerings that are exempt from registration under the Securities Act of 1933 and state blue-sky laws;
>
> More than 95% of private offerings rely on Rule 506 of Regulation D; however, less than 15% of those use a financial intermediary such as a broker-dealer. This is due in part to a lack of interest from registered broker-dealers given the legal costs and risk involved in undertaking a small transaction, ambiguities in the definition of "broker" and the danger of using unregistered finders.
>
> As documented in the findings of an American Bar Association Business Law Section Task Force in 2005 and endorsed by the SEC Government Business Forum on Small Business Capital Formation: (i) failure to address the regulatory issues surrounding finders and other private placement intermediaries impedes capital formation for smaller companies; (ii) the current broker-dealer registration system and FINRA membership process is a deterrent to meaningful oversight; (iii) appropriate regulation would enhance economic growth and job creation; and (iv) solutions are achievable through SEC leadership and coordination with FINRA and the states.
>
> The Advisory Committee is of the view that imposing only limited regulatory requirements, including appropriate investor protections and safeguards on private placement intermediaries with limited activities that do not hold customer funds or securities and deal only with accredited investors, would enhance capital formation and promote job creation.

The Broker-Dealer Placement Agent Dilemma

Broker-dealers lack an incentive to engage in small private capital-raising transactions. In addition to regulatory and liability concerns, the amount of a capital raise by small and emerging companies is often small (less than $5 million) and accordingly, the potential commission for a broker-dealer is limited as compared to the time and risk associated with the transaction. Most small and middle market bankers have base-level criteria for acting as a placement agent in a deal, which includes the minimum amount of commission they would need to collect to become engaged.

From a regulatory perspective, when acting as placement agent in a private offering, broker-dealers must consider FINRA filing rules, general know-your-customer and suitability requirements as well as statutory liability under Dodd-Frank and the SEC antifraud provisions.

Even when a broker agrees to act as placement agent, it can often be difficult to locate investors for small companies. It would be helpful if unlicensed individuals could refer investors to such a broker-dealer, who would then ensure that proper disclosure has been made to the investor, and that the investment is suitable for such investor. However, FINRA Rule 2040 prohibits the payment of transaction-based compensation by member firms to unregistered persons. FINRA Rule 2040 expressly correlates with Section 15(a) of the Exchange Act (discussed below) and prohibits the payment of transaction-related compensation unless a person is licensed or properly exempt from such licensing.

Rule 2040 prohibits member firms from directly or indirectly paying any compensation, fees, concessions, discounts or commissions to:

> (1) any person that is not registered as a broker-dealer under SEA Section 15(a) but, by reason of receipt of any such payments and the activities related thereto, is required to be so registered under applicable federal securities laws and SEA rules and regulations; or
>
> (2) any appropriately registered associated person, unless such payment complies with all applicable federal securities laws, FINRA rules and SEA rules and regulations.

FINRA guidance on the Rule states that a member firm can (i) rely on published releases, no-action letters or interpretations from the SEC staff; (ii) seek SEC no-action relief; or (iii) obtain a legal opinion from an independent, reputable U.S. licensed attorney knowledgeable in the area. This list is not exclusive and FINRA specifically indicates that member firms can take any other reasonable inquiry or action in determining whether a transaction fee can be paid to an unlicensed person.

FINRA Rule 2040 specifically allows the payments of finders' fees to unregistered foreign finders where the finder's sole involvement is the initial referral to the member firm of non-U.S. customers and certain conditions are met, including but not limited to that (i) the person is not otherwise required to be registered as a broker-dealer in the U.S.; (ii) the compensation does not violate foreign law; (iii) the finder is a foreign national domiciled abroad; (iv) the customers are foreign nationals domiciled abroad; (v) the payment of the finder's fee is disclosed to the customer; (vi) the customers provide written acknowledgment of receipt of the notice related to the payment of the fee; (vii) proper records regarding the payments are maintained; and (viii) each transaction confirm indicates that the finder's fee is being paid.

Current Rules on Finders' Fees

The SEC generally prohibits the payments of commissions or other transaction-based compensation to individuals or entities that assist in effecting transactions in securities, including a capital raise, unless that entity is a licensed broker-dealer. The SEC considers the registration of broker-dealers as vital to protecting prospective purchasers of securities and the marketplace as a whole and actively pursues and prosecutes unlicensed activity. The registration process is arduous, including, for example, background checks, fingerprinting of personnel, minimum financial requirements, membership to SRO's and ongoing regulatory and compliance requirements. However, despite the SEC's efforts, as mentioned in the introduction, a whole cottage industry of unlicensed finders has developed, simply overshadowing efforts by regulators.

Over the years, a "finder's" exemption has been fleshed out, mainly through SEC no-action letters and some court opinions. Bottom line: an individual or entity can collect compensation for acting as a finder as long as the finder's role is limited to making an introduction. The mere providing of names or an introduction without more has consistently been upheld as falling outside of the registration requirements. The less contact with the potential investor, the more likely the finder is not required to be licensed.

The finder may not participate in negotiations, structuring, document preparation or execution. Moreover, if such finder is "engaged in the business of effecting transactions in securities," they must be licensed. In most instances, a person that acts as a finder on multiple occasions will be deemed to be engaged in the business of effecting securities transactions, and needs to be licensed.

The SEC will also consider the compensation arrangement with transaction or success-based compensation weighing in favor of requiring registration. The compensation arrangement is often argued as the gating or deciding factor, with many commentators expressing that any success-based compensation requires registration. The reasoning is that transaction-based compensation encourages high-pressure sales tactics and other problematic behavior. However, the SEC itself has issued no-action letters supporting a finder where the fee was based on a percentage of the amount invested by the referred people (see Moana/Kauai Corp., SEC No-Action Letter, 1974).

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More recently, the U.S. District court for the Middle District of Florida in SEC vs. Kramer found that compensation is just one of the many factual considerations and should not be given any "particular heavy emphasis" nor in itself result in a "significant indication of a person being engaged in the business of a broker."

Where a person acts as a "consultant" providing such services as advising on offering structure, market and financial analysis, holding meetings with broker-dealers, preparing or supervising the preparation of business plans or offering documents, the SEC has consistently taken the position that registration is required if such consultant's compensation is commission-, success- or transaction-based.

As pertains to finders that act on behalf of investors and investor groups, there is a lack of meaningful guidance. On a few occasions, the SEC has either denied no-action relief or concluded that registration was required. However, the same basic principles apply.

The federal laws related to broker-dealer registration do not pre-empt state law. Accordingly, a broker-dealer must be licensed by both the SEC and each state in which they conduct business. Likewise, an unlicensed individual relying on an exemption from broker-dealer registration, such as a finder, must assure themselves of the availability of both a federal and state exemption for their activities.

The Exchange Act – Broker-Dealer Registration Requirement

Section 15(a)(1) of the Exchange Act requires any "broker" that makes use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security) to register with the SEC.

The text of Section 15(a)(1) – Registration of all persons utilizing exchange facilities to effect transactions is as follows:

> (a)(1) It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

From a legal perspective, determining whether a person must be registered requires an analysis of what it means to "effect any transactions in" and to "induce or attempt to induce the purchase or sale of any security." It is precisely these two phrases that courts and commentators have attempted to flesh out, with inconsistent and uncertain results. As a securities attorney, I always advise to err on the conservative side where the activity is at all questionable.

The SEC's Guide to Broker-Dealer Registration

Periodically, and most recently in April 2008, the SEC updates its Guide to Broker-Dealer Registration explaining in detail the rules and regulations regarding the requirement that individuals and entities that engage in raising money for companies must be licensed by the SEC as broker-dealers. On a daily basis, thousands of individuals and entities offer to raise money for companies as "finders" in return for a "finder's fee." Other than as narrowly set forth above, such agreements and transactions are prohibited and carry regulatory penalties for both the company utilizing the finders' services, and the finders.

Each of the following individuals and businesses is required to be registered as a broker if they are receiving transaction-based compensation (i.e., a commission):

"finders," "business brokers," and other individuals or entities that engage in the following activities:

Finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers, investment companies (or mutual funds, including hedge funds) or other securities intermediaries;

Finding investment banking clients for registered broker-dealers;

Finding investors for "issuers" (entities issuing securities), even in a "consultant" capacity;

Engaging in, or finding investors for, venture capital or "angel" financings, including private placements;

Finding buyers and sellers of businesses (i.e., activities relating to mergers and acquisitions where securities are involved);

investment advisers and financial consultants;

persons that market real estate investment interests, such as tenancy-in-common interests, that are securities;

persons that act as "placement agents" for private placements of securities;

persons that effect securities transactions for the accounts of others for a fee, even when those other people are friends or family members;

persons that provide support services to registered broker-dealers; and

persons that act as "independent contractors," but are not "associated persons" of a broker-dealer (for information on "associated persons," see below).

Consequences for Violation

The SEC is authorized to seek civil penalties and injunctions for violations of the broker-dealer registration requirements. Egregious violations can be referred to the attorney general or Department of Justice for criminal prosecution.

In addition to potential regulatory problems, using an unregistered person who does not qualify for either the statutory or another exemption to assist with the sale of securities may create a right of rescission in favor of the purchasers of those securities. That is a fancy way of saying they may ask for and receive their money back.

Section 29(b) of the Exchange Act, provides in pertinent part:

> Every contract made in violation of any provision of this title or of any rule or regulation thereunder… the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards 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…

In addition to providing a defense by the issuing company to paying the unlicensed person, the language can be interpreted as voiding the contract for the sale of the securities to investors introduced by the finder. The SEC interprets its rules and regulations very broadly, and so do the courts and state regulators. Under federal law the rescission right can be exercised until the later of three years from the date of issuance of the securities or one year from the date of discovery of the violation. Accordingly, for a period of at least three years, an issuer that has utilized an unlicensed finder could have a contingent liability on their books and as a disclosure item. The existence of this liability can deter potential investors and underwriters and create issues in any going public transaction.

In addition, SEC laws specifically require the disclosure of compensation and fees paid in connection with a capital raise. A failure to make such disclosure and to make it clearly and concisely is considered fraud under Section 10b-5 of the Securities Act of 1933 (see, for example, SEC vs. W.P. Carey & Co., SEC Litigation Release No. 20501). Fraud claims are generally brought against the issuing company and its participating officers and directors.

Moreover, most underwriters and serious investors require legal opinion letters at closing, in which the attorney for the company opines that all previously issued securities were issued legally and in accordance with state and federal securities laws and regulations. Obviously an attorney will not be able to issue such an opinion following the use of an unlicensed or non-exempted person. In addition to the legal ramifications themselves and even with full disclosure and the time for liability having passed, broker-dealers and underwriters may shy away from engaging in business transactions with an issuer with a history of overlooking or circumventing securities laws.

Historically, it was the person who had acted in an unlicensed capacity who faced the greatest regulatory liability; however, in the past ten years that has changed. The SEC now prosecutes issuers under Section 20(e) for aiding and abetting violations. The SEC has found it more effective and a better deterrent to prosecute the issuing company than an unlicensed person who is here today and gone tomorrow.

Conclusion

The payment of finders' fees is a complex topic requiring careful legal analysis on a case-by-case and state-by-state basis. No agreements for the payment or receipt of such fees should be entered into or performed without seeking the advice of competent legal counsel.

I am a strong advocate for a regulatory framework that includes (i) limits on the total amount finders can introduce in a 12-month period; (ii) antifraud and basic disclosure requirements that match issuer responsibilities under registration exemptions; and (iii) bad-actor prohibitions and disclosures which also match issuer requirements under registration exemptions.

I would even advocate for a potential general securities industry exam for individuals as a precondition to acting as a finder, without related licensing requirements. For example, FINRA, together with the SEC Division of Trading and Markets, could fashion an exam similar to the new FINRA Securities Industry Essentials Exam (see HERE) for finders that are otherwise exempt from the full broker-dealer registration requirements.

For reference, prior blogs on the topic of the broker-dealer registration requirements include (i) the no-action-letter-based exemption for M&A brokers (ii) the exemptions for websites restricted to accredited investors and for crowdfunding portals as part of the JOBS Act; (iii) the statutory exemption from the broker-dealer registration requirements found in Securities Exchange Act Rule 3a4-1, including for officers, directors and key employees of an issuer; and (iv) the American Bar Association's recommendations for the codification of an exemption from the broker-dealer registration requirements for private placement finders.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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