

The Danger of Paying Finder's Fees to Unregistered Broker-Dealers

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by Kenneth G. Sam

We get asked from time-to-time whether it is advisable for issuers to pay fees to unregistered “finders” for introducing potential investors in the United States to the issuer in connection with securities offerings. The short answer is “no.”

Most finders are engaged by issuers under finder's, advisory, or other arrangements, which typically require payment of “success fees” upon completion of a financing transaction. While these arrangements are sometimes structured to try to hide or disguise the true intent of the arrangement, payment of transaction-based compensation is treated by U.S. securities regulators as a nearly-conclusive indication that a person is engaged in the securities business and should be registered as a broker-dealer.

The relevant U.S. federal broker-dealer laws that should be of concern to an issuer using an unregistered finder include:

- Section 15(a)(1) of the Securities Exchange Act of 1934 (Exchange Act), which makes it unlawful for a person to “effect a transaction in securities” or “attempt to induce the purchase or sale of, any security” unless they are registered as a broker or dealer under the rules and regulations of the Financial Industry Regulatory Authority, Inc. (FINRA). FINRA is the regulatory organization designated by the Securities and Exchange Commission (SEC) to license and regulate broker-dealers.
- Section 29(b) of the Exchange Act, which provides that every contract made in violation of any provision of the broker-dealer registration requirements “shall be void” as to rights of persons who made or engaged in the performance of such contract. It results in the underlying purchase of securities becoming a voidable transaction that gives the investor a right of rescission, effectively granting a put right to the investor or purchaser.
- Section 20(e) of the Exchange Act, under which the SEC may impose aiding-and-abetting liability on any person that knowingly or recklessly provides substantial assistance in a violation of the Exchange Act.

The theory behind broker-dealer registration is to provide a gatekeeper to protect

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investors in the marketplace. FINRA members are required to “observe high standards of commercial honor and just and equitable principles of trade” in the conduct of its business, including determining if an investment is “suitable” for its customer. Finders assisting in transactions rarely make such determinations and view themselves simply as middlemen in making introductions to potential investors.

Because unregistered broker-dealers may not adhere to these high commercial standards, the SEC broadly construes the broker-dealer laws and narrowly construes the few permitted exceptions. Under SEC guidance derived from no-action letters, the SEC requires all intermediaries effecting transactions in securities to be licensed, subject to a few limited exceptions. Effecting a securities transaction may include, among other factors, receiving transaction-based compensation, recommending a company or the purchase of its securities, negotiating terms of a securities offering or purchase, attending meetings or presentations where the merits of the investment are discussed, performing or accommodating due diligence efforts, providing valuations or estimates of value, and other activities that facilitate a securities transaction.

The consequences of engaging an unlicensed finder can be troublesome:

Finder Risks: Any unlicensed person engaging in activities designed to effect a transaction in securities may violate broker-dealer laws. The SEC or state securities regulators may seek to enjoin the unlawful activities or seek monetary penalties or criminal sanctions.

Issuer Risks: Retaining and permitting an unlicensed intermediary to effect a securities transaction may be a violation of federal and many state laws, and may subject the issuer to possible civil and criminal penalties. Any person that knowingly or recklessly provides substantial assistance in a violation of the Exchange Act may be subject to aiding-and-abetting liability.

Rescission Risks: A violation of broker-dealer laws creates a right of rescission under federal and/or state securities law. The SEC or state securities regulators may require the issuer to offer investors rescission rights, and the issuer may be required to return the investment.

State Securities Violations: Many states have begun reviewing state notice filings on Form D (which report transactions exempt from registration under Regulation D) and actively monitoring finder’s fees paid in connection with securities transactions. Some states have required issuers to provide additional information related to unlicensed broker-dealers and, in some cases, to certify that finder’s fees or commissions have only been paid in compliance with broker-dealer laws.

Accounting Liability Risk: Auditors may raise accounting issues resulting from paying finder’s fees to unregistered broker-dealers and may require an issuer to account for potential liability arising from rescission rights.

Bad Actor Consequences: An issuer or finder that is convicted of any felony or

misdemeanor, is subject to any order, judgment, or decree of any court, or is subject to any order of certain regulators may be ineligible to participate in certain types of securities offerings, including Rule 506 of Regulation D offerings and Regulation A offerings.

Using an unlicensed finder can result in broker-dealer law violations. Many times the issue arises in the context of state notice filings and direct inquiries from state securities regulators where finder's fees or commissions are paid in connection with an offering. Other times, they arise from a failed investment where the investor may assert claims related to broker-dealer law violations to establish a right of rescission. Issuers should use caution in determining whether to engage a finder to assist in financing transactions.