Small companies and entrepreneurs often find difficulty obtaining capital from traditional sources such as banks, angel investors, venture capital funds and underwritten securities offerings. This has been particularly true during the past several years with tight credit and equity markets. As such, owners and executives of small companies often turn to their network of friends, family and business associates to help them source equity capital.

Individuals who find sources of equity capital are referred to commonly as "finders," and invariably, the company pays the finder some form of transaction-based compensation for the referral. Corporate law practitioners are often approached by clients to review "consulting" or "finder" agreements for contract law issues concerning such arrangements, but often fail to consider the securities law impact of such an agreement on both the company and the finder. In most cases, such agreements violate federal and state securities laws because they involve the payment of transaction-based compensation in connection with a securities transaction to a finder that is not a registered broker.

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 (Act) defines a broker as any person engaged in the business of "effecting transactions in securities" for the account of others. "Effecting transactions" includes assisting an issuer to structure prospective securities transactions, helping an issuer identify potential purchasers of securities, soliciting securities transactions or receiving transaction-based compensation. Section 15(a)(1) of the act provides that any broker "effecting transactions in securities," or inducing or attempting to induce the purchase or sale of securities, must be registered with the Securities and Exchange Commission. In addition, the SEC has made clear in its position that "a person's receipt of transaction-based compensation in connection with these activities is a hallmark of broker-dealer activity." Accordingly, any person receiving transaction-based compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer.
**Activities Requiring Registration**

Registration as a broker-dealer is required when the transaction involves the purchase or sale of a security. One area where there is some uncertainty as to whether registration is required, however, involves the situation of a "finder." The SEC’s Guide to Broker-Dealer Registration identifies the following activities as possibly requiring registration as a broker: (1) finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers; (2) finding investment banking clients for registered broker-dealers; (3) finding investors for "issuers," even in a "consultant" capacity; (4) finding investors for venture capital financings, including private placements; and (5) finding buyers and sellers of businesses where securities are involved. Despite the different types of finders, the SEC appears to apply the same standard to all of them when determining whether they should register as a broker-dealer, although the SEC does seem to require finders for a broker-dealer to register more frequently.

The less involved an individual is in the negotiation and structuring of a transaction, the less likely it is that the SEC will require registration as a broker-dealer. For example, the SEC has traditionally taken the view that "individuals who do nothing more than bring merger and acquisition-minded persons or entities together and who do not participate in negotiating the sale of securities, nor share in any profits realized, are probably not brokers … . In contrast … a professional who brings together potential buyers and sellers and advises the parties on questions of value, plays an integral role in negotiating the transaction, or provides other services to facilitate the transaction, may be deemed to be a broker."

Among the factors the SEC will use in determining whether a finder must register as a broker include whether the finder (1) participates in the various aspects of a securities transaction, including solicitation, negotiation or execution of the transaction; (2) receives compensation based upon the outcome or size of the transaction; (3) is otherwise engaged in the business of effecting securities transactions or was previously disciplined for such activity; (4) handles securities or funds in connection with the transaction; and (5) was involved in the solicitation of investors.

Case law similarly indicates that the following factors play an important role in the determination as to whether a finder should register, including whether the finder (1) is an employee of the issuer; (2) received commissions as opposed to a salary; (3) is selling, or previously sold, the securities of other issuers; (4) is involved in negotiations between the issuer and the investor; (5) makes an evaluation as to the merits of the investment or gives advice to a prospective buyer or seller; and (6) is an active rather than passive finder of investors.

**Exceptions to Registration**

Within a narrow scope described in SEC no-action letters, a person may perform certain limited activities without triggering broker-dealer registration requirements. States generally, but not always, follow a similar analysis. For instance, the ABA Task Force on Private Placement Broker-Dealers reported that an individual "can consult on structure, provide valuation reports, render technical advice, provide industry expertise and assist as accountants in the development of forecasts." These limited exceptions are regulatory interpretations and are not codified in federal or state securities laws; however, the pertinent question generally concerns how closely
tied the finder's activities are to the transaction and whether the finder received transaction-based compensation for his services.

Probably the most well-known SEC statement concerning the use of a finder is the 1991 Anka no-action letter, in which the SEC stated it would not seek enforcement action if Paul Anka provided the names of prospective investors to the Ottawa Senators Hockey Club in exchange for a finder's fee because Anka had a pre-existing business or personal relationship with the potential investors he would refer, all of whom he reasonably believed to be accredited, and would not participate in or prepare any advertisements, endorsements or general solicitations or perform any due diligence, negotiate financing or handle funds or securities. In recent years, however, several no-action letters seem to signal a shift away from the SEC's position in Anka.

In a June 2006 letter to John W. Loofbourrow Associates Inc., the SEC was unable to assure Loofbourrow that it would not recommend enforcement action where Loofbourrow paid an unregistered entity a finder or referral fee in consideration for the introduction of an investment banking client. Interestingly, many of the activities present in the Anka letter were present here; specifically, the finder would (1) not be involved in structuring or placing the securities; (2) be limited to introducing the parties; (3) not be involved in any negotiations or make any recommendations; (4) not offer or sell any securities or solicit any offers to buy securities; and (5) not handle funds or securities. In a June 2007 letter to Hallmark Capital Corp., the SEC was unable to assure Hallmark that it would not recommend enforcement action where Hallmark, an unregistered financial consultant and finder for small businesses, would assist companies with identifying targets for mergers and acquisitions and retaining broker-dealers to raise capital. In each case, Hallmark would be paid an upfront retainer fee and a fee based on the outcome of the transaction.

Finally, in a May 2010 letter to Brumberg, Mackey & Wall, the SEC was unable to assure Brumberg that it would not recommend enforcement action where Brumberg, a law firm, would introduce to a company "individuals and entities who 'may have an interest' in providing financing … through investments in equity or debt instruments," for which Brumberg would receive an amount equal to a percentage of the gross amount raised. The SEC determined that the introduction of "only those persons with a potential interest" anticipated "both 'pre-screening' potential investors and 'pre-selling' … securities to gauge the investors' interest." The SEC also determined that "the receipt of compensation directly tied to successful investments … would give [Brumberg] a 'salesman's stake' in the proposed transaction … and create a heightened incentive … to engage in sales efforts."

Running counter to the SEC's rollback of Anka is an April 2011 decision by the U.S. District Court for the Middle District of Florida in SEC v. Kramer. The SEC argued that Kramer was a broker because he received transaction-based compensation in connection with bringing together the parties to a transaction. He did not negotiate or discuss the details of the transaction with the parties nor did he analyze or promote an investment in the company to investors. The court ruled for Kramer, holding that the broker analysis under Section 15(a) "permits examination of a wide array of factors" beyond the receipt of transaction-based compensation, and "in the absence of a statutory definition of either 'effecting securities transactions' or 'engaged in the business' … the test for broker activity must remain cogent, multi-faceted, and controlled by the Exchange Act."
The court seemed particularly disturbed that the SEC has chosen informal no-action letters to make rules in this area and pointed to the SEC's own website, which states, "A 'no-action' letter is informal and possesses no binding legal authority." If upheld on appeal, this decision may compel the SEC to re-examine its rules concerning the use of finders.

**Consequences of a Violation**

There may be severe consequences if a broker fails to register as required by the SEC. The SEC is able to seek civil injunctions in federal district court against persons violating or about to violate provisions of the act, including the broker-dealer registration requirements. The SEC may also seek civil money penalties. The SEC has the authority, after notice and opportunity for a hearing, to issue a cease-and-desist order as well. Finally, the SEC is authorized to refer the matter to the attorney general for prosecution.

Also, customers of unregistered broker-dealers can seek rescission of the transaction. Generally, courts have not implied a private right of action under Section 15(a). Section 29(b) of the act, however, renders void "every contract made in violation of any provision of the act," and this has been interpreted to allow rescission of transactions in securities with unregistered broker-dealers. Damages may be awarded in lieu of rescission. The rescission possibility is problematic because it means that investors may seek rescission of a transaction if it does not work out to their advantage. A suit for rescission of a transaction brought under federal securities laws must be initiated within one year of discovery of the facts underlying the claim and, in any event, no later than three years from the time the violation occurred.

State penalties are similar to those provided in federal cases. In Pennsylvania, any person who willfully violates material provisions of the Pennsylvania Securities Act can receive monetary penalties and imprisonment. In addition, they may be ordered to disgorge their profits. Finally, the customer may sue at law or equity to rescind the transaction or receive damages if he no longer owns the security.

**A Fine Line**

There is a fine line between a finder and a broker-dealer. The SEC often resolves the issue when counsel for the finder requests a no-action letter from the Division of Trading and Markets. The no-action letter will state that the SEC either would or would not recommend enforcement against the finder for not registering as a broker-dealer. The law is unsettled in many aspects, and the SEC bases an enforcement decision on a number of factors, weighing each one under a totality of the circumstances test. Overall, the division does not appear to be particularly sympathetic to the role of unregistered finders in securities transactions, particularly if the finder receives transaction-based compensation.

If the decision is made to engage a finder, securities counsel should be sought to structure the agreement in a manner to avoid the activities that generally lead to the conclusion that a finder should be registered as a broker-dealer and to ensure the finder's activity falls within one of the limited exceptions. Specifically, the agreement should limit the finder's activities to providing introductions only to suitable, i.e., accredited, investors and avoiding substantive discussions with potential investors. Moreover, the agreement should not allow the finder to:
• Provide advice about the merits of particular opportunities.
• Receive compensation other than non-contingent and nominal flat fees.
• Participate in any negotiations between an issuer and potential investors.
• Directly assist an issuer or potential investors with the completion of any transaction.
• Handle funds or securities involved in completing a transaction.
• Hold himself out as providing any securities-related services.