THE DANGERS OF USING FINDERS IN EARLY STAGE FINANCING TRANSACTIONS

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Early stage companies almost always lack two critical resources: time and money. Not only do they barely have enough time to run the business, but they definitely don't have the time to raise the cash necessary to fund today's high growth businesses. Fundraising is often referred to, without love, as the CEO's "second job."

To make matters worse, early stage executive teams often do not know who the potential investors are, how the process works or how to create a market for the company's securities to ensure that the company gets the best deal. Worse yet, companies usually can't engage an investment bank, as banks won't work on deals of this size (such deals don't yield high enough fees), or on deals with this level of risk (banks only get success fees if the deal closes). Enter the "finder."

Finders purport to help companies plan for and execute a cash raising transaction. Tasks often include (i) building an investment deck describing the company, market opportunity and capital needs, (ii) building a set of pro forma financial plans that identify expected outcomes if the capital is raised, (iii) building an investor target list and (iv) facilitating communication between the investors and the issuing company. The quid for the quo is that the finder often charges a monthly retainer, and almost always charges a success fee. Because most of the compensation is predicted to come out of the deal's cash proceeds, it is an effective way for the company to bootstrap a resource.

Oddly, the responsibilities and structure of a finder deal sound an awful lot like engaging an investment bank, but in "securities law speak," an investment bank is almost always a *registered broker-dealer* <u>and finders are not.</u>

Distinguishing a Finder

A "broker" is defined quite broadly by the Securities and Exchange Commission ("SEC") as "any person engaged in the business of effecting transactions in securities for the accounts of others," and a "dealer" as "any person engaged in the business of buying and selling securities…for such person's own account through a broker or otherwise." Section 15(a)(1) of the Securities and Exchange Act of 1934 (the "Exchange Act") provides that it is unlawful for a broker or dealer to effect a transaction in securities or attempt to induce the purchase and sale of any security unless such person is registered as a broker or dealer. Registration means registering and complying with the requirements of the Financial Industry Regulatory Authority, Inc. ("FINRA"), the regulatory body tasked by the SEC to regulate broker-dealers. To best protect potential investors, FINRA's requirements are purposely difficult, expensive and designed to weed out bad actors.

So, what distinguishes a "finder" from a party merely in non-compliance with the broker-dealer registration requirements? Unfortunately, there is no bright line test, but rather a bunch of lore cobbled together from various cases and SEC no-action letters. The common wisdom is that finders cannot:

- receive compensation or a commission that is contingent upon the success of a transaction or which is otherwise tied to the transaction;
- provide advice or analysis on the merits or value of the transaction (i.e., they cannot encourage the investor to participate or provide justification that it is a deal worth doing);
- participate in the negotiations related to the transaction;
- assist in structuring the transaction;

- take on many of the tasks related to fundraising, such as pre-screening investors, pre-selling investors to determine interest level, or disseminating confidential information of the issuer (including the investment deck describing the company, market opportunity and capital needs);
- leverage a potential investor to participate by identifying other investors;
- handle the funds transferred by the investors; or
- be in the business of selling securities for compensation.

In essence, a finder must be paid solely to make a limited introduction, and then walk away. While every situation is a facts and circumstances test, the more involved the finder, the greater the likelihood that the finder has crossed the Rubicon into the land of unregistered broker-dealer. The one thing that is clear is that the presence of a contingent success fee (the most attractive part of the finder deal from the company's point of view) is the most aggravating factor in the regulatory analysis.

Possible Consequences

So, why should early stage companies and their executive teams care? Because a violation of the broker-dealer requirements can lead to a host of significant problems, both for the transaction under consideration but also for future transactions.

Criminal and Civil Penalties—The issuing company can be subject to both civil and criminal liability to the SEC and to state regulators; the officers and directors may have similar liability for aiding and abetting in violations of securities laws.

Rescission—The securities transactions at issue become voidable and provide the investors with an ongoing right to rescind the transaction and get their money back. This can create extreme risks that future investors will not invest as they are likely to refuse to subject their capital investments to such outflow risks.

Contractual Liability—Most financing transactions in the angel, venture capital and private equity worlds contain representations by the company that there were no unregistered broker-dealers and that the transaction was not in violation of applicable law. The use of a finder, particularly if undisclosed, can create multiple claims for breach of contract. Further claims may manifest in the event that some, but not all, of the investors then go on to exercise their rescission rights.

State Law Compliance—Many states have rules which mirror the federal rules regarding unregistered broker-dealers, and violations of such rules can limit an issuer's future ability to raise capital.

Bad Actor Risk—An issuer may become ineligible to utilize the customary private placement exemption or engage in other securities transactions, if such company or its directors or executive officers is subject to a order, judgment or decree arising out of the use of a finder who is deemed to be an unregistered broker. Further, future investors would be likely to demand contractual representations that the company and its principals have not been found to be "bad actors."

Market Viewpoint—Angel group investors and early stage venture capitalists hate paying fees to anyone, let alone an unregistered broker-dealer. And while they can sometimes swallow the presence of an investment bank (which they already dislike), the presence of a finder will often spook them as it telegraphs a company's willingness to be aggressive around compliance issues and may cause the investor to doubt the capabilities of the operating team.

While finders may be instrumental to the success of an early stage company, the risks of engaging a finder who is in fact an unregistered broker-dealer are significant. Companies should conduct careful diligence on any potential finder before engaging a finder and should discuss concerns with an attorney before the relationship is established.

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