

TOOLBOX

■ Finance

Risks in using unregistered finders to raise capital



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Most early-stage businesses need capital. Since many company founders aren't familiar with how to raise capital, they call upon investment professionals or financial intermediaries to locate investors.

The relatively small amounts of capital these early-stage companies require, however, aren't attractive to investment bankers that are registered broker-dealers. As a result, these companies often use individuals or companies known as "finders" to locate and negotiate with potential investors.

Companies should be aware that there are significant risks involved in using finders. These risks could threaten a company's ability to successfully raise capital currently and in the future.

The most significant risk is that if the finder is deemed to be an unregistered broker-dealer, then under federal and some state securities laws an investor may have the right to cancel its securities purchase contract and get its money back. Under federal law, this rescission right can be exercised until (1) three years from the date of issuance of the securities or (2) one year from the date of discovery of the violation, whichever is later. The right of rescission applies to any purchaser in the transaction, and not just those purchasers located by the finder. The company would have no assurances that any investor who is or later becomes dissatisfied with the direction of the company would not exercise the right of rescission.

An investor's right of rescission may not only affect the company's ability to

keep money from the capital raise in which the company used a finder, it may also hurt the company's ability to raise capital in the future. A company is required to disclose in Securities and Exchange Commission filings in connection with registered offerings and private placements under Regulation D the compensation it paid to finders in connection with the offering, as well as in many filings required under state blue sky laws. Disclosure about an unregistered finder could deter future investors from investing in the company, since they may be concerned about potential rescission claims.

If the finder is indeed an unregistered broker-dealer, the SEC may prohibit the company from using the private placement exemption in future offerings, limiting its ability to raise capital from private investors, including angel investors and venture capital funds. In addition, generally accepted accounting principles may require the company to accrue a liability for any resulting rescission responsibility, which could also dissuade potential investors.

Failing to disclose payments made to an unregistered broker-dealer in connection with a sale of securities could expose the company to potential liability for fraud. The use of an unlicensed finder could also subject the company to regulatory action by the SEC and state securities commissioners for aiding and abetting the finder's violation of the broker-dealer registration requirements. In addition, a company that uses a finder also could lose potential exemptions from securities registration requirements under federal and state securities laws that it could otherwise use.

Although no single factor can be used to determine whether a finder is engaged in the activities of a broker-dealer, SEC no-action letters reveal a variety of factors that are typically given some weight by

the SEC staff:

- whether the finder was involved in negotiations
- whether the finder engaged in solicitation of investors
- whether the finder discussed details of the nature of the securities or made recommendations to the prospective buyer or seller
- whether the finder was compensated on a transaction-related basis
- whether the finder was previously involved in the sale of securities and/or was disciplined for prior securities activities.

Any company contemplating the use of a finder should first find out whether the finder is registered as a broker-dealer with the SEC, the applicable state regulators and Financial Industry Regulatory Authority. If this information is not provided by the finder at the start of serious discussions, then it can easily be found online.

If the finder in question is not registered, then the company should strongly consider either forgoing the finder's assistance altogether, or consulting with counsel to determine whether the finder's activities or the transaction itself can be structured in a way to minimize the likelihood that the finder will later be found to have acted as an unregistered broker-dealer.

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