

SEC Update

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Finders May Pose Risk in Private Capital Raising

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Entrepreneurs, company executives, and private equity fund sponsors with a growing enterprise, innovative idea, or a new fund often find themselves needing help when it comes to raising capital to fund the new enterprise. As a result, they often turn to friends, colleagues and others with experience raising capital. These people frequently offer to help the enterprise raise capital or they suggest working with someone who has helped them raise capital in the past. Often times, the person agreeing to help raise capital (sometimes referred to as a “finder”) will agree to provide access to his or her contacts in exchange for a commission payment based upon the amount of capital raised.

Satisfied that this “finder” can help raise the necessary funds, the entrepreneur, company executive, or equity fund sponsor continues operating his or her business and lets the finder “do his thing” by making contacts with individuals interested in investing. What these parties often fail to recognize is the danger that such a relationship can present. Federal and state securities laws may not permit activities that are commonly thought of as “finding” activities, and securities regulators have acted to punish both finders and employers of finders for engaging in broker-dealer activities without registration.

Recent SEC Action

The Securities and Exchange Commission (SEC) recently took action against a private equity fund sponsor when a finder engaged by the private equity fund was determined to have overstepped the line between finder and broker-dealer. On March 11, 2013, the SEC issued an order under which Ranieri Partners LLC agreed to pay a penalty of \$375,000, and Donald W. Phillips, the firm’s managing director, agreed to pay a penalty of \$75,000 and was suspended from managing an investment adviser or broker-dealer for nine months. The SEC’s order found that Phillips aided and abetted William M. Stephens’ violations of the broker-dealer registration requirements and that Ranieri Partners caused Stephens’ violations.¹ An order was also issued requiring Stephens to pay a penalty and banning him from the securities industry.²

The SEC determined that Stephens’ activities went beyond those of a finder. Stephens worked for Ranieri Partners as an independent consultant to solicit investors and assist in raising capital for Ranieri Partners’ private investment funds. The SEC noted in particular that Stephens consistently communicated with prospective investors and their advisors and provided prospective investors with key investment documentation from Ranieri Partners. The SEC further noted that Stephens’ communications included urging at least one investor to consider adjusting its portfolio allocations to accommodate an investment with Ranieri Partners and providing his analysis of Ranieri Partners’ funds’ strategy and performance track record. The documentation Stephens provided included private placement memoranda, subscription documents, due diligence materials, and confidential information regarding other investors. The SEC brought the action against Ranieri Partners and Phillips because it found that they provided Stephens with the documentation and information related to Ranieri Partners’ private equity funds and did not take adequate steps to prevent Stephens from having substantive contacts with potential investors. The SEC’s action in this case should serve as a warning to anyone who wants to raise capital through finders or unregistered brokers.

Where is the (Fuzzy) Line?

A broker is defined as “any person engaged in the business of effecting transactions in securities for the accounts of others.”³ In contrast, the federal securities laws do not specifically define the term “finder.” As the Ranieri Partners incident illustrates, the distinction between a finder and a broker can have significant consequences.

Although, the federal securities laws have no formal definition of a finder, the SEC has indicated it considers various factors when deciding whether a finder has violated the securities laws by failing to register as a broker or dealer. According to case law and SEC no-action letters, the following facts are typical of finders who would not need to register as brokers or dealers:

- Introduces investors to issuers or their promoters without further involvement in discussions between the issuer and the investor(s) and without giving advice on the investment's structure or suitability;
- Receives compensation for making introductions and the compensation is not tied to the success of the capital raising (i.e. not a commission);
- Assists in transactions that convey all of a business's equity securities or assets to a single purchaser or group of purchasers; and
- Does not assist purchasers with obtaining financing, other than providing uncompensated introductions to third-party lenders or help with completing the paperwork associated with loan applications.

The following factors are typical of broker activity where the person involved would need to be a registered broker-dealer:

- Participates in discussions and negotiations between the issuer and the potential investors;
- Assists in structuring transactions;
- Receives transaction-based compensation, i.e., a commission or some form of compensation that varies with the size or type of the resulting investment;
- Engages in "pre-screening" potential investors to determine their eligibility to purchase securities;
- Engages in "pre-selling" the issuer seeking financing to gauge the level of interest;
- Conducts or assists with the sale of securities;
- Provides advice regarding the value of securities;
- Locates issuers on behalf of investors;
- Solicits new clients;
- Disseminates quotes for securities or other pricing information;
- Actively (rather than passively) finds investors;
- Is in the business of selling securities;
- Sends private placement memoranda, subscription documents, and due diligence materials to potential investors;
- Advises on portfolio allocations to accommodate an investment;
- Provides analyses of potential investments; and
- Provides potential investors with confidential information identifying other investors and their capital commitments.

As these lists demonstrate, there is very little that a finder may do without becoming a broker-dealer required to register. No factor alone will determine whether a finder should register as a broker-dealer; all existing factors are considered together in making such a determination. Nevertheless, some factors may carry more weight than others. One of the factors that appears to draw attention from the SEC is the existence of transaction-based compensation, which often signals that the individual is more involved in the transaction than simply making introductions. In connection with its recent orders discussed above, the SEC stated that "the federal securities laws require that an individual who solicits investments in return for transaction-based compensation be registered as a broker." One court stated, "[transaction-based compensation] is the hallmark of a salesman."⁴ Yet, the court rejected the notion that transaction-based compensation alone can trigger broker-dealer registration.⁵ The reason for the SEC's concern appears to be that the existence of transaction-based compensation creates a heightened incentive to engage in sales efforts, and the securities laws aim to regulate those who engage in selling securities.

Conclusion

A determination of whether or not an intermediary is acting as a finder or a broker-dealer is a very fact-specific analysis and can often times be very complex, as demonstrated in the Ranieri Partners case. Unfortunately for unwary entrepreneurs, company executives and equity fund sponsors, frequently a third party assisting with capital raising activity will be a broker-dealer, not a finder, and therefore should not be engaged unless properly registered.

If you have any questions regarding the use of finders, or capital raising in general, please contact the Venable lawyer with whom you work, one of the authors or a member of our **Corporate Finance and Securities Group** or our **Private Equity Group**.

¹ Securities Exchange Act Release No. 69091 (Mar. 8, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-69091.pdf>.

² Securities Exchange Act Release No. 69090 (Mar. 8, 2013), available at <http://www.sec.gov/litigation/admin/2013/34->

69090.pdf.

3 15 U.S.C. § 78c(a)(4).

4 *SEC v. Kramer*, 778 F.Supp.2d 1320, 1334 (M.D. Fla., 2011).

5 *Id.*