

The Risks of Using Finders and Unregistered Brokers

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The managers of private investment funds often use placement agents, finders, and other intermediaries to help raise capital for their investment funds. Before retaining an intermediary, however, fund managers should evaluate whether the intermediary is, or should be, registered as a broker-dealer with the Securities and Exchange Commission. Fund managers that use unregistered brokers expose themselves to significant legal liability and reputational risk.

The SEC takes an expansive view as to who is required to register as a broker

A broker is any person engaged in the business of effecting transactions in securities for the account of others. A person acting in this capacity is required to register as a broker with the Securities and Exchange Commission, except in very limited circumstances.

Sometimes it is easy to determine who is a broker. A placement agent who regularly solicits investors to participate in private placements of securities, and who is paid a commission based upon the amount of capital raised, clearly is a broker. Other times it is difficult to determine who is a broker because, in the view of securities regulators, there are a wide range of activities that can trigger a requirement to register as a broker. For example, anyone who helps an issuer identify potential investors, negotiates securities-related transaction documents, helps an issuer structure a transaction, handles money from investors, or otherwise participates in important parts of securities transactions, might be required to register as a broker.

A person who receives transaction-based compensation is probably a broker

When evaluating whether or not a person is required to register as a broker, one factor is more important than all others: the form of compensation. The receipt of transaction-based compensation is, in the SEC's view, the hallmark of being a broker. Anyone who receives transaction-based compensation related to a securities transaction is likely to be viewed as being engaged in the business of effecting transactions in securities and therefore must register as a broker. Transaction-based compensation is any compensation, such as a sales commission or success fee, that is related to the success or size of a transaction.

People who receive transaction-based compensation generally must register as broker-dealers because, according to the SEC, registration helps to ensure that people with a "salesman's stake" in a securities transaction operate in a manner consistent with the consumer protection requirements that are applicable to people who have registered as brokers.

"Finders" who receive transaction-based compensation probably are required to register as brokers

Finders place potential buyers and sellers of securities in contact with one another for a fee, but do not otherwise participate in securities transactions. Finders don't negotiate the terms of an offering, don't pass along offering documents, and don't make investment recommendations.

Many finders take the position that they are not required to register as broker-dealers, even if they receive transaction-based compensation. This position likely arises from guidance that the SEC provided in 1991 to the effect that it would not take enforcement action against an individual, Paul Anka, under the following factual scenario:

- Anka would provide the issuer of securities with the names and telephone numbers of people with whom he had a pre-existing business or personal relationship;
- Anka would not participate in any negotiations between the issuer and prospective investors, or even have any contact with the prospective investors concerning the investment; and
- Anka would receive a commission based upon the amount invested by his contacts.

Mr. Anka notably did not introduce the issuer to his personal contacts. He merely turned over his address book. The distinction is important because, according to public statements by one SEC official, if someone is actually providing introductions, the SEC sees that as a “form of solicitation” and as “an implicit recommendation in terms of the issuer and investor.”

Finders’ reliance on the Paul Anka guidance may be misplaced. In practice, finders rarely limit their activities to turning over their address books. And even if they did, the Paul Anka guidance might not offer much protection. As one SEC official stated, “The truth is, from the staff point of view, there is no progeny of Paul Anka, in fact, and the ways that we look at broker-dealer regulation today, I’m not even sure that we would issue the Paul Anka letter again.”

The consequences of using an unregistered broker are severe

The consequences of using an unregistered broker are significant and could include both civil and criminal penalties. Some of the potential consequences of using an unregistered broker include: civil or criminal liability for aiding and abetting the broker’s violations of securities laws; investors receiving rescission rights; being required by one’s auditors to account for potential liabilities arising from investors’ rescission rights; losing the right to rely upon Regulation D in future securities offerings; and reputational harm.

Fund managers should proceed with caution before retaining third parties to raise capital

The SEC’s mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. In its efforts to protect investors, the SEC takes an expansive view as to who is required to register as a broker. Because of the complexities of broker-dealer laws, and the severe consequences of using unregistered brokers, fund managers should proceed with caution, and consult with experienced legal counsel, before retaining a finder or otherwise agreeing to pay transaction-based compensation in connection with a securities offering.

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