THE NATIONAL LAW REVIEW

Is my Advisor a "Finder" or a "Broker"? Avoiding the Pitfalls of Raising Capital Using Unlicensed Broker-Dealers

Article By Foley & Lardner LLP
Richard J. Dancy
Manufacturing Industry Advisor

Financial Institutions & Banking
Securities & SEC
All Federal

Wednesday, July 18, 2018

Companies seeking to expand operations often face numerous challenges. One such challenge is raising the capital necessary to make such an expansion possible. When a company sees an expansion opportunity but does not have the financial resources on hand or readily available (cash, available bank debt, etc.) to make it happen, other avenues of financing must often be considered, including potentially taking on additional investors. This can be particularly challenging where a company is not in the habit of actively seeking outside investment and, as a result, lacks the institutional knowledge and contacts to identify and court external investors.

In cases such as these, companies often seek help from a third party advisor or "finder" to help identify and secure outside investors. While this seems like a relatively simple solution, the use of a third-party to identify and secure investors can present dangers to an unwary company that has not taken the proper steps to vet its advisor. In particular, the use of a finder or advisor that could be deemed to be an unlicensed "broker-dealer" under the federal securities laws could lead to potential adverse consequences for a company trying to raise capital, as outlined below.

The federal securities laws define a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others" and a "dealer" as "any person engaged in the business of effecting transactions in securities for the account of others." Further, Section 15(a)(1) of the Securities and Exchange Act of 1934 generally makes it unlawful for any broker-dealer to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless the broker-dealer is registered in accordance with the federal securities laws.

Although the Securities and Exchange Commission (the "SEC") has broadly interpreted these rules to cover a substantial amount securities transactions involving third-party advisors, there are still a substantial number of individuals and firms that hold themselves out as "advisors" or "finders" without actually being registered broker-dealers. While it is permissible to use an unlicensed finder or advisor in limited situations, companies need to be very careful when retaining an advisor or finder in a capital raising transaction with investors given the potential consequences to the issuer if the advisor or finder is found to be acting as an unlicensed broker-dealer, including:

- Criminal and Civil Liability. Companies that do not due their due diligence on a potential advisor can be subject to civil and criminal liability for aiding and abetting violations of the rules governing broker-dealers, particularly where the company knowingly or recklessly contributes to the violation.
- Recession on Investment. Both federal and state securities laws provide for a potential right of rescission in securities transactions involving an unlicensed broker-dealer. This means that a company may be required to refund an investment even where it was not the "bad actor" in a transaction.
- Injunction. The SEC and state regulators may elect to enjoin a transaction if they become aware that it involves an unlicensed broker-dealer, effectively putting a halt to the company's capital raising activities and discouraging investors from participating further.

The potential consequences above highlight why it is important that a company carefully evaluate a potential finder or advisor in a transaction involving outside investors. First and foremost, a company should confirm whether the finder or advisor it is considering retaining is a registered broker-dealer, including the use of publicly available resources such as the Financial Industry Regulatory Authority, Inc.'s Broker Check and asking that the advisor provide independent verification of their registration.

If a finder or advisor indicates that they are not registered as a broker-dealer, then a company must carefully consider the risk that the activities taken to secure investors will result in the finder or advisor being deemed a unlicensed broker-dealer if the company determines to proceed with the engagement. When determining whether a person is a broker-dealer, the SEC will consider a number of factors, including:

- Does the person participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does the person's compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal?
- Does the person receive other transaction-related compensation?
- Is the person otherwise engaged in the business of effecting or facilitating securities transactions?
- Does the person handle the securities or funds of others in connection with securities transactions?

In short, the more deeply involved a finder or advisor is in soliciting, negotiating and participating in the various aspects of an investment transaction, the more likely they are to be deemed a broker-dealer. In particular, the receipt of a transaction-based fee (or "success fee") can be nearly dispositive in determining that a person is a broker-dealer. Similarly, advisors who actively engage in the marketing (including the preparation of investment marketing and due diligence materials) and negotiation of an investment are also at high risk of being deemed broker-dealers. On the other hand, finders who help facilitate introductions for a fixed fee (and are not otherwise involved in the preparation, negotiation and execution of an investment transaction) are less likely to be deemed to be a broker dealer, though some risk still remains.

Companies should choose their advisors carefully when seeking to raise capital from outside investors. Although an experienced advisor or finder can be an invaluable asset in securing investors, companies need to be wary if a potential advisor does not possess the credentials of a licensed broker-dealer. In these cases, a company may be exposing itself to potential liabilities, particularly in situations where an investment does not go as planned and is subject to increased scrutiny from regulators and upset investors. As a result, companies should take pro-active steps to vet potential advisors and finders in advance, including conducting appropriate due diligence and seeking the advice of securities counsel to ensure that an advisor's role and compensation in a capital raising transaction does not put the company at odds with federal or state securities laws. Following this guidance will help ensure that a company is adequately protected and able to successfully execute its capital raising strategy.