« A Guide to the Administrative Safeguards of HIPAA's Security Rule | Main | SPYWARE: Living in a Cyber-Fishbowl »

Finding a Solution to the Problem With Finders in Utah

Finding a Solution to the Problem With Finders in Utah

by Brad R. Jacobsen and Olympia Z. Fay

A significant issue facing attorneys and their clients in Utah is the use of unregistered securities brokers by small businesses and start-up companies to raise investment capital. The unregistered securities brokers are commonly referred to as "finders," however, other titles exist to describe these individuals, including, unlicensed broker-dealers, intermediaries, private placement brokers, merchant bankers, investment bankers, financial public relations advisors and business consultants.1 Black's Law Dictionary, Sixth Edition, defines a finder as "an intermediary who contracts to find, introduce and bring together parties to a business opportunity, leaving ultimate negotiations and consummation of business transactions to the principals." For convenience of reference throughout this Article, these unregistered securities brokers will be referred to as "finders." Finders usually charge a transaction fee based on the amount of capital which the finders are responsible for bringing to the company. This type of compensation is commonly referred to as a "finders fee" and is usually paid in either securities or in cash (or a combination of both) as a percentage of the money raised (generally around 5-10%).

However defined, or by whatever name used, the use of a finder and the payment of a finders fee in Utah (subject to very narrow exceptions) is illegal and will likely cause a company, its officers, directors and agents to be subject to criminal sanctions and civil liability (on a personal and company level). Despite the illegal nature of using a finder in capital raising transactions, the American Bar Association (the "ABA") has recognized that in numerous instances, finders can provide beneficial services in raising capital for small businesses and start-up companies that is often not available from traditional lending sources or licensed broker dealers.2 On June 30, 2005, the ABA released a report titled "Reports and Recommendations of the Task Force on Private Placement Broker-Dealers" (the "ABA Report"), in which the ABA task force made a series of recommendations that seek to provide a uniform means by which individuals could more easily be licensed to act as finders. Such recommendations, however, will likely take years to implement due to the reviews and compromises required among many parties, including the National Association of Securities Dealers ("NASD"), the U. S. Securities and Exchange Commission ("SEC"), the North American Securities Administrators Association ("NASAA"), state regulators and others. This article discusses the current law and regulations facing finders as well as the ABA Report and recommendations for providing a reasonable solution to the current capital raising regulatory quandary facing small businesses and start-up companies.

I. SECURITIES BROKER-DEALERS vs. FINDERS

There is an important legal distinction between securities broker-dealers and finders. "Securities brokers are required to register with the SEC pursuant to Section 15 of the Securities and Exchange Act of 1934 (15 U.S.C. 78(a)(4)), which broadly defines any person engaged in the business of effecting transactions in securities for the account of others to be within the scope of the registration mandate."3 The SEC enacted the statute to combat abusive sales tactics and to protect investors by imposing standards of professional conduct on the securities brokers which are enforced through disciplinary actions.4 The activity of a securities broker-dealer is monitored by registered national securities associations and exchanges, in which membership is compulsory for all registered brokers. Most broker-dealers belong to, and are monitored by, the NASD. Additionally, registered brokers are governed by the SEC through its enforcement of federal securities laws, educational requirements and financial responsibility rules. These registration, compliance and educational requirements are not cheap, and such costs must be passed through to the consumer of a broker-dealer's services. Therefore, many small businesses and start-ups are often priced out of using valid capital raising services or otherwise not targeted by registered broker-dealers as clients.

Unlike a registered broker-dealer, a finder is an unregistered intermediary that assists companies in raising capital. Within certain limits, a finder may operate within applicable legal requirements. The SEC has recognized that a person who only occasionally makes mere introductions of potential investors to issuers, either for free or under a non-contingent fee arrangement, and not more, is a

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The next post in this blog is SPYWARE: Living in a Cyber-Fishbowl.

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investors to issuers, either for free or under a non-contingent fee arrangement, and not more, is a

finder who does not need to register as a broker. Through the use of No-Action letters, the SEC has attempted to promote additional standards by which finders may legally operate and, in certain circumstances, receive a transaction based fee.

In a well-known No-Action letter, the Ottawa Senators Hockey Club retained entertainer Paul Anka ("Anka") to act as a finder for purchasers of limited partnership units issued by the Senators.5 While initially proposing a much broader role, Anka eventually agreed to only furnish the Senators with the names and telephone numbers of persons in the United States and Canada who he believed might be interested in purchasing the limited partnership units. Anka additionally agreed that he would neither personally contact these persons nor make any recommendations to them regarding investments in the Senators. Anka's proposal letter to the SEC stated that he would be paid a finders fee equal to 10% of any sales traceable to his efforts. The SEC indicated that it would not recommend enforcement action if Anka engaged in the proposed activities without registering as a securities broker-dealer. The following summarizes the important factors considered by the SEC when issuing the Anka No-Action letter:

¥ Anka only provided names and contact information for prospective purchasers;

¥ The sales of the securities were to be made in compliance with the Securities Act of 1933;

¥ There was a bona fide, pre-existing relationship between Anka and his referrals;

¥ Anka would not advertise, endorse or solicit investors;

¥ Anka would not have personal contact with prospective investors regarding the investment;

¥ Only officers and directors of the Senators would contact the potential investors;

¥ Compensation paid to the Senators' officers and directors would comply with SEC Rule 3a-1, which governs compensating issuer agents;

¥ Anka would not provide financing for an investor;

¥ Anka would not perform due diligence on the SenatorÕs offering; and

¥ Anka had never been a broker-dealer or registered representative of a broker-dealer.6

While the Utah Division of Securities has stated that it will respect the Anka No-Action letter, it must be emphasized that the exception to using finders in capital raising transactions offered by such Letter is extremely narrow. It amounts to basically paying a well-connected person for a list of names and phone numbers. Rarely do finders act in such a limited capacity or are companies willing to pay such a high fee for such limited information.

II. CONSEQUENCES OF FINDERS' UNLAWFUL ACTIVITY

Federal and state securities administrators have enacted statutes detailing the consequences of finders' unlawful activities. Failure to comply with such statutes can result, in among other things: (1) a company losing its exemption for its securities offering; (2) a company, its officers, directors and agents being subject to criminal sanctions resulting from violations of applicable securities laws; and (3) company investors having the right to seek rescission of the applicable offering.7 In order to avoid the pitfalls of using a finder, it is important to understand the case law, applicable statutes and consequences of using one.

Federal Statute for Finders and Case Decisions

Section 15(a) of the 1934 Securities Act provides that "it shall be unlawful for any broker or dealer . . . to make use of mail or any means or instrumentality of interstate commerce to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security . . . *unless such broker or dealer is registered."* As previously discussed, a finder is an unregistered party attempting to induce others to purchase or sell securities.

In *SEC v. Walsh*, the SEC sued former Tyco director and the chairman of its compensation committee for signing a Tyco registration statement that he knew contained a material misrepresentation regarding the payment of a finders fee. In late 2000, Frank E. Walsh ("Walsh") recommended that Tyco consider acquiring CIT Group Inc. (ÒCITÓ).8 Subsequently, L. Dennis Kozlowski ("Kozlowski"), Tyco's former Chief Executive Officer, asked Walsh to set up a meeting between Kozlowski and CIT's Chief Executive Officer. After that meeting, Kozlowski proposed to pay Walsh a finders fee for his services if the transaction was completed. When the transaction was submitted to Tyco's Board ("Tyco Board"), Walsh voted in favor of the transaction but intentionally did not disclose to the Tyco Board that he would receive a finders fee in connection with the transaction.

The terms and conditions of the Tyco/CIT merger were set forth in the Agreement and Plan of Merger dated March 12, 2001 (the "Agreement and Plan of Merger"). The Agreement and Plan of Merger contained a representation by Tyco that, other than Tyco's investment bankers for the transaction, no other investment banking or finders fees were to be paid in connection with the

transaction. The Agreement and Plan of Merger was incorporated by reference in, and attached to, a registration statement (the "Tyco Registration Statement") filed by Tyco with the SEC for the securities that were issued in connection with the contemplated merger. As a director, Walsh signed the Tyco Registration Statement even though he allegedly knew that the Tyco Registration Statement contained a material misrepresentation regarding the payment of a finders fee and was aware that he would obtain a substantial fee if the transaction was completed.

After completion of the transaction Walsh received a finders fee of $20 million. The fee was paid by Tyco pursuant to the Walsh/ Kozlowski agreement. Additionally, the fee was disbursed without the knowledge of CIT's or Tyco's shareholders. Under the Agreement and Plan of Merger, the payment to Walsh was not permissible.

After investigation by the SEC, Walsh, without admitting or denying the allegations, consented to the entry of a final judgment permanently enjoining him from violations of the federal securities laws (Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Exchange Act Rule 10b-5). Consequently, Walsh was permanently barred from acting as an officer or director of a publicly held company, and ordered to pay restitution of $20 million.

Utah Rules and Penalties Concerning Finders

Issuers, due to a failure to plan in advance, often find themselves in a position of attempting to fit their offerings into the Anka No-Action letter exception after the fact. The Utah Division of Securities (the "Division") actively reviews Form Ds filed, and aggressively pursues instances where the issuer has indicated that it paid a sales commission or finders fee.9 Unless any such issuer used a licensed broker-dealer, it will need to demonstrate that it adhered to the procedures permitted by Anka (or used a licensed Issuer-Agent (discussed below)), otherwise such issuer, its officers, directors and agents will likely face significant consequences.

Described below are a number of the applicable sections of the Utah Code (the "Utah Act") that set forth certain of the consequences for using a finder in Utah.

Section 61-1-3(1) of the Utah Act provides that "[i]t is unlawful for any person to transact business in this state as a broker-dealer or agent unless the person is licensed under the Utah Act." Section 61-1-3(2) then goes on to provide that "[i]t is unlawful for any broker-dealer or issuer to employ or engage an agent unless the agent is licensed." The term "agent" is broadly defined as "any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities."10

Section 61-1-11(11) of the Utah Act requires that if an issuer wishes to use an agent, employee or other person to effect or attempt to effect a securities transaction, such person must either (i) be licensed and associated with a licensed broker-dealers or (ii) be an officer or director of the issuer; provided, that, with respect to clause (ii), such person also (A) does not receive any commission or other remuneration; *and* (B) is licensed (generally as an issuer agent). While Section 61-1-11 generally applies only to registrations by qualification, coordination or notification, an aggressive view of Section 61-1-11(11), in and of itself, could be read to include any securities issuances.

Section 61-1-22(1)(a) of the Utah Act provides that "[a] person who offers or sells a security in violation of Subsection 61-1-311 . . . is liable to the person selling the security to or buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at 12% per year from the date of payments, costs, and reasonable attorney's fees."

Section 61-1-22(4)(a) of the Utah Act adds that "[e]very person who directly or indirectly controls a seller or buyer liable under Subsection [61-1-22(a)], every partner, officer, or director of such a seller or buyer, every person occupying a similar status or performing similar function, every employer of such a seller or buyer who materially aids in the sale or purchase, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller or purchaser, unless the nonseller or nonpurchaser who is liable sustains the burden of proof that he did not know, and in exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist."

Violations of the securities laws in Utah will not only subject the issuer, its officers, directors and agents to rescission claims (*e.g.*, return of investment, plus 12% annual return from time of investment, plus attorneys fees) described above, but also criminal sanctions, including: (1) cease and desist proceedings; (2) fines; (3) disgorgement of any fees or other profits; (4) injunction orders; and (5) the potential conviction of a third degree felony (punishable by up to two years in jail).12 The investigative proceedings and orders by any federal or state regulatory authority will also be a reportable event for any person who is a broker-dealer, investment advisor or other NASD registered individual.

Limited Exceptions Under Utah Law

Certain limited finding activities may be conducted under applicable law. The limited involvement

described in the Anka No-Action letter is followed in Utah. As previously mentioned, however, few individuals can qualify for such an exemption and still effectively assist a company in obtaining financing. Additionally, Utah permits a licensed "Issuer-Agent" to represent a company in the issuance of securities. Such an Issuer-Agent, however, must first be registered and licensed with the State of Utah. The applicant must (1) file a NASD Form U-4; (2) provide proof that such applicant has passed the Series 63 or Series 66 examination; (3) pay a fee of $50; and (4) in certain circumstances post a surety bond.13 A registered Issuer-Agent, however, may not be involved in more than one offering in any twelve-month period.14 An individual who wishes to represent more than one company in any given twelve-month period must register as a licensed broker-dealer to do so. The ABA Report described below, argues that between an Issuer-Agent only being permitted to represent one company in a twelve-month period and the formal procedures of registering as a broker-dealer, there should be a middle ground (e.g., private placement broker-dealers subject to limited registration requirements that are permitted to engage in certain finding activities for a greater number of companies). The ABA Report refers to these licensed finders as "Private Placement Broker-Dealers."

III. ABA Recommendations

Registration Requirements for Finders

On June 30, 2005, the Task Force on Private Placement Broker-Dealers (the "Task Force") released the previously described ABA Report.15 The ABA Report discusses the problems that are associated with using a finder at both the state and federal level and makes recommendations for permitting expanded finders activities. The objectives of the ABA Report were:

¥ To present a comprehensive survey of the relevant issues relating to this vast gray market of securities brokerage; and

¥ To propose a solution that the Task Force believes will provide a reduced, but appropriate, level of regulation in the M&A and private placement arenas.

The ABA Report additionally set forth four critical goals for the proposed solution:

¥ To modify the amount and scope of the regulations that will apply such that they would be in proper balance with the scope of activities to those being regulated;

¥ To make possible and encourage the effective licensing of those finders who do adhere to honest and ethical business practices;

¥ To diminish the number of unlawful securities brokers to a level that will make effective enforcement actions more feasible; and

¥ To provide issuers and finders a means of distinguishing the good from the bad.

The ABA through the Task Force recommends that the SEC, NASD and state administrators work toward creating a simplified system for finders to be licensed. The system the ABA Report is proposing will permit finders to engage in activities similar to those of securities broker-dealers with a few limitations. The Task Force's new recommended limitations for finders include:16

¥ No participation in public offerings registered pursuant to the Securities Act of 1933, but with the ability to receive referral fees for introducing such offerings to full service broker-dealers.

¥ No statutory disqualification of the firms or its principals.

¥ Offerings by finders could be made only to accredited investors and other "qualified purchasers" when the SEC defines such term. Issuers, however, could separately offer to any investors qualified by the type of exemption.

¥ The finders may not handle or take possession of funds or securities.

¥ All offerings would be done on a best effort basis.

¥ All funds from offerings will be placed in escrow in an unaffiliated financial institution and in accordance with escrow requirements in SEC Rule 15c2-4.

¥ The finders may not engage in secondary market or trade activity, including assisting with maintenance of "desk drawer" markets at the issuer or the broker-dealer.

¥ Finders shall have successfully completed simplified NASD examinations appropriate to the scope of activities of the finders.

Statement of Activity and Examination Requirements

The Task Force recommends that a finder be required to file an annual statement of activity with the NASD and applicable states. The annual statements will summarize the transactions the finder has participated during the past calendar year and provide sufficient statistical information for regulators to analyze the effects of the finders program or conduct appropriate inspection.

The Task Force is proposing an examination requirement similar to that of the securities broker-dealers. Currently, examinations are not required for finders since the scope of their coverage does not exceed the knowledge required to perform obligations that the ABA anticipated for securities brokers. The Task Force recommends the securities regulators "develop new targeted examination for registered representatives and principals, such as finders, testing only relevant topics of their duties."17

Create an Environment Where Applicants Want to Register

An obvious concern for those finders who have engaged in transactions without registration in the past is that regulators, particularly state administrators, will require disclosure of past activities in their states. The Task Force recommends that states establish a period procedure under which prior activities would not require disclosure. If an applicant faces virtual certainty of a state regulatory proceeding and a demand for rescission, there is little incentive for compliance. The Task Force is urging the NASAA to promote among its members a system of encouraging, rather than discouraging, appropriate registration. Many states require letters from an applicant for securities registration stating that the entity has not engaged in securities transactions in the state in the past (often without a time limit). These letters have the effect of terrorizing the applicant who wants to come forward and become compliant. The Task Force is recommending a one-year hiatus in the use of such letters to permit individuals or firms to come to compliance.

CONCLUSION

Small businesses and start-up companies in need of investment capital are often in a "catch 22"18 when it comes to raising funds. Without additional capital, such companies may not survive, but if they raise capital through the use of a finder, they will likely be violating the law which, in turn, may lead to their demise. Such companies, additionally, are often not large enough to draw from traditional sources of capital or do not otherwise have contacts with available investment capital. Often, through no knowing violation of the law, these companies end up using finders to obtain desperately needed capital. The ABA acknowledges the difficult position small businesses and start-ups are in when it comes to raising capital. The ABA, through the Task Force, has recommended that by permitting individuals to be licensed simply as finders, smaller businesses and start-up companies would likely have additional access to legitimate investment capital not currently available. The licensing requirements, while less stringent than that of a broker-dealer, would provide protections and regulatory oversight not currently imposed on finders operating on and beyond the grey line of legality.

Until the SEC, state administrators and NASD resolve their concerns and issues regarding the licensing on finders recommended by the Task Force, Utah companies and attorneys would do well to steer clear of their unauthorized use. While some states, such as Michigan, have chosen to license finders ahead of final federal rules, little can effectively be done at the state level until federal securities laws and regulations expand activities permitted by finders. Practitioners who believe a limited exemption and registration for finders would be a beneficial addition to the current securities regulatory environment are encouraged to work with their legislators and regulators to push such recommendations through to adoption.

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1. *See* Mary M. Sjodquist, *ABA Reports and Recommendations of the Task Force on Private Placement Broker-Dealers*, June 20, 2005 at 2.

2. *See id.*

3. *See* Steven M. Hecht, *Securities Law: Are finders also broker-dealers?* The National Law Journal, March 8, 2004.

4. *See id.*

5. *See* Paul Anka, SEC No-Action letter (July 24, 1991)

6. *See id.*

7. *See* Utah Code Ann. ¤ 61-1-22 (2005).

8. *See* United States Securities and Exchange Commission Litigation Release No. 17896 (Dec. 17, 2002), at http://www.sec.gov/litigation/litreleases/lr17896.htm

9. *See* Form D, Section C, Question 4a.

10. *See* Utah Code Ann. ¤ 61-1-13(2) (2005).

11. Utah Code Ann. ¤ 61-1-22(1)(a) (2005) provides that a violation of "Subsection 61-1-3(1), Section 61-1-7, Subsection 61-1-17(2), any rule or order under Section 61-1-15, ... Subsection 61-

1-10(4) or 61-1-11(7), or offers, sells, or purchases a security in violation of Subsection 61-1-1 (2) ..." subjects the issuer and certain affiliated parties to rescission liability. Note, however, that a violation of Utah Code Ann. ¤ 61-1-11 (11) referenced in the prior paragraph is not included in the litany of violations that provides grounds for a rescission offer.

12. *See* Utah Code Ann. ¤ 61-2-17 (2005).

13. *See* Utah Regulations R164-4-1(E)(4).

14. *See* Utah Regulations R164-4-1(E)(4)(A).

15. *See ABA Report and Recommendations*.

16. *Id.*

17. *See id.* at 4.

18. The phrase "Catch 22" comes from Joseph Heller's novel of the same name. The paradox that trapped members of the US military: Anyone who applied to get out of military service on the grounds of insanity was behaving rationally and thus couldn't be insane.

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