



- BUSINESS LAW
- BROKER-DEALERS
- INVESTMENT ADVISORS
- ATTORNEYS
- RESOURCES YOU CAN USE
- OUR PLEDGE TO YOU
- SPEAKER SERVICES
- CLIENT COMMENTS
- CONTACT



## When Raising Investment Capital, Can You Pay Someone To Do It For You?

[< back to published articles](#)

Let's face it, raising investment capital for a business isn't easy-and most entrepreneurs would take all the help they can get.

If you're selling shares in your company to raise cash, it seems logical that you should get your company's sales staff, or outsourced services, to help you out. Perhaps you can even pay them a high commission on stock sales and they'll be extra motivated.

After all, few things motivate someone to sell like a big commission check.

Better yet, what about hiring one of these guys who call themselves "consultants" or "finders" and claim to help companies raise money? Just about anyone who's done some networking in the venture capital seminar scene has likely run across someone like this. They work on great terms: you don't pay unless they raise cash. And even if the fee they charge for their services may be high, who wouldn't give up a big chunk of cash (or a kidney) for the ease of having someone find investors for you?

On a fairly regular basis, my entrepreneur and investor clients ask me if they can pay their employees, or a finder-consultant a piece of the deal if they help the company raise investment dollars.

In almost every case, the answer is a definitive no. The payment of a finder's fee or commission in connection with the sale of securities to a person who is not a broker registered with FINRA (formerly the NASD) is generally illegal.

Another common misconception among entrepreneurs is that the payment of finder's fees falls within a "gray area" of the law. This is just wrong. It's a myth that seems to be perpetuated by entrepreneurs and finders who have engaged in this activity and haven't been caught.

I can't tell you how many times I have heard from clients "well, I know ABC Company who paid a finder a commission and didn't have any problems." My reply is always the same: "ever drive a car on the West Side Highway at 75 miles per hour and get passed by someone going faster than you...and neither of you got a ticket?" Just because you didn't get nabbed by New York's Finest doesn't mean you weren't breaking the speed limit by a fairly wide margin.

In my practice, I've represented clients who have had problems with regulators by unknowingly violating these rules. In nearly every case, the company went out of business or sought protection from creditors under the bankruptcy laws as a result of the mistake.

The business of getting paid commissions for introducing investors to companies is something that our government has taken a keen interest in regulating.

If you are serious about growing your business, you will need to become adept at raising capital when your company requires it. Educating yourself about what your employees and consultants can and cannot do to help you raise capital is critical to your company's health.

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Here are the basics about using employees and finder-consultants to help you with your capital raising efforts:

#### **What is a "finder?"**

A finder is an individual, company or service that receives compensation in connection with the solicitation of potential investors. The most common examples of *legal* finders are broker-dealers or investment bankers working for broker-dealers.

#### **What is a broker?**

A "broker" is defined under the securities laws as "any person engaged in the business of effecting transactions in securities for the account of others." Helping a company sell shares to raise capital, engaging in other activities like participating in presentations and negotiations, making recommendations to investors concerning securities, receiving transaction-based compensation (i.e. commissions or finder's fees), and continuing or regular involvement in sales of securities are evidence of activities rendering a person a broker.

If your employees or finder-consultants perform these tasks, typically the person is obligated to be registered as a broker with (and thus regulated by) FINRA.

#### **How can an employee help a company raise capital lawfully?**

Under certain conditions, a company can permit its employees to help it raise investment capital without triggering the broker registration requirements. For example, the SEC's Rules allow an employee, officer or director of a company to participate as a finder in a private offering provided that the employee:

- is not considered by the SEC to be a securities industry "bad boy";
- does not get paid commissions in connection with the offering;
- is not an associated person of a broker or dealer at the time of his participation;
- performs a job for the company other than in connection with the company's offering (i.e., marketing or customer relations);
- was not within the last year a registered broker; and
- does not participate in the company's securities offerings more than once every 12 months (with certain restrictions).

Keep in mind, that each state has its own set of regulations that may differ from federal regulations. For example, in some states only officers and directors of a company are permitted to engage in the sale of securities.

#### **Does a finder-consultant always have to be a registered as a broker with FINRA?**

There are some circumstances where a finder-consultant is not required to register as a broker. However, if you're acting as a finder (or you're a company hiring a finder), you must take extreme care to ensure that the finder's activities are limited so that he or she is not functioning as an unlicensed broker.

Finders can avoid registering as a broker by limiting their activities to:

- merely introducing prospective investors to a company without engaging in negotiations;
- not recommending the company's securities to prospective investors; and
- basing their compensation on a flat fee that is not contingent on the

closing of a securities sale (for example, the finder gets a fee of \$50,000 for making the introduction to an investor, regardless of whether the investor purchases shares or not).

#### **What kind of compensation cannot be paid to finder-consultants?**

Transaction-based compensation, or success-based compensation, like a finder's fee or commission, is compensation that is contingent on the transaction closing. Often the fee is a percentage of the amount of securities sold. Unregistered persons are not permitted to receive this type of fee from a company.

Permissible forms of compensation may include professional fees based on hourly billing rates or fixed fees; non-transaction based consulting fees; non-transaction based due diligence fees; or expense reimbursements.

You'll notice that common theme among permissible forms of compensation is that the fee is paid regardless of whether funds are raised. My experience is that most companies are unwilling, or at least reluctant to pay a finder a fee for services that may or may not turn into an investment.

Many companies have attempted to disguise a commission as a permissible fee. For example, entrepreneurs often hire "finders" as "consultants" and call the finder's fee a "consulting fee." However, if the compensation the consultant receives is ultimately tied to their activity of selling shares in the company, and they would not have received the fee absent the company raising capital, then the payment of the fee to an unregistered person is not permissible.

Regulators will easily sniff out a thinly disguised form of success-based compensation, and the fee will not be considered valid.

#### **What can happen if a regulatory agency determines that a finder-consultant or employee is acting as an unregistered broker?**

If a regulatory agency, like the securities division of a state or the SEC, determines that a finder-consultant or employee has acted as an unregistered broker, the SEC or state could impose fines on the finder, which may include disgorging to the issuer commissions paid. Further, regulators could bar the finder in some cases from ever registering as a broker in with their agency in the future.

#### **What can happen to a company if the SEC determines it unlawfully used an unregistered finder?**

If a regulator determines that a company used an unregistered finder to locate investors, they could force the company to offer investors the right to rescind their purchase and obtain a return of their entire investment. This may be a problem if you've spent the investment money and there's nothing in the company's coffers to purchase shares back from investors.

Also, under certain circumstances, the regulators could impose fines on the company for participating in a transaction that violated the securities laws or prohibit the company from engaging in securities transactions in the regulators' jurisdiction in the future.

Finally, any irregularity in early financing activities can make subsequent rounds of financing more difficult to complete. When disclosed to subsequent investors, errors made in early-stage funding efforts may cut the company off from funding options in the future.

This article was meant to be a brief overview of the rules related to using employees and finder-consultants to help you raise investment capital. It was intended solely to alert you to the dangers of engaging in this activity.

This is a nuanced area of the law and you should not rely on this information alone when engaging in a securities offering. If you plan to conduct a

securities offering and wish to lawfully use your employees, consultants or finders to help you with your capital raising plans, I recommend that you seek the advice of competent securities counsel.

- by [Stephen T. Furnari](#)

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