



If it looks like a duck and quacks like a duck: Finders or unregistered brokers?

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Private equity firms, particularly mid-market players, increasingly are employing unregistered third party "finders" in an effort to promote their funds to potential investors. Motivation in utilizing such finders rather than registered brokers is often rooted in smaller-sized firms' inability to attract the attention of placement agents. Appealing as the use of finders may be, however, it can raise regulatory compliance issues of which private equity firms should be aware. This article aims to highlight the differences between finders and brokers and suggests that private equity firms should be cognizant of the narrow scope of activity that can be performed by finders without subjecting themselves to the broker registration requirements of the Securities and Exchange Commission (SEC).

What is a broker?

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." The breadth of this definition has led the SEC Staff to issue a number of clarifying no-action letters over the years. Though these letters are limited to the particular sets of facts and circumstances presented therein, they nevertheless elucidate the SEC's approach to determining whether a finder's activities constitute brokerage and trigger the broker registration requirement.

In one letter, the staff noted that a person effects a transaction in securities "if he or she participates in such transactions at key points in the chain of distribution," including "assisting an issuer to structure prospective securities transactions, helping an issuer to identify potential purchasers of securities [and] soliciting securities transactions...."[1]

The SEC has set forth the core characterizations of a broker in its "Guide to Broker-Dealer Registration," published most recently. In this guide, the SEC's Division of Market Regulation indicates that the following questions are relevant to determining whether registration as a broker may be necessary:

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

Answering any of these questions in the affirmative may indicate that one is acting as a broker who would be required to register with the SEC.

Where does a finder fit into all of this?

Finders are intermediaries whose primary function is to introduce potential investors to available investment opportunities. Essentially financial matchmakers, finders differ from brokers in that their role ends once initial introductions are made. The SEC staff has issued several no-action letters in which it has agreed, in very limited situations, not to take action against finders for failing to register as brokers where such finders "do nothing more than ... bring together" parties who are inclined to engage in a securities transaction.[2] In one oft-cited no-action letter involving an entertainer helping to raise money for a professional hockey team, the SEC staff expounded on this "finder's exemption" in an offering where the finder was paid a fee in exchange for furnishing a managing partner with the names and telephone numbers of potential investors in a limited partnership but had no contact with the investors regarding the investment opportunity and did not participate in any negotiations between them and the limited partnership; the SEC staff further noted that the entertainer had not been involved previously in the securities industry and had no intention of acting as a finder in the future.[3]

What are the ramifications of using an unregistered broker?

The SEC staff has made clear that "a person who plays an integral role in negotiating, closing, and effecting... transactions in securities, particularly one who receives a commission for his efforts based on the value of the securities, generally is deemed to be either a broker or a dealer... and is required to register with the SEC pursuant to Section 15 of the Act." [4] The failure of finders to register as brokers when their activities go beyond the very narrow scope of those permitted under the prevailing no-action letters can have serious consequences both for the finders and, in certain instances, for the issuers who employ them.

Participation by an unregistered broker to facilitate securities transactions constitutes a violation of the antifraud provisions of federal securities laws, exposing the unregistered broker to potential civil and criminal penalties. Moreover, an issuer who knowingly or recklessly employs an unregistered broker may be liable for aiding and abetting the unregistered broker's fraud and could find itself subject to a variety of adverse consequences, including, in some states, investor rescission rights. Accordingly, exposure to this type of issuer liability could have significant negative effects on a private equity firm's current and future fund-raising activities.

Where is the middle-ground?

The SEC has established parameters within which finders may lawfully act without having to register as brokers. These parameters do not extend much further than making introductions to potential investors. Activity outside these parameters by a finder will almost surely tip the scale in favor of broker status, which will trigger the broker registration requirement. It is important that private equity firms seeking to raise capital be aware of the delicate balance between finders and unregistered brokers and recognize that use of finders must be strictly limited in accordance with state and federal law. Otherwise, if your finder looks like a broker and quacks like a broker... he or she probably is an unregistered broker.

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1. BondGlobe, Inc., SEC No-Action Letter, 2001 LEXIS 401 at *2 (Feb. 6, 2001).
[\[Back to reference\]](#)
 2. May-Pac Mgmt. Co., SEC No-Action Letter, 1973 LEXIS 1117 at *3 (Dec. 20, 1973).
[\[Back to reference\]](#)
 3. Paul Anka, SEC No-Action Letter, 1991 LEXIS 925 at *3, 4 (July 24, 1991).
[\[Back to reference\]](#)
 4. Castagna Business Brokerage, Inc., SEC No-Action Letter, 1920 LEXIS 3208 at *4 (Apr. 15, 1980).

4. Castagna Business Brokerage, Inc., SEC NO ACTION LETTER, 1720 LEADS 3278 at 4 (Apr. 13, 1988).
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