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Use of Finders in Securities Transactions

May 2006

Many entrepreneurs and corporate executives at small companies are not sure where to turn when they decide to raise capital or buy or sell a business. So they ask around to friends, neighbors, and business associates. They hear anecdotes about John Doe (an unregistered intermediary herein referred to generically as "Finder") who helped a friend of a friend find a bunch of money for his company. Intrigued, the executive/entrepreneur meets the Finder, likes what he hears, and decides to hire him to use his magic on his company's behalf. He signs an advisory agreement with the Finder (or his firm) that typically calls for most or all of the fee to be paid only upon successful completion of the transaction. He walks out of the Finder's office licking his chops over the prospect of the money rolling in a few weeks.

What he does not realize is that in many such situations both his company and the Finder have just violated federal and state securities laws. Federal law and most state laws make it unlawful to "effect a transaction in securities" unless registered as a broker/dealer pursuant to the rules and regulations of the National Association of Securities Dealers, Inc. ("NASD"), an industry self regulatory organization. (The SEC has delegated the responsibility of regulating broker/dealers to NASD.) There are hundreds of individuals and firms operating a business in which they help effect a transaction in securities without holding a license to do so. In nearly all such instances, they are operating illegally.

Why are there broker/dealer laws?

The federal broker/dealer laws are embodied in the Securities Exchange Act of 1934. The major impetus behind this depression era law is investor protection. The laws are designed to protect the public from unscrupulous sellers of securities. The laws require that a broker of securities adhere to standards of conduct mandated by the SEC and implemented by NASD. NASD requires adherence to a comprehensive code of conduct and fair dealing. Its overriding guiding principle is "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." NASD Rule 2110. One of its mainstays is the requirement that the NASD member determine that an investment is "suitable" for its customer. The suitability determination is very broad and places a heavy burden on the member firm to carefully consider the merits of the securities it sells as well as the appropriateness of the securities for each customer in light of the customer's economic and other circumstances. It would not, for example, be consistent with principles of fair dealing for a member firm to sell securities based upon sales materials containing fraudulent statements, material fact omissions or wildly optimistic projections of future performance. Nor would it be suitable to sell a highly speculative stock to an octogenarian on a fixed income with preservation of capital as his primary investment objective.

Against this backdrop, it is not hard to understand why the SEC broadly construes the broker/dealer laws, and narrowly construes the few exceptions it has allowed. See Stevens v. Abbott, 288 F. Supp. 836 (E.D. VA 1968). Most of the SEC guidance over the past several decades has come from no-action letters issued by the SEC staff. The staff position has become tougher in recent years. Prior to 2000, many in the investment banking community and the legal communities advising it, took comfort in the staff decision in Dominion Resources, Inc., SEC No Action Letter (August 22, 1985). In that case, the SEC staff outlined in detail the activities to be undertaken by an intermediary in a securities transaction and reached a conclusion that a broker/dealer license was not necessary. The decision opened the door for the rise of many unregistered parties serving as intermediaries in securities transactions.

In 2000, however, the SEC staff effectively overruled its earlier Dominion Resources, Inc. decision, SEC No Action Letter (March 7, 2000). Now nearly all intermediaries must be licensed, unless one of the extremely limited exceptions described below applies.

What is effecting a transaction?

Generally, almost anything more than providing a name and contact information for a prospective purchaser of a security will be deemed to be "effecting" a securities transaction. Recommending a company or the purchase of its securities, negotiating terms of a securities offering or purchase, attending meetings or presentations where the merits of the investment are discussed, performing or accommodating due diligence efforts, providing valuations or estimates of value, all have been found to be activities that would require registration as a broker/dealer. See e.g. May-Pac Management Co., SEC No Action Letter (Dec. 20, 1973).

What is a security?

Generally the following would be deemed to a “security:”

- Common stock, preferred stock, as well as warrants or options to purchase stock, and
- Most limited liability company membership interests, as well as limited partnership interests (general partnership interests usually are not securities.)
- Most debt issuances such as bonds, and notes (home mortgages, consumer loans, and certain types of commercial bank loans are not securities).

Are there exemptions?

- There is a very limited exception for qualified “finders.” The so-called finder exemption applies to a person who makes a referral of a potential purchaser of securities to an issuer. The finder can do almost nothing more than provide the name and phone number to the issuer to qualify for the exemption. Paul Anka, SEC No-Action Letter (July 24, 1991).

- Professionals who work for issuers such as accountants or lawyers usually will not be deemed to require a broker/dealer license unless they receive contingent compensation and engage in activities requiring registration. Consultants, particularly financial consultants, usually are exempt if they are paid non-contingent compensation, such as an hourly rate. Consultants paid on a contingent or commission basis are likely not to be exempt unless they never communicate with potential investors.

- Employees of an issuer usually are exempt unless they are paid a commission or receive a contingent compensation relating to the securities offering or purchase.

- Effecting the sale of a company's assets is not subject to the securities laws because it does not involve the sale of a security. (This is more of an exclusion than an exemption).

Is Finder usage common?

Finders are very common. The American Bar Association Business Law Section Task Force on Private Placement Broker/Dealers recently submitted a report to the SEC recommending relaxation of the broker/dealer laws applicable to private placement activities. 60 The Business Lawyer 959 (May 2005). The report described Finder's activity as a "vast and pervasive 'grey market' of brokerage activity."

Why don't Finders register?

NASD registration is available to qualified firms, not individuals. The application process, which typically takes about six months, requires submission of a business plan, and personal interviews of the principals. Principals of the applying firm must pass examinations on topics related to the securities business. Once accepted as a member, the firm must pay NASD and state fees and assessments, maintain minimal capital requirements, file periodic financial reports, and undergo an annual audit. It also must comply with myriad SEC and NASD rules, and be subject to periodic detailed compliance examinations by the SEC, NASD, and state securities regulators. Penalties for failure to comply with applicable regulations can be severe.

Consequences of using Finders

The consequences of hiring an unlicensed intermediary can be draconian:

- *For the issuer*, hiring an unlicensed intermediary to effect a securities transaction is a violation of federal and many state laws. It subjects the issuer to possible civil and criminal penalties. It also results in a voidable transaction that gives the investor, buyer or seller, a right of rescission, effectively granting a put right to the investor or purchaser. (Section 29(b) of the Securities Exchange Act of 1934 provides "Every contract made in violation of any provision of this title or any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of [the Exchange Act] or any rule or regulation thereunder, shall be void . . . .")

- *For the Finder*, engaging in activities designed to effect a transaction in securities is a violation of law that subjects the Finder to potential civil and criminal penalties, see e.g. Colorado v. Milne, 690 P.2d 829 (1984) (conviction for selling securities without a license), and also creates a put right for the investor, buyer or seller. It is possible, moreover, that the SEC, or state securities regulators or attorneys general will seek to enjoin the unlawful activities, seek monetary penalties, or criminal sanctions.

- *For the Investor*, or buyer or seller in an M & A transaction, an unexpected benefit may be provided in that the put right protects him against an investment that later goes bad.

Conclusion

Using an unlicensed intermediary can be hazardous to the health of an issuer or a Finder. Due to resource constraints, regulators do not often actively police broker/dealer law violations. Most often, the issue arises in the context of a failed investment. In such event, the investor's lawyer can be expected to raise broker/dealer law violations to establish his client's right of rescission.

Ensuring compliance with the different laws of each state involved in a securities transaction, in addition to the federal requirements, can be a challenging task. Experienced legal practitioners in this area can provide valuable front-end assistance to prevent back-end headaches.

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This Alert was written by Wayne Lee, a member of the Corporate and Securities Practice in the Tysons Corner office. Please contact Mr. Lee at 703.749.1394 or your Greenberg Traurig liaison if you have any questions regarding the subject matter of this GT Alert.

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