

Founder Fundamentals

Using a Finder to Raise Capital? Proceed With Caution

By Emily Yukich

Raising capital is one of the greatest challenges entrepreneurs face. Early-stage funding is particularly difficult for entrepreneurs who don't have existing connections to capital or have a limited capital network. Entrepreneurs can be forgiven for being tempted by claims from individuals promising to "open their rolodex" and make introductions to potential investors in exchange for a success fee. Typically these individuals are not licensed and, therefore, not permitted under federal or state securities laws to earn success fees in connection with raising capital.

In our experience, most finders exaggerate their connections and overstate their networks. Many are just downright sketchy characters. In a best-case scenario, these unlicensed "finders" waste entrepreneurs' time by making introductions that lead to discussions but never get across the finish line.

In a worst-case scenario, however, an unlicensed finder makes an introduction and money is raised, but the investor becomes unhappy for some reason and demands its money back (along with attorneys' fees and costs) on the grounds that the money was raised using an unregistered broker-dealer who earned a success fee based on the investment. The investor's right to rescind the transaction can continue for three years or more — a fact that the company will have to disclose to future potential investors, thereby chilling investor interest and threatening the company's prospects for long-term growth and success.

In this article we:

- Summarize some of the risks under federal and state law of using unlicensed broker dealers to raise capital
- Provide guidance for determining if a finder is an unlicensed broker-dealer
- Describe a finders' agreement that complies with federal law

Risks of Using Unlicensed Broker-Dealers

- **Rescission rights:** Federal law. Under Section 29(b) of the federal Securities Exchange Act, a contract to purchase securities secured through the use of an unlicensed broker-dealer can be voided by the investor, who can demand that the contract be rescinded and require the issuer to return the funds. This right can be exercised until the later of three years from the date the securities were purchased, or one year from the date the investor discovered the legal violation.
- **Rescission rights:** State law. In certain states such as California, not only can the sale of securities be rescinded, but the purchaser can exercise that right even if it no longer owns the securities, and can be awarded attorneys' fees and costs.

- **Disclosure Obligations.** A company that pays an unregistered broker-dealer to raise capital must disclose that fact in any future transactions requiring SEC and state securities filings. The sword of Damocles hangs heavy, as these disclosures can dissuade potential investors from investing (or result in significantly discounted purchase prices), and legal counsel for the company will be limited in what they can include in their legal opinions. If that isn't scary enough, failure to disclose payments to unregistered broker-dealers could result in charges of fraud under federal and state securities laws, resulting in fines, disgorgement of proceeds and bans on individuals being employed by publicly traded companies.

How to Recognize an Unlicensed Broker-Dealer

Entrepreneurs should consider the following factors to determine if the SEC would likely deem a finder to be an unlicensed broker-dealer:

- Is the finder's compensation based on the amount of funds raised? This is a key factor used by the SEC in determining if a finder is acting as a broker-dealer. The amount of compensation doesn't matter; if the compensation varies based on the success of the raise, it is considered transaction-based compensation and

can be a dispositive factor. Note that the compensation doesn't need to be cash to be considered transaction-based. For instance, issuing stock to the finder does not change the analysis.

- **Will the finder solicit potential investors?** "Solicitation" can range from general online advertisements to in-person conversations, and can include activities such as pre-screening investors.
- **Will the finder advise the company or negotiate with potential investors?** Finders should not do either of these. At most, they should limit their involvement to passing information between the company and the investor, without comment and without discussion.
- **Do they have a history of disciplinary action?** A finder may be a former broker-dealer who has been barred from such work by the SEC or by a state securities agency and is trying to work around the registration requirements. It can be very useful to check the SEC website for enforcement actions or ask your attorney to do so.

Does a 'Work-around' Work?

Finders who are unlicensed broker-dealers may suggest a "work-around" that they claim protects the company issuing the securities from these issues. For example, they will suggest entering into an agreement for multiple services, including "assisting with raising capital," and the agreement will avoid the issue of compensation, or state that compensation will be mutually agreed-upon. But as with

most legal documents, if the parties do something different from what is in the agreement, their actions will literally speak louder than the written word. If the company actually pays the finder transaction-based compensation, the SEC will look at substance over form.

An agreement with an unlicensed broker dealer that complies with SEC and most state laws will (among other things):

- Provide flat-fee compensation regardless of whether the finder is successful
- Limit the finder's activities to making introductions
- Specify that the finder **shall not:**
 - > Solicit investors
 - > Negotiate with investors
 - > Discuss valuations with investors or advise the company regarding valuations
 - > Make representations about the company or the transaction
- Include a representation by the finder that he or she has not been subject to disciplinary action by the SEC or state securities authorities

We strongly recommend that entrepreneurs who are considering using a finder first consult with an attorney who is well-versed in both federal and applicable state securities laws and regulations. The attorney can help assess and balance the risks of working with the finder against the capital that the finder may (or may not) actually find.

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