

TOPIC FIVE – INVESTOR FINDER AGREEMENTS – HOW TO STAY OUT OF JAIL

In the seemingly endless search for startup capital, founders frequently seek to engage “finders” to identify prospective investors and facilitate investments, often in return for a success-based commission. Engaging finders who are not registered as broker-dealers with the SEC, the Financial Industry Regulatory Authority and/or state securities regulators can be a risky affair.

Engaging a finder who is in violation of state and federal broker-dealer registration rules can result in an investment being voidable by the investor (effectively giving the investor a put right or right of rescission), subject the issuer and finder to civil and criminal fines, or make the issuer’s financing activities subject to court injunction (halting the issuer’s ability to raise capital).

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 generally defines a “broker” broadly as “any person engaged in the business of effecting transactions in securities for the account of others.” While the ultimate determination of whether a finder is a broker is a factual determination based on a number of factors, the most relevant and common factors at play are:

1. whether the finder receives compensation based on the size of the funds raised,
2. whether the finder does this as a business (do they provide similar services to other issuers), and
3. whether the finder is actively involved in activities “effecting” the investment, which may include providing investment advice, negotiating transactions, performing diligence services, delivering investment information, providing valuation advice and similar activities.

While we generally advise clients to avoid engaging unregistered finders, this is not always possible. When asked to help navigate agreements for unregistered finders,

- We primarily focus on compensation structures which are not success-based commissions and restricting finders from activities which could be construed to be “effecting” the transaction.
- Engaging finders as employees or exclusive service providers can also help avoid a determination that the provider is in the business of being a finder.

Our recommended read: <https://www.sec.gov/about/reports-publications/investor-publications/guide-broker-dealer-registration>