

## **Employing Finders and Solicitors: Proceed with Caution**

Fund managers are often presented with opportunities to have friends, family members, colleagues, or business contacts bring in potential investors to their funds. In exchange for such opportunities, fund managers typically want to provide such persons with compensation. Rarely are such persons registered as broker-dealers with the Securities and Exchange Commission (SEC), and thus they are often referred to in the industry as “finders.” Any opportunity to use finders presents a dilemma to fund managers: on the one hand, there are tempting reasons for using such casual channels for fundraising, but, on the other hand, the SEC’s rules provide very limited exemptions from the general requirement that all persons who effect transactions in securities or attempt to induce the purchase or sale of any security (other than certain exempt securities) must be registered as broker-dealers. In addition, if the fund manager is a registered investment advisor, the use of a finder would require compliance with the rules regarding “solicitors” (defined below). Finally, even the activities of the fund managers, whether or not registered as investment advisors, and others within the fund involved in the sale of interests in the fund must fit within the exemptions to the broker-dealer registration requirements.

### **Finders**

Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act) generally requires any person who effects securities transactions through U.S. jurisdictional means to register with the SEC as a broker-dealer, unless, in the case of an individual, such person is an associated person of a registered broker-dealer. In very limited circumstances, finders who are not registered broker-dealers may be used without violating the federal securities laws. The determination of whether a finder should be registered as a broker-dealer typically involves an analysis of the following:

1. Is the finder planning on being involved in the negotiations for the sale of the securities? The more involved the finder, the more likely the SEC is to view the finder as engaged in activities that require registration as a broker-dealer.
2. Is the finder intending to discuss with potential investors the details of the securities sold, or otherwise make any recommendations? Discussing details and making recommendations increase the likelihood that the SEC would require registration.

3. Will the finder be compensated by transaction-based compensation (e.g., commission contingent on the volume of securities sold) with respect to a securities transaction? Compensation of finders based upon the success/closing of the sale of securities, the amount of securities sold, or otherwise in a manner that could be viewed as transaction-based compensation is likely to be viewed by the SEC as evidence that the finder is, in fact, a broker-dealer that should be registered.
4. Has the finder previously been involved with effecting securities transactions? Any previous compensation or other evidence of previous involvement in effecting securities transactions increases the likelihood that the SEC will view the finder as engaged in activities that require registration as a broker-dealer.

### *The Risks of Engaging an Unregistered Broker-Dealer*

A finder's failure to be properly registered as a broker-dealer may subject that person to potential liability, including criminal penalties, fines, suspension, and disbarment. No single factor is determinative of whether a finder is required to register as a broker-dealer. The SEC maintains an approach that enables it to judge each situation on its facts and circumstances. As such, caution dictates that the use of finders must be discouraged because the risks to the fund and the fund manager of engaging an unregistered broker-dealer are considerable and the SEC has proposed and continues to propose additional requirements to regulate this area even further in the future.

- **Investor Rescission Right.** Investors solicited by an unregistered broker-dealer will have a rescission right, meaning that they could demand full repayment of their contributed capital and unwind the transaction to the detriment of the fund and other investors.
- **Liability as an Aider and Abettor.** The fund manager could also be subject to sanctions from federal securities regulators as an aider and abettor of the activities of an unregistered broker-dealer including fines, prohibition on future securities offerings, and criminal actions.
- **Negative Publicity.** An additional risk is the potential negative publicity to the fund by simply being associated with an SEC investigation. The damage to the fund's reputation would be grave.
- **State Law Compliance.** In addition to SEC regulations, fund managers should also be wary of violating state laws regarding the use of finders. Funds must give notice of the sale of its securities to both the SEC and any state wherein they sold securities by filing a Form D<sup>1</sup> or by complying directly with state securities law filing requirements. The Form D requires the fund to disclose if it paid

---

1. The Form D is a brief notice required by 17 C.F.R. §§ 230.501 et seq. (Regulation D) after a company sells its first securities. The funds must file this form with both the SEC and the state governments in those states where they sold securities if they intend to comply with the Regulation D safe harbor rules.

compensation to any person to sell such securities. Therefore, state regulators are attuned to look for this information and fund managers should be aware of and in compliance with state regulations with regard to finders, which in many cases may be stricter than those imposed by the SEC.

### ***Recommended Steps to Increase the Availability of the Exception***

If used, a finder should do no more than make introductions of investors to the fund manager, and should only be compensated by a flat fee that is earned by the finder on some basis unrelated to the number or value of securities sold. The engagement letter with the finder should narrowly circumscribe the finder's limited duties based on the factors enumerated above. Lastly, the finder should make a representation that he or she has reviewed and understands the statutory and regulatory provisions governing brokerage activities and has obtained all licenses required by federal and state law. Such precautions increase the likelihood that unregistered finders may be used without violating the federal securities laws.

### **Solicitors**

In addition to concerns regarding registration requirements under the Exchange Act, if a fund retains a registered investment adviser to manage the fund (whether or not such adviser is an affiliate of the fund managers), finders must comply with SEC Rule 206(4)-3 under the Advisers Act of 1940 (Advisers Act) regarding "solicitors." Rule 206(4)-3 establishes a "safe harbor" from investment adviser registration for those persons who, on a recurrent basis and for compensation, refer potential clients to an investment adviser. Such solicitors would be viewed as associated persons of the investment adviser (with respect to their solicitation activities for the investment adviser) and thus would not be required to register individually as investment advisers.

To ensure that the interests of investors are protected adequately, Rule 206(4)-3 requires that prospective advisory clients be informed that the person soliciting for an investment adviser has a financial interest in that solicitation. This disclosure is intended to allow the prospective client to weigh the solicitor's potential bias and inquire more fully into the basis for the solicitor's recommendation of the investment adviser.

Rule 206(4)-3 requires that cash fees, directly or indirectly, paid to a solicitor for solicitation activities on behalf of the adviser must be in accordance with the conditions of the rule. The conditions that must be met before referral fees can be paid depend on the relationship between the adviser and the solicitor. Both in-house solicitors (i.e., employees compensated with sales commission) and third-party solicitors are subject to the rule, but in-house solicitors are subject to only a few of its conditions. A full analysis of the solicitation rule under the Advisers Act is beyond the scope of this article, but fund managers and advisers are strongly encouraged to contact their Morgan Lewis fund counsel to discuss the rule if use of a solicitor is contemplated.

Compliance with Rule 206(4)-3 is required in connection with the use of solicitors by registered investment advisers, but does not eliminate the requirement that such solicitor be registered as a broker-dealer if the activities of such solicitor would otherwise require such registration.

## Marketing by Fund Managers and Others Within a Fund

The SEC provides an exemption for issuers (such as fund managers themselves) to sell their own securities. Fund managers can rely on Rule 3a4-1 under the Exchange Act, which sets forth a nonexclusive safe harbor under which the manager representatives will not be considered to be acting as brokers if they comply with the conditions of the rule. These conditions prohibit the receipt by manager representatives of transaction-based compensation in connection with the sale of securities and are not available if the representatives are “associated persons” of a broker-dealer. The representatives must also have clean regulatory records and be free from so-called “statutory disqualifications.” In addition, each representative must meet one or more of the following requirements under Rule 3a4-1 in connection with offers and sales to prospective offerees:

- The representative must limit his or her sales activity to certain institutional investors; certain exempt securities under the Securities Act of 1933; transactions pursuant to a pension, profit-sharing, or similar plan; or transactions in connection with reorganizations, reclassifications, or acquisitions.
- The representative must primarily perform substantial duties for the fund manager or the funds other than in connection with transactions in securities, must not have been a broker-dealer or an associated person of a broker-dealer within the last 12 months, and must not have participated in an offering of securities more than once in each 12-month period.
- The representative must engage only in “passive” sales efforts. This provision permits a representative to prepare and deliver to potential purchasers written communications that are approved by a fund manager.<sup>2</sup> The representative may not, however, engage in any direct solicitation.

\* \* \*

---

2. In addition, the third alternative permits individuals to respond to inquiries from a potential purchaser in communications initiated by the purchaser in response to the issuer’s original written communications. Such responses may be oral or in writing, but must be limited to information contained in the fund’s offering document. The third alternative also permits an associated person of the issuer to perform ministerial or clerical activities involved in effecting transactions.

For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

### **About Morgan Lewis's Private Investment Funds Practice**

Morgan Lewis has one of the nation's largest private investment fund practices and is ranked the Second Most Active Law Firm in the U.S. based on the number of funds worked on for general and limited partners by *Dow Jones Private Equity Analyst* (2009).

### **About Morgan, Lewis & Bockius LLP**

With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—more than 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis or its practices, please visit us online at [www.morganlewis.com](http://www.morganlewis.com).

This memorandum is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered Attorney Advertising in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2009 Morgan, Lewis & Bockius LLP. All Rights Reserved.