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The Southern District's 'Limited Exception' for Finder's Fee Contracts

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Businesses need capital to scale and grow. So-called "finders," individuals who connect businesses with investors in exchange for a fee, are an important capital-raising tool, especially for smaller and emerging companies that cannot attract institutional investors. Notwithstanding their importance to capital formation, the regulatory status of finders is murky. It is notoriously difficult to determine when a finder violates the securities laws by acting as an unregistered "broker." This uncertainty leads to securities violations, unenforceable "finder's fee" contracts, and lost capital-raising opportunities.

A recent decision in the Southern District of New York, *Rhee v. SHVMS,* 2023 WL 3319532 (S.D.N.Y. May 8, 2023), provides important guidance on the distinction between a finder and a broker. This article explains the distinction, the surrounding legal uncertainty, and how *Rhee* creates a practical roadmap for drafting compliant and enforceable "finder's fee" agreements.

'Broker' Definition And Consequences

The Securities Exchange Act of 1934, as amended (Exchange Act), defines a "broker" as a person "engaged in the business of effecting transactions in Securities for the account of others." It is illegal for a "broker" to effect a securities transaction unless she registers with the appropriate regulators, including the Financial Industry Regulatory Authority (FINRA), and the Securities and Exchange Commission (SEC). The registration requirement, and attendant regulatory supervision, ensures that securities are sold by knowledgeable professionals who are aware of their obligations to investors. However, registration is

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costly and burdensome. Brokers are subject to numerous investor protection regulations, including professional standards, reporting obligations, and recordkeeping requirements.

Thus, the question of whether a person involved in the capital-raising process raises capital as a "broker" is critical. Unregistered brokers—and the issuers who use their services to raise funds—may be subject to SEC and FINRA enforcement actions. Further, the Exchange Act invalidates contracts that violate the securities laws:

Any contract made in violation of [securities laws or regulations] and every contract ... the performance of which involves the violation of [securities laws or regulations] shall be void as regards the rights of any person who, in violation of [securities laws and regulations] shall have made or engaged in the performance of any such contract.

15 U.S.C. § 78cc(b).

Under this provision, a capital-raising agreement with an unregistered broker may be unenforceable. More troubling for issuers, the illegal use of an unregistered broker may provide investors the right to rescind investments, turning their investments into option contacts.

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Brokers Versus Finders

Case law and SEC no-action letters (i.e., the SEC opining that specific facts do or do not violate the securities laws) leave room for capital-raising activity by unregistered "finders." But the line between a finder and broker is difficult to draw and depends on a fact specific inquiry. The relevant case law identifies various factors, including whether the individual: "may be characterized by a certain regularity of participation in securities transactions at key points in the chain of distribution"; "is an employee of the issuer" (suggesting that the individual is not acting as a broker); "received commissions as opposed to a salary"; "is selling, or previously sold, the securities of other issuers"; "is involved in negotiations between the issuer and the investor"; "makes valuations as to the merits of the investment or gives advice"; and "is an active rather than passive finder of investors." See *Dervan v. Gordian Group,* No. 16-CV-1694, 2017 WL 819494, at *10 (S.D.N.Y. Feb. 28, 2017).

One factor is particularly important: an individual's receipt of transaction-based compensation—that is, compensation proportionate to the capital successfully raised. The SEC's position is that the receipt of transaction-based compensation is the "hallmark" of broker activity.

Accordingly, an individual "receiving transaction-based compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer." See *Brumberg, Mackey, & Wall,* SEC No-Action Letter (May 17, 2010) (emphasis added). The registration process ensures that an individual with a "salesman's stake" in securities transactions adheres to customer protection standards. 1st Global, SEC No-Action Letter (May 7, 2001).

Regulatory Uncertainty

The atypical circumstance where a "finder" may receive transaction-based compensation without violating the broker registration requirement is difficult to define. Thus, issuers often avoid paying transaction-based compensation to unregistered finders. Unfortunately, that is usually the most sensible way to compensate a finder. Issuers do not want to pay for introductions that do not bear fruit; and it is difficult value an "introduction" by any other metric.

In October 2020, the SEC recognized "the regulatory uncertainty associated with playing even a limited role in a capital raise," and proposed a "finder" rule "to provide regulatory clarity to investors, issuers, and the finders who assist them." See SEC Press Release, Notice of Proposed Exemptive Order (Oct. 7, 2020). The SEC proposed a "safe harbor" for finders with written agreements limiting their activities to: "identifying, screening, and contacting potential investors; distributing issuer offering materials to investors; discussing issuer information included in any offering materials, provided that the finder does not provide advice as to the valuation or advisability of the investment; and arranging or participating in meetings with the issuer and investor."

Finders looking to avoid an illegality defense, and issuers looking to minimize regulatory risk and secure capital against opportunistic investor claims of rescission, should take notice.

The rub is the third restriction, which would be a difficult standard to apply in practice. A dissenting SEC commissioner called the third restriction "form over substance," as a finder could avoid registration simply by not saying "you should invest" at the end of a pitch.

Ultimately, the SEC did not act on the proposal; and it does not appear that "regulatory clarity" will come from the SEC anytime soon. Against this backdrop, the Rhee decision provides helpful guidance on permissible finder's fee agreements.

'Rhee v. SHVMS'

Rhee was a contract dispute between a hedge fund, SHVMS, and Rhee, its former director of marketing and investor relations. Rhee's employment contract provided transaction-based compensation—specifically, "carried interest" proportionate to the capital that she "was directly involved in sourcing." The contract did not describe her employment responsibilities. In July 2020, Rhee's employment was terminated under disputed circumstances. Rhee had worked on a successful raise from a pension fund, but she claimed that SHVMS refused to pay her the carried interest specified in her contract, and she sued for breach.

After discovery, SHVMS moved for summary judgment, arguing that the carried interest payment would be illegal transaction-based compensation to an unregistered broker. Accordingly, SHVMS asserted that Rhee's contract was unenforceable.

To assess SHVMS's illegality defense, Judge Liman provided a helpful synthesis of the sparse authority on the distinction between a finder and a broker. The court held that that "this district [i.e., the Southern District of New York,] has recognized

a limited finder's exception from registration," under which "those who collect commissions from purely locating potential buyers and sellers, stimulating interest, and bringing parties together, are not in fact 'effecting transactions'" under the Exchange Act. Although "the line between a 'finder' and a 'broker' remains elusive," the court held that "merely providing information and or bringing two sophisticated parties together" does not constitute broker activity. Critically, Judge Lewis Liman held that "commission-based payment, standing alone, is not dispositive of whether a party acts as a broker-dealer."

The court did not try to "define precisely" the line between finder and broker activity. Rather, Liman ruled that SHVMS did not establish as a matter of law that *Rhee* acted as a "broker" under any plausible definition of that term. SHVMS submitted barebones evidence that *Rhee* "qualified" the pension fund as an investor—meaning that she provided the fund "information" about SHVMS, identified the "right people" at the pension fund to "receive information," maintained contact during the process, and connected the head of the pension fund to SHVMS. Her role also involved "aiding with meetings," "follow-ups," "sending materials requested by" the pension fund, and "being involved in the due diligence process." These vague assertions did not establish that *Rhee* "exercised discretion" or "engaged in sales or negotiating activities." Absent "details on the content of her behavior," the court found a material issue of fact as to whether Rhee's contractual fee provision violated the Exchange Act.

Guidance

The guidance provided by *Rhee* should not be overstated; the decision merely denies summary judgement. Given the evidence in the record, the court could not determine whether Rhee was or was not a "broker." Moreover, *Rhee*'s analysis is not binding on the SEC or FINRA, either of which could take a more rigid approach to transaction-based compensation. Nonetheless, the court's reasoning provides important guidance on the conduct that falls within, in Liman's words, the Southern District's "limited finder's exception from registration." Under *Rhee,* a finder can be paid transaction-based compensation for "merely directing interested individuals to the right people," as long as she does not have substantive involvement in the sales process.

Based on *Rhee*'s guidance, a finder's fee agreement should carefully delineate the finder's role in non-substantive terms—identifying, screening, referring, passing along offering materials, and the like. As a finder's activity encompasses more discretion—such as substantive discussions about performance and strategy—the risk that a regulator or litigant will question the validity of a finder's fee contract (and distinguish *Rhee*) increases. At a minimum, *Rhee*'s guidance allows contracting parties to make more informed benefit/risk judgments when engaging a finder.

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