

## Friends with Money

**How the pay-to-play scandal in the pension fund industry could get in the way of raising capital for start-up companies**

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*July 16, 2010*

The Securities and Exchange Commission crackdown on unregistered placement agents could make it harder for start-ups to raise capital.

At issue are “finders,” which serve as matchmakers between entrepreneurs and angel investors. Finders can be firms or individuals, such as accountants, lawyers, consultants, or insurance brokers. They maintain a Rolodex of potential investors — typically friends, associates and clients — who can put hundreds or thousands of dollars to work in a start-up.

Finders can be a valuable resource for entrepreneurs because they can locate prospective investors much faster than a would-be issuer could on its own.

“Think in terms of a start-up or small company that’s too small for venture capital to get involved, [let alone] do any kind of public offering,” said **Stephen Goodman**, a co-head of the mergers and acquisitions practice at **Pryor Cashman LLP** in New York. “What they really want to do is raise \$5 million to push their technology to the next stage of development, where they might be able to attract some VCs. The only way to get that money is to go to some wealthy individuals.”

The relationship that finders already have with these investors allows an issuer to stay in compliance with the Securities Act of 1933, which prohibits the “general solicitation or general advertising” of a private placement. Potential investors who have a pre-existing relationship with a finder are deemed to have the same pre-existing relationship with an issuer that uses the finder.

Steven G. Rowles, a chair in the San Diego corporate group at Morrison & Foerster’, said there is a vast “grey market” of thousands of such individuals and firms operating in California’s technology and life sciences centers.

Securities lawyers say the difficulty for prospective issuers lies in the fact that finders' matchmaking activities may qualify them as broker-dealers in the SEC's eyes, but many finders are reluctant to register with the Financial Industry Regulatory Authority because of the cost.

That puts issuers at risk. Investors who get cold feet can argue that, because the issuer used an unlicensed broker, they are entitled to rescind their investment and be refunded the purchase price, interest and costs. Issuers who use unregistered broker-dealers also expose themselves to civil and criminal penalties, and having potential securities law violations on the books can lead to problems if an issuer eventually goes public or sells itself.

There were never clear guidelines as to what kinds of matchmaking activity would trigger a requirement to register as a broker-dealer. Most of the guidance the SEC has provided has been in the form of no-action letters that deal with individual cases and cannot be relied upon as precedent. Nevertheless, securities lawyers say many finders are probably on the wrong side of the law, either because their compensation is based on how much money they help raise or because they provide introductions to potential investors too frequently.

Many lawyers are warning their clients that it is no longer safe to assume they can operate under the SEC's radar. The agency has come under heavy criticism for its lack of oversight before the financial crisis. And the pay-to-play scandal in the fund industry has focused attention on firms that use unlicensed placement agents. As a result, the SEC recently proposed rules that would prohibit virtually all private investment managers from paying anything to any person to solicit a government entity for investment advisory services.

Rowles said the SEC is already cracking down on unregistered broker-dealers that help public companies raise private capital. In June of last year, the agency brought enforcement proceedings against two individuals and a firm they owned for raising money for so-called PIPE transactions without registering as broker-dealers. They were suspended from the business and fined over \$500,000.

Notably, the only basis for the enforcement action was the failure to register as a broker-dealer; in the past, the SEC typically brought enforcement actions only against finders who had engaged in fraud; failure to register as a broker-dealer was a secondary claim in such cases.

Rowles said he wouldn't be surprised to see similar enforcement proceedings in the venture capital world.

Some of the most recent guidance the SEC has provided to finders also suggests the agency is taking a broader view of the kinds of fund-raising that require registration. In May the agency refused to grant no-action relief to a law firm, Brumberg, Mackey & Wall, PLC, that wanted to assist a renewable energy company acquire funding. While Brumberg would not negotiate the terms of investment, the SEC said the transaction-based compensation the law firm sought would give it a strong incentive to “pre-sell” the company.

The no-action letter sparked a rash of client notes from securities lawyers “The staff may be trying to remind finders that the stakes have gotten much higher in the current regulatory environment,” Goodman said in one such note.

It remains to be seen whether the increased regulatory scrutiny will push start-ups to stop using finders that are not registered as broker-dealers, or whether more finders will feel compelled to register. Either way, securities lawyers say, the cost of raising capital is likely to rise.

“To the extent people currently acting as finders comply with the current regulatory regime, their costs of operations would increase, at least part of which I imagine issuers would need to absorb,” said Matthew Kuhn, an associate at Faegre & Benson LLP in Minneapolis.