Finders Are Not Keepers: 'Pay to Play' Scandal May Lead to Changes in the Venture World

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By Steven G. Rowles and Matt Steiner

Any lawyer who regularly represents start-ups or smaller venture funds frequently runs into the "finder" dilemma. Unfortunately, too often finders, founders of start-ups or funds, and their advisors have collectively taken a "don't ask, don't tell" approach. Observers have time and again noted the disconnect between the law and the methods and practices routinely used to fund or sell early-stage businesses or venture capital funds. To be clear, the activities of reputable finders are critically important to start-up fundraising, and the creation of jobs through small business capital formation is essential to our economy, particularly in the current economic environment. Notwithstanding these facts, in the authors' opinion, the confluence of events described below triggered by the so-called recent "pay to play" scandal in the fund world makes it imperative that finders and the start-ups and venture funds they serve revisit the risk/reward calculation.

The Market

There is a vast "gray market" of individuals and firms acting as finders in connection with both fundraising activities for start-ups or venture funds and M&A activities for small companies, with thousands of operating in California's technology and life sciences centers. Finders come in many forms and by many names: placement agents, business brokers, consultants, merchant bankers, investment bankers, CPAs, insurance brokers, retired executives and former politicians. Some are consummate professionals who add value to the venture capital world. Others represent the dark side of the profession—tying up founders and their technologies under unconscionable fee arrangements and promoting opportunities at the edge of the law or beyond.

The Law

It is unlawful for any broker to "effect any transactions in, or induce or attempt to induce the purchase or sale of, any security" without first registering as a broker-dealer with the Securities and Exchange Commission (the "SEC").[1] A broker-dealer is "any person engaged in the business of effecting transactions and securities for the account of others."[2] Registered broker-dealers must become members of a self-regulatory organization, such as the Financial Industry Regulatory Authority, and are subject to the SEC's rules regarding financial responsibility and conduct. Registration with the SEC is relatively time consuming and expensive. Annual compliance costs further add to the burden of registration. In contrast, a finder is a person who acts in a role other than as a principal in a securities transaction, and is not required to register as a broker because of his or her limited role.

Unfortunately, the legal definition of a "finder" is not clear. Most guidance is found in the form of SEC no-action letters that are highly fact-specific and cannot be relied upon as precedent. No single factor is dispositive in making the determination of whether a purported finder should be considered a broker-dealer, triggering registration. Important factors weighed by the SEC include:

- The receipt of transaction-based compensation or "success fees."
- Involvement in negotiations with or provision of detailed advice or information to a buyer or seller of securities.
- Solicitation of investors.
- Discussion or recommendation of securities.
- Previous involvement in the sale of securities and/or previous discipline for violation of securities laws.

Registration of broker-dealers is not solely the domain of the SEC. Each state has its own regulatory regime, and accordingly, a state-by-state analysis must be undertaken. For example, California law provides a right of rescission and an extended statute of limitations for investors against an unlicensed broker-dealer.

The vast majority of finders we encounter come down on the wrong side of the two most critical issues: they receive transaction-based compensation and have engaged in similar transactions in the past (and intend to engage in similar transactions in the future). It is our view that these finders have little chance of convincing the SEC that they should not be registered.

The Effect of the "Pay to Play" Scandal and the Changing Regulatory Environment

The long-standing status quo regarding the use of finders needs to be revisited in light of the subprime meltdown, the failure of Lehman Brothers, and the resulting great recession of 2008–2009. In May 2009, New York Attorney General Andrew M. Cuomo issued subpoenas to over 100 investment firms and their agents in his expanding corruption and kickback investigation involving the New York State and City pension funds. A number of individuals have already pleaded guilty to securities fraud, grand larceny, bribery, and money laundering, and smart money is betting that there are more to follow. What finders and the companies and funds using them should take away from these developments is that the investigation and the attendant subpoenas have focused on which firms used unlicensed agents, why they used them and in what manner, what fees unlicensed agents were paid, and for what services, how the firms came to retain the unlicensed agents, whether the firms conducted proper due diligence about the unlicensed agents, and whether payments to unlicensed agents were disclosed to investors.

The fallout from these developments has been immediate. The SEC has proposed rules that would prohibit virtually all private investment fund managers from paying anything to any person to solicit a government entity for investment advisory services. These rules would further provide that political contributions by any investment advisor or fund manager trigger a two-year "time-out" from receiving compensation in connection with providing advisory services to the related government entity. The California Public Employees' Retirement System ("CalPERS") has instituted a policy requiring that funds disclose the retention of placement agents and the fees paid to them and prohibiting unregistered placement agents from being involved with a CalPERS investment. CalPERS has also publicly announced an internal investigation into investments it has made through placement agents. New York, New Mexico and other states have banned the use of placement agents in connection with their investments.

In June 2009, the SEC brought enforcement proceedings against two individuals and a firm they owned for carrying on the business of finding money for investors in so-called "PIPE" transactions without registering as broker-dealers. The penalties included suspension from the business and fines, penalties, and interest for each in excess of $500,000. It is critical to note that the only basis for the enforcement proceedings was failure to register as a broker-dealer. In the past such enforcement proceedings were typically a secondary claim accompanied by fraud or some other form of obvious wrongdoing.

The current Congress and the Obama Administration have made it abundantly clear that they intend to implement a massive overhaul of the oversight and regulatory system relevant to financial institutions and securities markets. The SEC and other regulatory agencies have been sharply criticized for their lack of oversight preceding the financial meltdown. In the confluence of all these events, it is hard to imagine that similar enforcement proceedings and additional regulations will not find their way to the venture capital world.

The Risks

The consequences of utilizing an unlicensed finder for both finders and companies include:

FINDER	COMPANY
• Regulatory enforcement action • Unenforceability of fee contract • Civil litigation • Rescission in California	• Aiding and abetting liability • 10b-5 liability—use of unregistered broker without disclosure • Rescission claims demanding return of investor money— loss of securities exemption • Toxic finders' contracts • Responsibility for finders' actions—general solicitation, fraudulent misrepresentation • Loss of institutional investors' interest • Tainted financial statements • Unavailability of legal opinions • SEC review on IPO • Loss of qualified director candidates

The Bottom Line

The bottom line is that the most common finders' arrangements often do not stand up under scrutiny. Until recently, the SEC has not undertaken enforcement activities or acted on the American Bar Association's thoughtful report and recommendations requesting "broker-dealer lite" registration.[3] Responsible members of the corporate bar have outlined the risks to both finders and issuers, but the fact is that inappropriate activity of unregistered brokers has continued relatively unabated.

In short, think twice and then think again before you use finders to raise money in connection with start-up companies or venture funds or the sale of venture-backed companies. The risks may now outweigh the rewards. Continuing business as usual may look silly in hindsight. Remember, many technology and life sciences executives thought little of option backdating practices until relatively recently. Reputable finders who do bring value to transactions should bite the bullet and register with the SEC or associate with a registered broker-dealer and join with the bar in lobbying the SEC for a "broker-dealer lite" registration option.

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1 Section 15(a)(1) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")
2 Section 3(a)(4) of the Exchange Act
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