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IMPROVING THE EFFICIENCY OF THE ANGEL FINANCE MARKET: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting

John L. Orcutt[†]

The continuous creation of new rapid-growth start-ups plays a substantial role in the success of the U.S. economy.¹ As economist Joseph A. Schumpeter noted more than a half century ago, a healthy economy is a dynamic organism that is constantly in a state of change and renewal.² Schumpeter described the process as one of “Creative Destruction” whereby competition and innovation constantly revolutionize the economy from within—“incessantly destroying the old one, incessantly creating a new one.”³ By seeking innovations to render their competitors obsolete, entrepreneurs create new products, markets, processes for doing business, and even new industries, while old inefficient ones are destroyed. These newly created ventures must be more innovative and productive than their already established competitors in order to compete, which has the added benefit of forcing the established competitors to improve. Established competitors, as well as entire industries, that cannot meet the increased competition and innovations are forced out of business, which causes a constant renewal of the economy.

In considering the importance of rapid-growth start-ups, it is critical to understand that not all start-ups are the same. Small businesses (generally defined as having less than 500 employees)⁴ have received a substantial

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1. MARK VAN OSNABRUGGE & ROBERT J. ROBINSON, ANGEL INVESTING: MATCHING START-UP FUNDS WITH START-UP COMPANIES—THE GUIDE FOR ENTREPRENEURS, INDIVIDUAL INVESTORS, AND VENTURE CAPITALISTS 22 (2000); *see also* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003).

2. JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 83 (3d ed., 1950).

3. *Id.*

4. U.S. Small Business Administration, Frequently Asked Questions, <http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24> (last visited Oct. 3, 2005).

amount of attention in recent years as the key to economic growth. The U.S. Small Business Administration Office of Advocacy consistently publicizes statistics about small business, such as the following:

- They represent more than 99% of all employers;
- Employ half of all private sector employees;
- Create more than 50% of non-farm private gross domestic product; and
- Generate 60% to 80% of net new jobs annually.⁵

Such statistics give the impression that small businesses are a homogenous group and that policies aimed at improving the economy and job creation should address small businesses generally.⁶ Viewing small businesses as a homogenous group, however, is highly inaccurate.⁷ In reality, the term *small business* encompasses a wide range of different types of businesses. This article will draw a distinction between two very different segments of small businesses: those that start small and are likely to stay small (“livelihood businesses”) and those that are built to grow rapidly (“rapid-growth start-ups”).⁸ The object of most livelihood businesses is:

The Office of Advocacy [of the U.S. Small Business Administration] defines a small business for research purposes as an independent business having fewer than 500 employees. Firms wishing to be designated small businesses for government programs such as contracting must meet size standards specified by the U.S. Small Business Administration (SBA) Office of Size Standards. These standards vary by industry

Id.

5. *Id.*

6. Daniel Sandler, *Tax Incentives and Angel Capital: Federal & State Incentive Review and Commentary*, VC EXPERTS, Nov. 2, 2004, http://vcexperts.com/vce/news/buzz/archive_view.asp?id=245 (subscription required) (article on file with author).

7. Robert Heilbroner and Lester Thurow discussed this misconception as follows:

In the last two decades the assertion has often been made that most of the jobs in America are being created by small businesses and that, as a result, such business should be seen as the engines of national economic success. By implication, nothing else is necessary or important. Such assertions are neither factually correct nor economically true.

What creates jobs are not small businesses as such, but small businesses that grow large (Wal-Mart, Hewlett Packard, Microsoft).

ROBERT HEILBRONER & LESTER THUROW, *ECONOMICS EXPLAINED: EVERYTHING YOU NEED TO KNOW ABOUT HOW THE ECONOMY WORKS AND WHERE IT'S GOING* 171 (rev. ed., Simon & Schuster 1998) (1982).

8. This is a common way of dividing up the world of small businesses. See DANIEL SANDLER, *VENTURE CAPITAL AND TAX INCENTIVES: A COMPARATIVE STUDY OF CANADA AND THE UNITED STATES* 2 (2004). To be more specific, the category of rapid-growth start-ups will often be divided into two separate categories:

(1) “Middle-market firms have growth prospects of more than 20 percent annually and five-year revenue projections between \$10 and \$50 million.” VAN OSNABRUGGE & ROBINSON,

to provide an income for the organizers and perhaps members of their families There is no “exit strategy,” no expectation of a dynamic multiple of earnings being paid for the business five years down the road, no equity investors other than the founder . . . no sources of cash capital other than the local bank.⁹

For example, owner-operated convenience stores, suburban construction companies, or hair salons would fall under the livelihood business classification. These livelihood businesses, which account for more than 90% of small businesses,¹⁰ are not the entrepreneurial force that drives the economy nor are they particularly strong job creators. In fact, these livelihood businesses are more aptly described as “job churners.”¹¹ In addition to being large job creators, livelihood businesses are also the largest “destroyers” of jobs, due to rapid job turnover, layoffs and frequent bankruptcies, resulting in a much more modest net creation of jobs by these firms.¹² Moreover, these “churned” jobs are generally low paying with poor benefits, lack of job security, and few opportunities for advancement.¹³

supra note 1, at 20. These middle-market firms will typically not be capable of attracting investment funds from formal VC funds, because their potential size does not warrant the size investments made by formal VC funds. Such firms, however, do attract angel investors. These firms, “if properly structured, offer capital gains and cash-out opportunities for investors . . . [and] make up the backbone of the entrepreneurial economy” JOHN FREEAR, JEFFREY E. SOHL & WILLIAM E. WETZEL, JR., U.S. SMALL BUS. ADMIN., CREATING NEW CAPITAL MARKETS FOR EMERGING VENTURES 5 (1996) [hereinafter REPORT TO SBA].

(2) “High-potential” firms, which:

are those with a vision for growth that are also innovative, risk taking and able to change. They typically plan to grow into a substantial firm with fifty or more employees within five to ten years, have five-year revenue projections in excess of \$50 million, and anticipate annual growth rates in excess of 50 percent. The “big-time-winning” firms are often the primary recipients of a couple of rounds of external equity finance, early on from business angels and later from venture capitalists.

VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 20 (citations omitted).

These high-potential firms attract angel investments and form the primary pool for formal VC fund investments. *Id.* at 21.

For simplicity’s sake, this article will focus on the rapid-growth/livelihood firm distinction, and will not address the distinctions between the two categories of rapid-growth start-ups.

9. 1 JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS 7 (2d ed. 1995).

10. SANDLER, *supra* note 8, at 2.

11. See JIM STANFORD, PAPER BOOM: WHY REAL PROSPERITY REQUIRES A NEW APPROACH TO CANADA’S ECONOMY 128–33 (1999) (focusing on Canada’s experience with small businesses); see also SANDLER, *supra* note 8, at 2–3.

12. See STANFORD, *supra* note 11, at 128–33.

13. See *id.*; see also SANDLER, *supra* note 8, at 2–3.

The small businesses that have demonstrated a capacity to create a disproportionate amount of the macroeconomic growth,¹⁴ innovation,¹⁵ and net new jobs¹⁶ in the United States are the rapid-growth start-ups.¹⁷ The classification of a company as rapid-growth does not necessarily mean the company will in fact grow at an impressive rate. The classification is meant to capture those companies that are created with the intention to rapidly and substantially expand. Rapid-growth start-ups are those start-ups with the potential to grow into large businesses. While high-technology and biotechnology companies are well represented in this category (e.g., Amgen, Apple, Cisco, and Microsoft were once rapid-growth start-ups), they do not define the category. For example, FedEx, McDonalds, Starbucks and Wal-Mart were also once rapid-growth start-ups. One factor that links almost all rapid-growth start-ups, however, is a need for substantial capital to grow the company. The creation and survival of these

14. See VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 22.

15. One technique that has been used to measure the innovation advantage from rapid-growth start-ups is to examine the patents that come out of companies that have received financing from VC funds. See Samuel Kortum & Josh Lerner, *Assessing the Contribution of Venture Capital to Innovation*, 31 RAND J. ECON. 674, 674-75, 689-91 (2000) (finding that VC-backed companies produced more patents than non-VC-backed companies and the patents the VC-backed firms produced were apparently more valuable).

16. See Jeffrey E. Sohl, *The Early-Stage Equity Market in the USA*, 1 VENTURE CAPITAL 101, 105 (1999).

Over the last 4 years [from 1996 to 1999], these high growth start-ups added 6 million jobs to an economy that added 7.7 million jobs in total. For entrepreneurs, size is a transient characteristic where firms start small (and as such receive the small business label) but grow fast.

Id.; see also DAVID BIRCH ET AL., WHO'S CREATING JOBS? 6-7 (1994).

Most of the new jobs attributable to small firms are thus created by a relatively few small firms that start small and grow fast. Said another way, most small firms grow slowly. It is not the local drug store or beauty shop or restaurant that is the main engine of job growth—it is the Gazelle [Birch's nickname for "mostly smaller firms that start with the intent to grow, and pull it off"].

Id.

From 1989 to 1993, gazelles (which accounted for no more than 3% of firms) added 4.4 million jobs to the economy, during a period when the economy hardly grew. *Id.* at 6.

17. Moreover, these rapid growth start-ups serve the beneficial role of culling less productive companies and industries, which allows those resources to be redeployed in a higher value-add manner. One study examined the impact of small firms generally on the competition level of industries in which they operate. Joan E. Mitchell, *Small Firms: A Critique*, THREE BANKS REV. 50 (1980). This essay argues that "small firms have a special role in increasing competition" with large firms within an industry, and they can increase the competitive level of the industry as a whole. *Id.* at 54. One reason is that small firms may be less inclined to adopt collusive and restrictive practices, which can reduce the competitive level of the industry. *Id.* at 54-55.

rapid-growth start-ups is highly dependent on their ability to procure capital.¹⁸ Without sufficient funds, these companies simply cannot be built.

As will be discussed in greater detail below, entrepreneurs founding these rapid-growth start-ups will typically be required to seek outside equity financing in order to fund their ventures. The media has focused predominantly on the role of institutional venture capital (“VC”) funds in providing this external equity funding.¹⁹ While the U.S. VC-fund market is a very valuable asset of the U.S. economy, it provides only a fraction of the equity financing for new rapid-growth companies.²⁰ Of equal, and potentially greater, significance in the financing of new rapid-growth companies is the less formal, and less well-understood, angel market.²¹ Sometimes referred to as the “invisible” venture capital market,²² the angel market is made up of a diverse and dispersed population of wealthy private investors.²³ Even after twenty years of research, this market remains largely mysterious.²⁴ What is known is that the angel market suffers from systematic problems, including information and agency problems and high transaction costs that limit investment capital for rapid-growth start-ups.²⁵ In turn, this reduced level of angel funding leads to a reduced level of creation of new rapid-growth start-ups.

A common market response to such market problems would be the formation of a class of intermediaries who would help to reduce the problems. So long as the benefit generated by these intermediaries, less the

18. See SANDLER, *supra* note 8, at 2.

19. For example, the following recent Wall Street Journal articles all give the impression that VC funds are the predominant financier of rapid-growth start-ups, including in their earliest stages, with no mention whatsoever of angels. Ann Grimes, *Venture Capitalists Regain Confidence in Start-Up Firms*, WALL ST. J., July 27, 2004, at C1; Ann Grimes, *Venture Capitalists Are Pushing on the Accelerator Again*, WALL ST. J., June 24, 2004, at C1; Ann Grimes, *Venture Firms Seek Start-Ups That Outsource*, WALL ST. J., Apr. 2, 2004, at B1. As well, this author conducted the following two WestLaw searches in the Wall Street Journal database on February 21, 2005: (i) “venture capital” & “start-up” turned up 1499 articles; whereas (ii) “angel” & “start-up” turned up only 151 articles.

20. PAUL A. GOMPERS & JOSH LERNER, *THE MONEY OF INVENTION: HOW VENTURE CAPITAL CREATES NEW WEALTH* 9 (2001) [hereinafter *MONEY OF INVENTION*]; see also VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 5; John Freear, Jeffrey E. Sohl & William Wetzel, *Angles on Angels: Financing Technology-Based Ventures—A Historical Perspective*, 4 *VENTURE CAPITAL* 275, 278 (2002).

21. See VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 5; see also Freear, Sohl & Wetzel, *supra* note 20, at 275–76; SANDLER, *supra* note 8, at 35–36.

22. John Freear, Jeffrey E. Sohl & William E. Wetzel, Jr., *The Private Investor Market for Venture Capital*, 1 *THE FINANCIER: A CMT* 7, 9 (1994). The angel market is often referred to as the “invisible” venture capital market because of angel investors’ preference for anonymity. *Id.*

23. See discussion *infra* Part II.A.

24. Freear, Sohl & Wetzel, *supra* note 20, at 276, 281–82.

25. See discussion *infra* Part II.B.

cost for their services, is greater than the costs caused by the market problems, the development of intermediaries makes sense. For example, a long and impressive list of intermediaries has developed to improve the efficiency of the public equity market.²⁶ These intermediaries, which include such market fixtures as investment banks, research analysts, public auditors, and mutual fund managers, help to reduce for the public equity market the very market problems that plague the angel market. The angel market, however, lacks meaningful intermediaries to help lessen the impact of its problems.²⁷ One logical group that could potentially serve a meaningful intermediary role in the angel market is finders.

In the private equity setting, a finder is generally defined to encompass persons or entities who bring together buyers and sellers of securities for a fee, but who have no role, or at least a very limited role, in bringing the ensuing transaction to closure.²⁸ Finders are meant to provide introductions between potentially interested parties, but not actively consummate transactions. While finders are currently tolerated by the existing regulatory regime, their use can raise serious problems if the finder's role is deemed to be that of a "broker-dealer," which would subject the finder to a substantial array of federal and state securities regulations.²⁹ The issue of whether a finder's activities rise to the level of broker-dealer status is unfortunately a murky one.³⁰ This uncertainty, coupled with the substantial burden of complying with broker-dealer regulations, has severely hampered the development of a professional class of finders who could potentially help reduce the problems that plague the angel finance market.³¹

Fashioning an appropriate role for finders in the private capital markets is an issue that is ripe for a solution. In December 2003, the SEC-hosted Government-Business Forum on Small Business Capital Formation³² recommended that:

26. See discussion *infra* Part II.C.1.

27. See discussion *infra* Part II.D.

28. Allan J. Berkeley & Alissa A. Parisi, *Questions and Answers About an Issuer's Ability to Obtain Investors in Private Placements*, SK066 ALI-ABA 115, 118 (Mar. 10–12, 2005); see also John Polanin, Jr., *The "Finder's" Exception from Federal Broker-Dealer Registration*, 40 CATH. U. L. REV. 787, 789 (1991).

29. See discussion *infra* Part III.B.

30. See discussion *infra* Part III.C.–E.

31. See discussion *infra* Part III.F.

32. The Government-Business Forum on Small Business Capital Formation is hosted annually by the SEC as mandated by the Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980). One of the major reasons for this Forum is "to provide a platform for small business to highlight impediments in the capital-raising process and address their necessity." 22ND ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS

[t]he SEC should work with [the North American Securities Administrators Association (NASAA)] and the [National Association of Securities Dealers, Inc. (NASD)] to undertake the following: (a) address the regulatory status of finders; (b) facilitate an appropriate role for finders in the capital-raising process; and (c) clarify the circumstances under which issuers and others can legally compensate finders and other capital formation specialists who meet minimum standards.³³

An American Bar Association (ABA) task force has also been studying the appropriate role of finders since 2002, with a focus on their role in assisting private companies to raise capital.³⁴ This ABA task force, recently issued its report, which recommends, among other things, that finders be subject to a reduced regulatory burden from full fledged broker-dealers.³⁵

This Article examines the role of finders in the private capital setting and considers the impact of allowing them to operate under a reduced regulatory burden with the assumption that they will play a more meaningful role in private capital raising. If finders are empowered to act more freely in the private capital setting, it should be expected that early-stage rapid-growth start-ups will be the issuers most likely to engage them and that angels are likely to be the primary target of the finders as they seek investors.³⁶ In this setting, finders could assume a meaningful intermediary role and should help to improve the efficiency of the private capital markets. Unfortunately, an expanded role of finders would not be problem free. For example, is it appropriate for government policy to implicitly encourage angel investors

CAPITAL FORMATION, FINAL REPORT 1 (2003). The Forum is hosted by the SEC, “but [the SEC] does not seek to endorse or edit any of the Forum’s recommendations.” *Id.*

33. *Id.* at 14. The Forum has made some form of recommendation relating to the regulatory status of finders and their role in the capital raising process for the last few years. *See* 21ST ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT 17, 23–25 (2003). *See generally* 20TH ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT (2002); 19TH ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT (2001); 18TH ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT (2000).

34. The task force was formed by the Business Law Section of the ABA’s Committee on Small Business and was composed of representatives from the Committees on Small Business, Federal Regulation of Securities, Negotiated Acquisitions, and State Regulation of Securities. The Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 959 (May 2005).

35. *Id.* at 961–65.

36. *See* discussion *infra* Part IV.

(who are largely amateur investors) to invest in the high-risk world of early-stage rapid-growth start-ups?³⁷

This Article concludes that the potential benefits of an empowered class of finders for the private capital raising process outweigh the potential problems. This leads to the main proposal of this Article: rather than regulate finders who assist private companies to obtain start-up capital as a sub-category of broker-dealers, this Article proposes a new class of federally registered “finders” whose activities would be exempt from federal and state broker-dealer regulations. This tailored regulatory regime for finders in the private capital raising setting would be aimed at expanding their use based on a principle of improving the efficiency of the private capital markets. Specifically, the focus of the regulatory treatment of these finders should be to encourage their ability to reduce market problems (e.g., information and agency problems and high transaction costs) in the private capital markets, while discouraging their ability to increase existing, or create new, market problems (e.g., commit fraud), including by restricting the type of investors who can be “found” to those who are sufficiently sophisticated. By improving the market efficiency of the private capital markets (with a particular focus on the angel market) in such a manner, this approach should improve the allocation of resources that are dedicated to creating and nurturing rapid-growth start-ups, while not exposing less sophisticated investors to undue investing dangers.

This Article proceeds as follows: Part I provides an overview of how rapid-growth start-ups are financed and highlights the critical financing role played by angel investors. Part II provides an overview of the angel market and examines both certain problems with the angel finance market and the role traditionally played by intermediaries in resolving similar problems for other markets. Part III examines the legal limitations on the role of finders in the private capital setting and how the current regulatory setting impedes their formation as viable intermediaries for the angel market. Part IV examines a potential expanded role of finders in the private capital raising setting and considers whether such a change is advisable. Part V sets forth a proposal for regulating finders in the private capital setting in a manner that should increase their utility as financial intermediaries for the private capital markets generally, and the angel finance market specifically. Finally, Part VI offers a conclusion as well as some cautionary qualifications.

37. See Joshua Lerner, “Angel” Financing and Public Policy: An Overview, 22 J. BANKING & FIN. 773, 775, 780 (1998).

I. RAPID-GROWTH COMPANIES DEPEND ON OUTSIDE EQUITY FINANCING

Available capital is critical to the creation of new rapid-growth start-ups. Such companies generally require substantial amounts of capital to launch and grow.³⁸ Because most entrepreneurs do not have sufficient resources to self-finance such a venture, they must secure outside funding for their ventures.³⁹ At the start-up's early stages, however, the external funding options are typically very limited.⁴⁰ As will be discussed in more detail below, the primary source of external funding for early-stage rapid-growth start-ups is the angel market.⁴¹ Unfortunately, this market is plagued with serious and systematic problems that limit the amount of capital that is dedicated by such investors to rapid-growth start-ups.⁴² In order to understand the significance of these problems and the importance of reducing them, it is useful to review the typical financing pattern of rapid-growth start-ups and the critical financing role played by angels.

A. *External Funding: Debt v. Equity*

When seeking external funding, new companies may look to raise debt capital or equity capital. With respect to rapid-growth start-ups, material debt financing is not widely available until they are highly mature companies. Debt financing involves borrowing money from a lender in exchange for a promise to repay the debt. Such repayment will involve repayment of the principal (i.e., the amount borrowed) and will also require interest payments that are meant to compensate the lender for its cost of lending the money. For small businesses generally, debt financing from commercial banks is a very important financing tool,⁴³ with loans guaranteed by the Small Business Administration serving as a substantial source of small business capital.⁴⁴ Because of the way that rapid-growth

38. SANDLER, *supra* note 8, at 2.

39. See MONEY OF INVENTION, *supra* note 20, at 7; see also PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 127 (2002) [hereinafter VENTURE CAPITAL CYCLE].

40. VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 23.

41. See discussion *infra* Part I.B and I.C.3.

42. See discussion *infra* Part II.B.

43. U.S. Small Bus. Admin., Financing Basics, <http://www.sba.gov/financing/basics/basics.html> (last visited Oct. 4, 2005) ("Traditionally, banks have been the major source of small business funding.").

44. *Id.* The principal role of banks:

has been as a short-term lender offering demand loans, seasonal lines of credit, and single-purpose loans for machinery and equipment. Banks generally have been reluctant to offer long-term loans to small firms. The [Small Business Administration ("SBA")] guaranteed lending program

start-ups are structured, they are generally not eligible for such commercial bank loans.⁴⁵ To begin with, rapid-growth start-ups are built for growth and will generally sacrifice near-term profitability for this growth. As a result, these companies typically face several years of negative earnings and, therefore, lack the necessary excess cash flow to make the required principal and interest payments.⁴⁶ As well, rapid-growth start-ups generally do not have meaningful securable assets,⁴⁷ which is a fundamental requirement for most loans to high-risk borrowers. The primary assets for a rapid-growth start-up are likely to be intellectual property assets, which are very difficult to collateralize.⁴⁸

Most rapid-growth start-ups, therefore, are left with equity financing as the only viable option to finance their company. Equity financing involves selling a share in the actual ownership of the company. This will typically occur by selling either common stock⁴⁹ or convertible preferred stock⁵⁰ in the company.

encourages banks and non-bank lenders to make long-term loans to small firms by reducing their risk and leveraging the funds they have available. The SBA's programs have been an integral part of the success stories of thousands of firms nationally.

Id.; see also U.S. Small Bus. Admin., Snap Shot, <http://www.sba.gov/financing/sbaloan/snapshot.html> (last visited Oct. 4, 2005) ("The SBA offers numerous loan programs to assist small businesses. It is important to note, however, that the SBA is primarily a guarantor of loans made by private and other institutions.").

45. MONEY OF INVENTION, *supra* note 20, at 11; see also U.S. GEN. ACCOUNTING OFFICE, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 5 (2000) [hereinafter GAO REPORT].

46. MONEY OF INVENTION, *supra* note 20, at 11.

47. A securable asset refers to those assets of a company that can be pledged as collateral to support a loan.

48. William Murphy, *Proposal for a Centralized and Integrated Registry for Security Interests in Intellectual Property*, 41 IDEA 297, 297 (2002) (proposing the creation of a centralized or integrated registry to ease the perfecting of collateral interests in intellectual property rights); see also MONEY OF INVENTION, *supra* note 20, at 6.

49. Common stock is the most basic unit of ownership in a corporation. An owner of common stock will typically have voting rights regarding the election of directors and certain other important corporate matters (e.g., the approval of mergers). In the event the corporation is liquidated, claims of secured and unsecured creditors and preferred stock holders all take priority over the claims of common stock holders. In such a liquidation, common stockholders are the recipients of the remaining assets of the corporation once all higher priority claimants have been paid. See discussion *infra* Part II.C.2.

50. Convertible preferred stock is a very commonly used security for start-up financings. Convertible preferred stock is a senior equity security that, depending on how it is structured, can have certain characteristics of debt in addition to its equity nature. Convertible preferred stock is convertible into common stock of the issuer. Convertible preferred stock is referred to as a "senior" equity security because it comes in line before common stock with respect to dividends and liquidation claims. See *id.*

*B. Primary Sources of External Equity Financing for
Rapid-Growth Start-ups*

Much of the media attention that surrounds start-up financing focuses on the role of the institutional VC funds. These VC funds are portrayed as the primary source of external equity capital for the rapid-growth start-up community.⁵¹ While VC funds are a critical source of start-up funding, they typically restrict their investments to “later-stage and larger deals.”⁵² For the early-stage rapid-growth start-up that needs external funding, the primary source of equity funding will be angel investors.⁵³ To illustrate this point, one can divide the equity fundraising process for rapid-growth companies into three fundamental stages: (1) the seed, or start-up, stages; (2) the early stages; and (3) the later stages.⁵⁴

1. Seed, or Start-up, Stages

The seed, or start-up, financing stages raise the initial funds that are used to get the company started and to determine whether the venture is worth pursuing. For example, the funds may be used to hire a few initial employees, secure initial office space and conduct product development. Seed/start-up funding will typically come from internal (or quasi-internal) sources of the company, such as the founders themselves and their friends and family.⁵⁵ Funding from the founders will often be derived from personal

51. See *supra* note 19 and accompanying text.

52. Jeffrey E. Sohl, *The U.S. Angel and Venture Capital Market: Recent Trends and Developments*, J. PRIVATE EQUITY, Spring 2003, at 13. Professor Sohl states that, “[t]his move to later stage represents a systemic, rather than a reactionary trend, and is evident over the last decade.” *Id.*; see also VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 47–52; GAO REPORT, *supra* note 45, at 10.

53. Freear, Sohl & Wetzell, *supra* note 20, at 275; see also Sohl, *supra* note 52 at 13. See generally GAO REPORT, *supra* note 45, at 10.

54. Please note, this division of stages has been greatly simplified and is merely meant to be illustrative of the start-up funding process to help readers understand generally how angel investors fit into the start-up financing process and the critical nature of their role. The division of start-up funding stages can be, and has been, formulated in a much more detailed manner by others. For example, The Center for Venture Research divides the start-up equity funding process into four stages: Pre-Seed, Seed/Start-up, Early, and Later. Sohl, *supra* note 52, at 11. The GAO Report divides the process into seven stages: Seed, Start-up, First Stage, Second Stage, Third Stage, Bridge Stage, and Exit/Liquidity Stage. GAO REPORT, *supra* note 45, at 9. Professors Gompers and Lerner divide the process into nine stages: Seed, Start-up, Early stage, First stage, Other early, Expansion, Second stage, Third stage, and Bridge. VENTURE CAPITAL CYCLE, *supra* note 39, at 155.

55. See Sohl, *supra* note 16, at 106–07; GAO REPORT, *supra* note 45, at 9.

savings, credit card debt, and second home mortgages.⁵⁶ The upper limit of these internal sources of funding will typically be in the \$100,000⁵⁷ to \$250,000⁵⁸ range.

2. Early Stages

If there is promise to the company's concept, the founders will seek to tap the first sizeable external source of equity funding, since the amount of capital to start and develop most rapid-growth start-ups will generally far exceed the \$100,000 to \$250,000 range. These external rounds can be classified as the firm's "early-stage" financings. Funds raised in early-stage financings are likely used to complete product development, begin marketing, and commence an initial roll-out of the company's product or service. Angel investors are the primary source of funding for a rapid-growth start-up's early-stage financings.⁵⁹ The upper limit for the early-stage rounds tends not to exceed the \$1 million⁶⁰ to \$2 million⁶¹ range.

3. Later Stages

As the company grows, so does its need for additional capital. The later stage financings are for those companies that have demonstrated some level of success and are looking to finance a major expansion. It is these later stage financings where the institutional VC funds play a dominant role, although angel investors may still invest marginal amounts in later-stage rounds.⁶²

56. See Sohl, *supra* note 16, at 107. Entrepreneurs will also commonly resort to a technique referred to as "bootstrapping." Bootstrapping can be defined as "highly creative ways of acquiring the use of resources without borrowing money or raising equity financing from traditional sources." John Freear, Jeffrey E. Sohl & William E. Wetzels, Jr., *Who Bankrolls Software Entrepreneurs*, FRONTIERS OF ENTREPRENEURSHIP RESEARCH (1995), <http://www.babson.edu/entrep/fer/paper95/treear.htm>.

57. Sohl, *supra* note 52, at 14.

58. GAO REPORT, *supra* note 45, at 9.

59. See Sohl, *supra* note 52, at 13; see also REPORT TO SBA, *supra* note 8, at 4.

60. MONEY OF INVENTION, *supra* note 20, at 10.

61. Sohl, *supra* note 52, at 13. The \$2 million figure presumably includes the impact of the increased formation of angel syndicates. See *infra* notes 91-94 and accompanying text (discussing angel syndicates).

62. Sohl, *supra* note 52, at 11, 13; VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 49-52. REPORT TO SBA, *supra* note 8, at 3-5. See generally GAO REPORT, *supra* note 45, at 8-10.

C. Start-up Financing Trends Increase Importance of Angel Financing

A few trends have been documented in the private equity market for rapid-growth start-ups that have substantially increased the importance of angels in financing these companies.

1. VC Funds Move to Later-Stage Investing

The first trend has been the move by VC funds to later-stage investing. Through the mid-1980s, VC funds were likely to be active investors in the earlier rounds of financing.⁶³ Beginning in the late 1980s, however, a substantial portion of the VC-fund industry began to shift its focus to later-stage financings.⁶⁴ This shift does not appear to be a reactionary trend, but instead appears to be a systemic change in the way VC funds operate.⁶⁵

The VC funds' substantial exit from early-stage investing has significantly increased the importance of angel investors, who now serve in the critical role as the financial bridge from internal sources of funding to the deep pockets of the VC-fund world. Angels and VC funds appear to have a complimentary relationship, where the angels provide "a kind of 'farm system of venture portfolios.'"⁶⁶ Angels provide the early-stage finance, and potentially the managerial experience, to enable the rapid-growth start-ups to grow to a point where they might be attractive to the formal VC investors. The result is that a healthy angel market is a necessary component of the formal VC-fund market's success.⁶⁷

2. VC Funds Increase the Floor on their Investments to \$5 Million

Another major trend has been the tendency of VC funds to concentrate on investments that are at least \$5 million.⁶⁸ The \$5 million minimum investment trend appears to stem from a few factors. First, screening and monitoring of a new investment opportunity are a relatively fixed cost,

63. SANDLER, *supra* note 8, at 8.

64. *Id.*; see also VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 49–52; Sohl, *supra* note 52, at 13.

65. Sohl, *supra* note 52, at 13.

66. Jeffrey A. Timmons & Harry J. Sapienza, *Venture Capital: The Decade Ahead*, in *THE STATE OF THE ART OF ENTREPRENEURSHIP* 402, 421 (Donald L. Sexton & John D. Kasarda eds. 1992).

67. Colin Mason & Richard Harrison, *Stimulating 'Business Angels,'* in 4 *VENTURE CAPITAL AND INNOVATION* 54, 61 (Organisation for Economic Co-operation and Development, Working Paper No. 98, 1996), available at <http://www.oecd.org/dataoecd/35/59/2102064.pdf>.

68. See VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 23.

irrespective of the size of investment. For example, the resources required to conduct due diligence prior to making an initial investment do not vary substantially based on the size of the investment. Assuming it costs \$50,000 to conduct due diligence, it is more cost-effective to spread that \$50,000 over a \$5 million investment (in which case the due diligence cost is 1% of the investment) than a \$1 million investment (in which case the due diligence cost is 5%). By focusing on larger investments, the VC funds have more funds available to focus on investments, rather than screening and monitoring costs.

Another major factor driving the minimum investment size is the increased size of VC funds. As the average size of a VC fund has increased from \$42 million in 1990 to \$141 million in 2002,⁶⁹ the number of investment professionals that typically manage a VC fund has not increased at all.⁷⁰ As a result, each investment professional is responsible for managing a larger sum of capital. Because partners are subject to physical limitations on how many investments they can source and monitor at one time, one solution has been to increase the investment size.

The VC funds' increased minimum investment serves the same practical purpose as their substantial exit from the early stage financings. In fact, the increased floor is further confirmation that VC funds are investing in more mature start-ups, as start-ups that hope to obtain VC financing are now required to survive longer on non-VC funds.

3. Funding Gap

With the move by VC funds to later stage financings with larger minimums, a substantial funding gap has been documented for rapid-growth start-ups in the \$250,000 to \$5 million range.⁷¹ As the following table illustrates, this funding gap occurs in the rapid-growth start-ups' early stages, which are typically financed by angels:⁷²

69. THOMSON VENTURE ECONOMICS, 2003 NATIONAL VENTURE CAPITAL ASSOCIATION YEARBOOK 18 (2003).

70. *Id.* In fact, the average number of investment professionals that manage a VC fund has decreased from 10.2 in 1990 to 9.5 in 2002. *Id.*

71. GAO REPORT, *supra* note 45, at 12–13; *see also* Sohl, *supra* note 52, at 14–15 (citing statistics from the Center for Venture Research—University of New Hampshire, which indicate two separate funding gaps). The first funding gap is from \$100,000 to approximately \$2 million and a secondary funding gap arises between \$2 million and \$5 million. Sohl, *supra* note 52, at 11, 14–15.

72. *See* GAO REPORT, *supra* note 45, at 9.

<u>Financing Stage:</u>	<u>Capital Needed:</u>	<u>Financing Sources:</u>
Seed/Start-up Stages	Up to \$250,000	Primary: <ul style="list-style-type: none"> ●Entrepreneurs themselves ●Friends and family Other: <ul style="list-style-type: none"> ●Angel investors
Early Stages	\$250,000 to \$5 million	Primary: <ul style="list-style-type: none"> ●Angel investors Other: <ul style="list-style-type: none"> ●Early-stage VC funds⁷³ ●Small Business Investment Companies⁷⁴ ●Strategic and other partnerships
Later Stages	Over \$5 million	Primary: <ul style="list-style-type: none"> ●VC funds Other: <ul style="list-style-type: none"> ●Angel investors ●Corporate venture funds ●Strategic partnerships

In effect, the angel market is having trouble supplying the demand for early-stage financing. In the past, similar funding gaps have been viewed as supply-side problems with the gap being attributed primarily to a lack of available funds.⁷⁵ For the current funding gap, the cause is not so clear. Available angel funds do not appear to be lacking. While estimates on the size of the angel market vary substantially,⁷⁶ Professor Sohl, Director of the Center for Venture Research—University of New Hampshire (“Center for

73. These are VC funds that specifically target early-stage investments. To be clear, some VC funds do invest in early-stage investments. However, they make up a very small percentage of early-stage dollars invested.

74. A Small Business Investment Company, or SBIC, is a private investment company that is licensed and regulated by the SBA. “SBICs provide equity capital, long-term loans, debt-equity investments and management assistance to qualifying small businesses. They make venture-capital investments with their own funds plus funds obtained by borrowing at favorable rates with an SBA guaranty.” U.S. SMALL BUS. ADMIN., EQUITY INVESTMENT SOURCES FOR SMALL BUSINESS (brochure on file with author).

75. Linda Duxbury, George Haines & Allan Riding, *A Personality Profile of Canadian Informal Investors*, 34 J. SMALL BUS. MGMT. 44, 45 (1996).

76. The differences in estimates are due primarily to the informal nature of this market, which makes accurate data collection difficult.

Venture Research”), has estimated that roughly 300,000 angels invest approximately \$30 billion annually in approximately 50,000 businesses.⁷⁷ Professor Sohl further estimates that the number of latent or potentially active angel investors could exceed the number of active angels by a factor of five-to-one.⁷⁸ Such pent-up capital could substantially help to alleviate the current funding gap. Part II.B of this article will explore certain documented problems in the angel market that may help to explain why angel investors are not doing more to fill this funding gap.

II. ANGEL MARKET IS THE PRIMARY SOURCE OF CAPITAL FOR EARLY-STAGE RAPID-GROWTH START-UPS

A. Overview of the Angel Market

The term *angel* originated in the early 1900s to refer to wealthy backers of Broadway shows who made risky investments to support these productions.⁷⁹ Now, the term “angel investors” refers to wealthy individuals that invest in start-up companies, typically in their early stages. Because of the informal and fragmented nature of the U.S. angel market, it is difficult to get specific data on the angel market, or its individual investors. Much of the information that has been gathered on angels is either anecdotal or has come from survey-oriented research.⁸⁰ Both techniques can result in serious data distortions,⁸¹ so the data presented in this section should be taken as illustrative, and not definitive.

The combined angel market wields a substantial amount of financial clout. The Center for Venture Research has published the following statistics on the size of the angel market:

77. Sohl, *supra* note 52, at 13.

78. *Id.*

79. GERALD A. BENJAMIN & JOEL MARGULIS, FINDING YOUR WINGS: HOW TO LOCATE PRIVATE INVESTORS TO FUND YOUR VENTURE 5 (1996).

80. MONEY OF INVENTION, *supra* note 20, at 9.

81. *See id.*

	<u>2002</u> ⁸²	<u>2003</u> ⁸³	<u>2004</u> ⁸⁴
Aggregate Amount Invested (in billions)	\$15.7	\$18.1	\$22.5
Number of Ventures Receiving Angel Funding	36,000	42,000	48,000
Number of Active Angel Investors	200,000	220,000	225,000

It must be noted that the range of estimates regarding the activity level of angels varies considerably, with the low end being a few billion dollars per year.⁸⁵ Even considering the estimates on the low side, the angel market's significance remains evident when one considers that VC funds invest in substantially fewer companies than angels. In 2002, for example, VC funds invested in only approximately 2,500 companies, although the amount invested was approximately \$21 billion.⁸⁶

Unlike VC funds, who largely invest other people's money,⁸⁷ angels invest their own capital. Because angels are made up of hundreds of thousands of individual investors from a multitude of backgrounds, it is difficult to characterize angels with any precision. Researchers, however, have found that many active angel investors share a number of common characteristics, such as:

- Many are former entrepreneurs or business executives who are first generation money.⁸⁸ They typically invest in companies that operate in industries, or focus on technologies, with which they are personally familiar.⁸⁹ Active angels also include, however, a significant number of non-business professionals, such as doctors, dentists, and lawyers.⁹⁰
- They often prefer not to invest alone, but instead will invest as part of a group of angels or following the commitment of a respected lead investor.⁹¹ For the more sophisticated angels, there is a growing trend

82. Center for Venture Research, *The Angel Investor Market in 2002: Investment Activity and Growth Prospects*, June 11, 2003, http://wsbe.unh.edu/Centers_CVR/2002AR.cfm.

83. Center for Venture Research, *The Angel Investor Market in 2003: Angel Market Rebounds, but a Troublesome Post Seed Funding Gap Deepens*, Apr. 23, 2004, http://wsbe.unh.edu/Centers_CVR/2003PR.cfm.

84. Center for Venture Research, *Angel Investor Market Sustains Modest Recovery in 2004, According to UNH Center for Venture Research*, Mar. 22, 2005, http://wsbe.unh.edu/Centers_CVR/2004pressrelease.cfm.

85. See MONEY OF INVENTION, *supra* note 20, at 9–10.

86. THOMSON VENTURE ECONOMICS, *supra* note 69, at 27.

87. See discussion *infra* Part II.C.2.

88. Sohl, *supra* note 16, at 108.

89. REPORT TO SBA, *supra* note 8, at 8.

90. MONEY OF INVENTION, *supra* note 20, at 10.

91. Sohl, *supra* note 16, at 111.

for them to create formalized groups, called “angel syndicates.”⁹² The degree of organization varies substantially between syndicates, with the most formalized having full-time management, standardized investment structures, a public-relation strategy that provides the group with a “public face,” and, on occasion, a formal fund structure akin to the VC fund approach.⁹³ The Center for Venture Research has estimated that the number of angel syndicates has increased over the last five years from approximately fifty to potentially as many as 170.⁹⁴

- They invest in the early-stages of a company’s life⁹⁵ and in relatively small increments.⁹⁶ A typical early-stage angel financing is in the \$100,000 to \$1 million range, with six to eight angels participating.⁹⁷ Some angel deals may be a bit larger when angel syndicates are involved.⁹⁸
- They tend to invest in companies that are located close to where they live—often within a day’s drive.⁹⁹
- Many contribute more than just money as part of their investments.¹⁰⁰ They may also contribute their business expertise and serve as mentors to the business.
- Angels tend to guard their anonymity very closely.¹⁰¹ This tendency towards anonymity likely stems from angels’ desire to avoid entrepreneurs inundating them with requests for money.¹⁰²
- The due diligence process conducted by angels, and the financing terms and conditions they agree to, vary dramatically from one angel to another. As a general rule, angels employ weaker screening and monitoring mechanisms when making their investment decisions than professional investors such as VC funds.¹⁰³

92. Ewing Marion Kauffman Foundation, *Report from Angel Summit*, VC EXPERTS (Nov. 30, 2004), http://vcexperts.com/vce/news/buzz/archive_view.asp?id=251 (subscription required) (article on file with author).

93. *Id.*

94. *Id.* Some of the more well-known examples of angel syndicates are Band of Angels, a Silicon Valley based group, and the angel breakfast that is sponsored by the New York Media Association. JOSEPH W. BARTLETT, *FUNDAMENTALS OF VENTURE CAPITAL* 12 (1999).

95. REPORT TO SBA, *supra* note 8, at 8.

96. Sohl, *supra* note 16, at 108, 111.

97. *Id.*

98. See VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 44–45. Presumably, it is the increased presence of angel syndicates that have caused some researchers to increase their estimates on the potential size of angel investments to as high as \$2 million.

99. REPORT TO SBA, *supra* note 8, at 8.

100. *Id.*

101. Freear, Sohl & Wetzel, *supra* note 22, at 8.

102. *Id.*; see also VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 46.

103. See discussion *infra* Part II.C.–D.

While the above profile can be informative, the amount of diversity amongst angel investors is substantial. One issue that is striking when considering angels is the diversity of financial and investment sophistication between them. Some angels are extremely sophisticated in financial and investment matters and invest in a manner similar to professional investors.¹⁰⁴ The majority of angels, however, do not appear to be as highly sophisticated. For purposes of this Article and its proposal, angel investors will be divided between “sophisticated” and “unsophisticated.” There is no bright-line test to make this distinction. Rather, this division is being made simply to highlight the fact that many angels may not have a very high financial acumen.

B. Angel Market Problems

In an ideal world, all markets would be efficient. In an efficient market, scarce resources are allocated to their highest valued use through fully-informed buyers and sellers negotiating at arm’s length with low transaction costs. Such an ideal situation never exists, and all known markets suffer from various problems that reduce the overall efficiency of the markets. The more serious and systematic the problems are for a market, the greater the allocative inefficiencies. The angel market has demonstrated a number of systematic problems that limit the amount of capital that is invested in rapid-growth start-ups. This Article will focus on three substantial problems: (1) information problems, (2) high transaction costs, and (3) agency problems.

1. Information Problems

Information is often characterized as the “lifeblood” of securities markets. Accurate information about an investment facilitates proper allocation of investment capital among competing investment opportunities. On the one hand, the seller of the investment (e.g., the entrepreneur/founder) is properly informed about the value of the company and the optimal timing and structure of the financing so as to achieve the lowest cost of capital. On the other hand, the buyer of the investment (e.g., the angel investor) is properly informed about the merits of that particular

104. See VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 43. Examples of highly sophisticated angels include Paul Allen, H. Ross Perot, Ben Rosen (former chairman of Compaq Computer), Leonard Riggio (chairman and CEO of Barnes and Noble), and Sandy Robertson (founder and former CEO of the investment bank Robertson Stephens). *Id.*

investment as well as other available investment opportunities, so that the buyer can allocate her capital to the investments that are likely to generate the highest returns. Ideally, such information is both perfectly accurate and costless. While no known securities market produces such perfectly accurate and costless information, the angel market's information problems are particularly acute. The more serious the information problem, the less willing investors are to invest, and those that do invest will demand a greater rate of return to compensate for the increased risk that stems from the information problem.

a. Uncertainty

One information problem that impacts the angel market involves uncertainty about the future performance of rapid-growth start-ups.¹⁰⁵ Because angels invest in these companies in their very early stages when there is virtually no track record, the uncertainty about their future performance is exacerbated. Uncertainty surrounds almost all of the critical questions that an investor should consider prior to making an investment. Questions such as: Will management make the appropriate decisions regarding both the development and the execution of the company's business plan? Will the company's new product or service succeed? How will existing firms react to the presence of this new company?

Not surprisingly, this heightened uncertainty negatively impacts the willingness of investors to invest¹⁰⁶ and requires an investor to have a heightened level of expertise in this type of investment to make a properly informed investment decision.

b. Asymmetric Information

Another information problem that impacts the angel market involves asymmetric information between the entrepreneur/founder and the angel investors. Asymmetric information occurs when one party to a negotiated transaction has materially less accurate information than the other party. The entrepreneur/founder who is seeking angel financing, due to her day-to-day involvement, will typically have much better information about the potential positives and risks involved with investing in the company than any potential angels.¹⁰⁷ To make the matter worse, the entrepreneur/founder's self-interest may cause her to exploit this

105. VENTURE CAPITAL CYCLE, *supra* note 39, at 127-28.

106. *Id.*

107. *Id.* at 128.

information advantage to the detriment of the angel investors.¹⁰⁸ The entrepreneur/founder is likely to emphasize the potential upside to the company while downplaying the negatives about the company.¹⁰⁹

Where asymmetric information prevents investors from being able to distinguish good companies from bad companies, a classic “lemons problem” occurs.¹¹⁰ In such a setting, investors are likely to view all investment opportunities as roughly average. This means that investors will likely underpay for good companies (i.e., insufficient capital is dedicated to good companies, since they are judged as average) and overpay for bad companies (i.e., too much capital is allocated to them, since they are also judged to be average). Because good companies are penalized by this effect, they will strive to differentiate themselves from bad and average companies. If good companies cannot differentiate themselves, they will likely leave the market as they will be disappointed with the price paid by investors. These good companies will seek alternative forms of financing that provide them a more appropriate cost of capital. Left unchecked, this lemons problem will cause bad companies to dominate the market because they will be the most motivated by the average price paid by investors—jeopardizing the very existence of the market.¹¹¹

2. High Transaction Costs

Another impediment to an efficient market is high transaction costs. In a competitive market, buyers and sellers are able to find each other easily. Motivated buyers and sellers can then negotiate to determine if they wish to conduct a deal. Where buyers and sellers have substantial difficulty in finding each other, however, the cost of reaching a deal is dramatically increased. The angel market is notorious for the existence of substantial impediments on entrepreneurs and angels finding each other. The first impediment stems from angels’ well-documented desire to maintain anonymity.¹¹² As a general rule, most angels will not make their status as an

108. *Id.*

109. The entrepreneur/founder may even resort to providing misinformation about the company. While providing such misinformation is clearly actionable under both federal and state law, the fact that many entrepreneurs are effectively judgment proof substantially reduces the deterrence impact of possible investor lawsuits.

110. The impact of asymmetric information on markets and the resulting “lemons problem” can be traced back to George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970). Mr. Akerlof won the Nobel Prize in Economics for this 13-page paper.

111. *See generally id.*

112. Freear, Sohl & Wetzel, *supra* note 22, at 9.

angel readily known, primarily out of a desire to avoid being inundated by requests for money from entrepreneurs.¹¹³ This makes for an interesting situation, as angels try to balance their desire for deal flow with their inability to handle, or desire to avoid, an inordinate number of financing requests. Because many angels are not full-time investors, they do not have the time or resources to deal with large numbers of requests.

In addition to the angels' desire to retain some level of anonymity, federal and state regulations impose an additional burden on the ability of entrepreneurs to locate potential angel investors. Absent an exemption, federal securities law requires that every offer or sale of a security that involves the "use of any means or instruments of transportation or communication in interstate commerce or of the mails" to comply with the registration requirements of section 5 of the Securities Act of 1933 (the "Securities Act").¹¹⁴ The typical funding of a start-up company by either angel investors or VC funds will involve a non-public offering of equity securities of the start-up that is exempt from the registration requirements of section 5. The most common exemption relied on is Rule 506 of Regulation D of the Securities Act.¹¹⁵ In order to qualify under Rule 506, Regulation D prohibits the use of general advertising or general solicitation in seeking potential investors for the offering.¹¹⁶ Specifically, Rule 502(c) states that "neither the issuer nor any person acting on its behalf shall offer or sell securities by any form of general solicitation or general advertising."¹¹⁷ For example, an issuer cannot make "use of mass media or other similar marketing techniques to effect a widespread offering of securities to the public."¹¹⁸ While some have argued that what constitutes a general solicitation is unfortunately vague,¹¹⁹ it is apparent that for a solicitation to

113. *Id.*; see also VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 46.

114. 15 U.S.C. § 77e (2000).

115. Securities Act Rule, 17 C.F.R. § 230.506 (2004). One reason for the popularity of Rule 506 is its special status under the National Securities Markets Improvement Act of 1996 (the "NSMIA"). Pub. L. No. 104-290, 110 Stat. 3416. The NSMIA limits the role of state securities regulation in a few explicit areas. One of those areas involves securities offerings of "covered securities." 15 U.S.C. § 77r(a)(1)(A) (2000). Specifically, amended section 18 of the Securities Act preempts state regulation that would require "registration or qualification of [covered] securities, or registration or qualification of securities transactions" that involve covered securities. *Id.* § 77r(a)(1). The definition of a "covered security" includes securities sold under Rule 506, but does not include any other of the common section 5 exemptions for start-up private equity financings. See *id.* § 77r(b).

116. Regulation D of the Securities Act refers to 17 C.F.R. §§ 230.501–230.508; 17 C.F.R. § 230.502(c).

117. 17 C.F.R. § 230.502(c).

118. Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 68 (1989).

119. *Id.* at 70.

qualify as limited, rather than general, the SEC has a strong preference that the solicitor and the potential investor have a “pre-existing, substantive relationship.”¹²⁰ For a new entrepreneur who does not have a ready rolodex of potentially interested investors from prior ventures, this prohibition on general solicitation can amount to a substantial impediment to obtaining outside equity capital.¹²¹

To compound matters, angels themselves complain about having substantial difficulties in locating start-up investment opportunities. For active angel investors, studies have shown that limited deal flow is a substantial constraint on the amount of capital they invest in rapid-growth start-ups.¹²² While this limited deal flow is likely caused by angels’ efforts to preserve their anonymity and could be cured by angels making it known that they wish to receive more investment proposals, this outcome is unlikely because most angels simply are not equipped to deal with high volumes of unfiltered deals. The problem is not simply a lack of deal flow for active angels, but a lack of prescreened, high-quality deal flow.

3. Agency Problems

The above problems have involved largely “pre-investment” concerns for investors. There are also “post-investment” concerns. These post-investment concerns revolve around the classic agency problems that arise in external equity investments due to the separation of ownership from control.¹²³ Agency problems may arise whenever a principal-agent relationship exists and the agent is given decision-making authority, but her interests are not fully aligned with the principal. In such situations, it should

120. See William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 13–14 (2004).

121. See generally *id.* (arguing for a relaxation on the general solicitation/advertising prohibition so as to facilitate the fundraising efforts by small and emerging companies).

122. Stephen Prowse, *Angel Investors and the Market for Angel Investments*, 22 J. BANKING & FIN. 785, 789 (1998).

123. Adam Smith described the problem as follows:

The directors of [joint-stock] companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

ADAM SMITH, *Of the Revenue of the Sovereign or Commonwealth*, in AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 264–65 (Univ. of Chi. Press 1976) (1776).

be expected that if both the agent and principal are utility maximizers, “the agent will not always act in the best interests of the principal.”¹²⁴

External equity investment conflict arises from the separation of ownership of the firm from its management, as the managers of the firm (i.e., the agents) may have differing interests from the external shareholders (i.e., the principals).¹²⁵ For example, the managers may be incentivized to spend the firm’s resources on wasteful perquisites (items that do not generate direct financial returns to the firm, such as lavish offices, first-class travel or private club memberships, but do provide non-pecuniary benefits to the recipient of the perquisites), because the manager will enjoy 100% of the fruits of such perquisites, but bear only a small percentage of the cost of such perquisites since the managers own only a portion of the firm’s equity.¹²⁶ This dynamic may also encourage a manager to work at a less than optimal level (e.g., the manager may prefer to spend time golfing rather than building the business), because the manager receives the full benefit of her shirking while once again only bearing a fraction of the cost.

C. *Coping with Information, Agency, and Transaction Cost Problems—Intermediaries in the Public Equity and Formal VC-Fund Markets*

The information, agency, and transaction cost problems that plague the angel market are not unique to the angel market. Such problems are, in fact, quite common to capital markets and require costly information gathering and assessment endeavors, as well as costly monitoring activities to overcome. In the case of external equity investments, these information and monitoring efforts are made more difficult by the presence of diverse shareholders which leads to a collective action problem.¹²⁷ Namely, while the cost of gathering and assessing the information or monitoring management may be justified by the benefit to the shareholders as a whole, such cost is greater than the benefit that would be received by any one shareholder (or potential shareholder).¹²⁸ For example, a single shareholder who expends resources individually to monitor management may improve the corporation’s management and benefit all of the shareholders of the

124. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. OF FIN. ECON. 305, 308 (1976).

125. *Id.* at 309, 312–13.

126. *Id.* at 312–13; *see also* VENTURE CAPITAL CYCLE, *supra* note 39, at 129; SANDLER, *supra* note 8, at 14.

127. Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 271 (2003).

128. *Id.*

corporation collectively. However, the single shareholder will likely have to bear this cost on its own.¹²⁹ Therefore, while the collective group of shareholders may benefit from this increased monitoring, including those that did not bear the cost,¹³⁰ such monitoring will not likely take place unless the benefit is so great that it is justified by the individual benefit to the single shareholder. Without a mechanism to spread the costs of gathering/assessing information or monitoring across the shareholders (or potential shareholders) collectively, it should be expected that a suboptimal level of such activities will take place.

With respect to the public equity market and the formal VC-fund markets, one market solution to the information, agency, and transaction cost problems (and one which takes account of the collective action problem) is the formation of financial intermediaries to provide information and monitoring services.

1. Public Equity Market

Numerous financial intermediaries have developed to provide information and monitoring services for the public equity market, including investment banks and research analysts. The following is meant to be illustrative of the role that financial intermediaries can play and is by no means meant to be a cataloguing of financial intermediaries for the public equity market.

a. Investment Banks and Underwritten Offerings

Investment banks provide a variety of intermediary services for the capital markets. One such service is the underwriting role they play in public equity offerings where they bridge corporations in search of capital with public investors who provide the capital. Raising public equity is a highly complex process, and investment banks are able to lower the transaction costs for the process based on their specialization in the sale and distribution of securities. In the typical public offering, the issuer does not sell its securities directly to public investors, but instead hires a few investment banks to serve as underwriters (i.e., the investment banks purchase the securities from the issuer and then sell those securities to public investors) and to shepherd the corporation through the public offering process (e.g., help to obtain regulatory clearance, to position the

129. *Id.* at 278.

130. *Id.*

corporation so that it will interest potential investors, and to prepare the corporation for the rigors of being a public company).

Moreover, the investment bank/underwriters help to alleviate the asymmetric information problem between the issuer and the potential public investors.¹³¹ The issuer's management has superior information about the investment worthiness of the company and may have an incentive to be dishonest about the quality of the company. Investment banks reduce the "lemons problem" by serving as a "certifier" of the information that the issuer provides to investors. Investment banks effectively prescreen issuers on behalf of public investors. Only a fraction of the companies that wish to conduct underwritten offerings are actually accepted by investment banks. While investment banks may wish to underwrite offerings for low quality companies simply to garner the fee, their status as frequent and repeat players in the public equity markets and their dependence on a good reputation to be able to conduct future offerings serve as strong checks on such misbehavior.¹³² This intermediary role improves the ability of (i) issuers to raise public equity capital, because their information has been "certified" by the underwriting investment banks, and (ii) public investors to invest, because it reduces their information gathering and assessment costs (e.g., the public investors can focus their detailed due diligence efforts on higher quality, prescreened companies).

b. Research Analysts

Research analysts are another common market intermediary. There are three main categories of research analysts: sell-side analysts (who work for brokerage firms and provide investment information to their firms' clients); buy-side analysts (who work for institutional investors and provide them with investment information); and independent analysts (who provide investment information to third-party clients like sell-side analysts but are

131. This asymmetric information problem in the public equity market is identical to the asymmetric information problem in the angel market.

132. See Lily H. Fang, *Investment Bank Reputation and the Price and Quality of Underwriting Services 1-2* (Nov. 8, 2002) (unpublished Ph.D. dissertation, University of Pennsylvania) (on file with author). This paper deals with investment banks' role in the public debt markets, but the same analysis applies to their role in the public equity markets. Ms. Fang points out that investment banks are dependent on their "reputational capital."

[Investment banks'] viability and stream of future income is directly tied to their reputation. Although one-time dishonesty may increase short-term profit, such profit will be earned at the cost of losing reputation and future income. As long as the present value of future income exceeds the one-time profit from cheating, investment banks will find cheating sub-optimal.

Id.

not linked to a brokerage firm).¹³³ In each case, the research analyst's primary intermediary role is to "gather information (both publicly available and not publicly available) about the [issuer], its industry, and its competitors," and to analyze this information to help its clients better understand the dynamics that will drive a security's future performance.¹³⁴ Analysts help to overcome the collective action problem that plagues individual investors by providing their service to a collective group of investors.¹³⁵ Moreover, much of the analysts' information gathering and analysis efforts will be absorbed by the market as a whole, either through dissemination of the analysts' research reports (which quickly get into the market) or through individual investors acting on the advice given by an analyst. The United States Supreme Court, quoting the SEC, noted that the "value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."¹³⁶

While many have questioned the effectiveness of analysts in forecasting company performance and picking stocks, including this author,¹³⁷ there remains little doubt that analysts do perform a valuable information service and help to reduce the collective action problem.

c. Other Common Intermediaries for the Public Equity Market

There is no lack of intermediaries in the U.S. public equity market. In addition to investment banks and research analysts, there are a number of other intermediaries that play substantial roles in helping to reduce information and agency problems and transaction costs in that market. For example, public auditors "provide certification and verification of a company's financial statements."¹³⁸ Institutional investors, which include mutual funds, play a number of intermediary roles, including serving as a substantial collectivizing agent for shareholders. This collectivizing role allows individual shareholders to collectively pay for an investment professional to screen investment opportunities and monitor the actual

133. John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1, 7–10 (2003).

134. *Id.* at 49.

135. *See id.* at 48–49.

136. *Dirks v. SEC*, 463 U.S. 646, 658 n.17 (1983) (quoting Securities Exchange Act of 1934 Release No. 17480, 21 SEC Docket 1401, 1406 (Jan. 22, 1981)).

137. *See* Orcutt, *supra* note 133, at 48–54 (reviewing various studies that document analysts' shortcomings in forecasting company performance and picking stocks).

138. Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45, 47 (2004).

investments.¹³⁹ Proxy advisors are another prominent intermediary.¹⁴⁰ Institutional Shareholder Services, Inc., for example, which is one of the largest proxy advisory services, describes its core business as “analyzing proxies and issuing informed research and objective vote recommendations for more than 33,000 companies across 115 markets worldwide.”¹⁴¹ By doing so, the proxy advisory service provides research and monitoring on management in a collective manner for a substantial number of shareholders.

2. Formal VC-Fund Market—VC-Fund Managers are Intermediaries

Financial intermediaries have also developed to provide information and monitoring services for the formal VC market. The most specialized intermediaries for the formal VC-fund market are the managers of the VC funds. To understand the intermediary role these managers play, it is helpful to examine the set-up for a typical VC fund. VC funds are generally structured as limited partnerships.¹⁴² Outside investors such as pension funds,¹⁴³ other institutional investors (e.g., banks, endowments, and insurance companies), and wealthy individuals invest in the fund by purchasing limited partnership interests. Because of the limited partnership structure, the outside investors are not permitted an active role in the management of the fund or in the approval of particular investments that the

139. *See id.*

140. *See id.*

141. Institutional Shareholder Services, About ISS, <http://www.issproxy.com/about/index.jsp> (last visited Oct. 5, 2005).

142. Gilson, *supra* note 1, at 1070.

143. Interestingly, one reason for the substantial growth of VC funds since the early 1980s has been the investment by pension funds in VC funds. The Employee Retirement Income Security Act of 1974 (“ERISA”) is a federal law that establishes a set of standards for most voluntarily established pension and health plans in private industry. Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 5, 18, 26, 29, 31, 42 U.S.C.). One of the standards that ERISA establishes is to provide “fiduciary responsibilities” for persons who manage and control a plan’s assets, one of which is to manage the plan’s assets with the care of a “prudent man” (i.e., carefully and conservatively). 29 U.S.C.A. § 1104 (West Supp. 2005). During the 1970s, most plan managers were concerned that investing in private equity was too risky and would violate the “prudent man” standard. In 1979, the U.S. Department of Labor ruled that portfolio managers could consider portfolio diversification in determining the prudence of a particular investment. 29 C.F.R. §§ 2550.404a-1. The implication was that pension funds could allocate a portion of their portfolios to higher risk investments, such as venture capital funds. This ruling allowed one of the largest sources of investment capital in the United States to start flowing into venture capital.

fund will make.¹⁴⁴ Instead, the management of the fund is conducted by the fund's general partner.¹⁴⁵ The general partner, which is typically a limited liability company itself, exerts this management through individuals that serve as fund managers.¹⁴⁶ It is these fund managers who make and monitor the VC-fund's investments and who serve in the financial intermediary role.¹⁴⁷

The VC-fund managers employ a number of mechanisms to help reduce the impact of information, agency, and transaction cost problems.¹⁴⁸ To begin with, the managers' specialization in the private financing process helps to reduce the transaction costs for the process. For example, the problem of issuers and investors finding each other is greatly reduced for the formal VC-fund market. From the entrepreneur's standpoint, formal VC funds are not very difficult to find.¹⁴⁹ Numerous sources exist that identify the formal VC funds and provide their contact information. For example, *Pratt's Guide to Venture Capital Sources*,¹⁵⁰ which is published annually, contains contact information for over 1,400 VC funds.¹⁵¹ From the VC funds' perspective, the fund managers employ a number of means for identifying potential investment candidates. The fund managers will typically possess specialized industry knowledge about the particular industries in which their VC fund invests.¹⁵² This specialized industry knowledge, which generally comes from prior work or investment experience in the industry, allows the managers to gauge what is occurring in the industry, including recognizing when a start-up begins to achieve the

144. Gilson, *supra* note 1, at 1070–71. Moreover, most VC funds are structured as “blind pools.” *Id.*

At the time an institution decides whether to participate in a venture capital fund, it receives an offering memorandum that discloses the fund's investment strategy—for example, that the fund will specialize in a particular industry, like the Internet, or a distinct development stage, like early stage investments. However, the particular companies in which the fund will invest are not yet known.

Id.

145. *Id.* at 1071.

146. *Id.* In popular parlance, these fund managers are often referred to as, or given the title of, “partners” in the VC fund. To avoid any confusion that a reader might have with the limited partners, or the general partner, this Article will employ the term VC fund managers to describe the individuals that run the VC funds.

147. *Id.*

148. See discussion *supra* Part II.B.

149. SANDLER, *supra* note 8, at 14.

150. PRATT'S GUIDE TO VENTURE CAPITAL SOURCES (David Kwateng ed., Thomson Financial Venture Economics 2001).

151. *Id.* at 125.

152. See MONEY OF INVENTION, *supra* note 20, at 44.

level of success that would make it attractive to a VC fund.¹⁵³ The managers' specialized industry expertise is often supplemented by a "network of experts," including employees within the industry, formerly financed entrepreneurs, and various investment professionals (e.g., investment banks and certain law firms).¹⁵⁴

Regarding the information and agency problems, VC fund managers employ a number of techniques and mechanisms that allow them to reduce the impact of these problems. Such techniques/mechanisms include: (i) employing a substantial screening process prior to making an investment; (ii) staging investments over time; (iii) requiring protective financing terms and mechanisms; and (iv) strategically composing the company's board of directors.¹⁵⁵

a. Employing a Substantial Screening Process

VC investment professionals typically conduct a detailed screening process of the potential investment candidate prior to committing any funds. This process, often referred to as due diligence, involves an intensive review on a number of different fronts, including a review of:

- The management team and its ability to successfully run the company;¹⁵⁶
- The start-up's business plan, with a particular focus on the size, and potential for growth, of the start-up's targeted market, the executability of the plan, potential competitive advantages (e.g., barriers to entry to the market) that the start-up might possess and the start-up's competitors;
- The quality of the product or service being offered by the start-up,¹⁵⁷ including through discussions with current customers;
- The strength of the start-up's intellectual property rights;¹⁵⁸ and

153. *Id.*

154. *See id.* at 45–46.

155. *See id.* at 43.

156. Georges Doriot, who is credited by many as the founder of modern venture capital, has been credited as saying something along the following lines regarding the importance of management in the investment decision: "Always consider investing in a grade A man with a grade B idea. Never invest in a grade B man with a Grade A idea." William D. Bygrave, *The Entrepreneurial Process*, in *THE PORTABLE MBA IN ENTREPRENEURSHIP* 12 (William D. Bygrave & Andrew Zacharakis eds., 3d ed. 2004).

157. For technology companies, this entails understanding the strength and viability of any new and proprietary technology being developed by the company.

158. It is common that a rapid-growth start-up's primary assets are intellectual property. As a result, it is critical for investors to understand the strength of those rights. For example, if the start-up's product is based on technology licensed from another party, what are the parameters/restrictions of that license? If the value of the start-up depends on its ability to patent its proprietary technology, what is the anticipated strength of those patents?

- A detailed review of the start-up's financial projections.¹⁵⁹

The screening process is very arduous and few businesses that submit funding requests to VC funds actually receive funding.¹⁶⁰ The purpose of this process is both to gather the information necessary to make an informed investment decision and eliminate those management teams that will require an inappropriate amount of monitoring.

b. Staging Investments

Rather than provide a company with the capital needed to fund its entire business plan, VC funds typically stage the capital.¹⁶¹ The investments are staged through various rounds, with each round of financing intended to finance the company to a particular milestone or milestones.¹⁶² Staging the investments provides the VC funds with an "option to abandon"¹⁶³ the investment, which can be a powerful tool to reduce both information and agency problems.

To begin with, staging helps to reduce the uncertainty problem.¹⁶⁴ For example, if the VC fund is concerned about the viability of the company's technology or its ability to achieve certain milestones, staging the investment allows the company to risk only a portion of the investment on the company up front.¹⁶⁵ The initial investment may be of an amount to allow the VC fund to become more comfortable with the technology or to allow the company to reach some of the milestones.¹⁶⁶ The result is that projections about the company are replaced with fact.¹⁶⁷ Staging the investments also reduces information asymmetries by providing VC funds with improved access to the company's most confidential information. Prior to becoming an investor, the company's management has substantially greater access to crucial information about the investment worthiness of the company, such as the reliability of the company's financial projections and the true capabilities of management.¹⁶⁸ Making a partial initial investment

159. Because the value of the company will generally depend on the expected future profitability of the company, projections (including how they were developed and their reasonableness) are a fundamental part of the due diligence process.

160. SANDLER, *supra* note 8, at 14.

161. Gilson, *supra* note 1, at 1073 (citing Paul A. Gompers, *Optimal Investment, Monitoring and Staging of Venture Capital*, 50 J. FIN. 1461, 1463-67 (1995)).

162. *Id.*

163. *Id.* at 1078.

164. *Id.* at 1078-79.

165. *Id.*

166. *See id.*

167. *Id.* at 1079.

168. *Id.* at 1080-81.

allows the VC funds to obtain similar access as management to much of this information,¹⁶⁹ in particular since the VC fund will likely receive board representation.¹⁷⁰ The end result is that staging allows the VC fund to postpone a substantial portion of its investment decision until it has better information about the company.

Finally, staging helps to reduce agency concerns for the VC funds.¹⁷¹ First, staging places the decision of whether to continue to fund the company in the hands of the VC funds, which shifts a substantial amount of discretion regarding the direction of the company from its managers to its owners (i.e., the VC funds).¹⁷² As Professor Gilson points out:

This power, in turn, gives the venture capital fund the incentive to make the investment in monitoring necessary to evaluate the portfolio company's overall performance over the initial funding period. In the absence of the power to act in response to what it discovers, the venture capital fund would have no reason to expend time and resources in the kind of monitoring necessary to balance the intense incentives created to align the two parties' interests.¹⁷³

Requiring management to remain beholden to the VC funds for additional funding greatly reduces the ability of the company's managers to act strategically.¹⁷⁴

c. Including Protective Financing Terms and Mechanisms

VC funds will also typically require the investee to agree to a number of terms in the financing documents that are meant to protect the investment of the VC funds and to better align the interests of the entrepreneurs with those of the VC funds. For example, VC funds generally insist on receiving

169. *Id.*

170. *See* discussion *infra* Part II.C.2.d.

171. *Id.* at 1079–80.

172. *Id.* at 1081. Professor Gilson points out that staging does not eliminate the agency problem, but merely shifts discretion from the entrepreneur to the VC fund. It shifts the ability to act strategically from the company's managers to the VC fund, which may misuse its power in pricing the next round of financing. Professor Gilson goes on to note that in this type of setting:

[T]he goal is to shift discretion to that party whose misuse of it can be most easily constrained. As will appear, misuse of the discretion shifted to the venture capital fund is policed by market forces in the venture capital market, whose functioning is crucial to the feasibility of the entire organizational and contractual structure.

Id.

173. *Id.* at 1082.

174. *See id.* at 1082–83.

convertible preferred stock when they make investments.¹⁷⁵ A primary benefit to the VC funds of receiving convertible preferred stock is that it has a higher priority than common stock, which means that holders of preferred stock get paid before holders of common stock if the company is liquidated.¹⁷⁶ Because the company's founding entrepreneurs and its management typically own common stock, preferred stock provides a substantial incentive to the managers to run the company successfully.¹⁷⁷ If they do not, the only parties who are likely to see any return on their investment will be the VC funds.¹⁷⁸ The VC funds may also insist on a variety of other contractual terms in the financing documents that attempt to better align the incentives of the VC funds and the entrepreneurs/managers, including:¹⁷⁹ (i) participation rights;¹⁸⁰ (ii) mandatory redemption rights;¹⁸¹ (iii) special voting rights;¹⁸² and (iv) anti-dilution rights.¹⁸³

d. Strategically Composing the Company's Board of Directors

State corporate statutes typically contain a code section that provides that the corporation will "be managed by or under the direction of a board of directors."¹⁸⁴ As a result, the board is the ultimate decision making authority

175. MONEY OF INVENTION, *supra* note 20, at 55.

176. The liquidation of a company refers generally to the winding up, or ending, of the company in its current form. The liquidation can occur because the company is sold to another entity or is shut down.

177. *Id.* Another rationale for the use of preferred stock is the "cheap stock" issue. For a discussion of the cheap stock issue and why it may encourage the issuance of preferred, rather than common, stock to VC funds, see Michael J. Halloran et al., *Taxation of Equity Based Compensation*, in VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION 15-7 to 15-8 (3d ed. Supp. 2001).

178. See MONEY OF INVENTION, *supra* note 20, at 55.

179. *Id.* at 55-58.

180. Participation rights refer to additional liquidation rights that may be granted to preferred stockholders. Preferred stock is referred to as having "participation rights" when the preferred stockholders, after receiving their full liquidation preference, are then entitled to "participate" with the common stockholders in any additional amounts distributed to stockholders.

181. A mandatory redemption right is a right for the investor to require the company to repurchase its stock at a certain price and during a certain time period.

182. Common special voting rights include class voting rights on business combinations or new financings.

183. Anti-dilution rights increase the amount of stock the preferred stockholders receive in the event that a future financing is done at a lower valuation.

184. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2005); see also MODEL BUS. CORP. ACT § 8.01(b) (2003) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors . . ."); see FRANKLIN A. GEVURTZ, CORPORATION LAW, HORNBOOK SERIES 190 (2000) for the proposition that most states have a similar state corporate code provision.

for a corporation. One way for the VC funds to reduce information and agency problems is to insist on substantial board representation, and thereby become part of the corporation's management. The directors that are ultimately chosen by the VC fund will typically be representatives of the fund. By taking meaningful positions on the board, the VC funds are better able to monitor their investments and to reduce information asymmetries because, under state corporate law, the corporation's officers answer to the board.¹⁸⁵

D. Coping with Information, Agency and Transaction Cost Problems – The Angel Market

At first glance, one might expect that angel investors would operate in a substantially similar manner as the formal VC investors. Both are patient investors¹⁸⁶ who invest in high-risk, non-public entrepreneurial companies. Angels, however, take a very different approach to investing than VC funds.

It is important to remember that angels concentrate their investing in early-stage companies, while VC funds focus on later-stage companies. This is relevant because earlier stage companies experience higher failure rates¹⁸⁷ and should be expected to suffer from greater information problems (e.g., more uncertainty). The logical response to such an investment environment would be to increase the screening and monitoring of such investments. In fact, angels appear to do the opposite. They expend substantially less resources on screening and monitoring mechanisms than VC funds. While some angels are extremely sophisticated and are capable of investing in a manner similar to formal VC funds,¹⁸⁸ this does not appear to be the rule. A recent study on the differences between angel investors and VC funds reached the following conclusion:

Business angels are less concerned with financial projections and are less likely to calculate rates of return. They do less detailed due diligence, have fewer meetings with entrepreneurs, are less likely to take up references on the entrepreneur and are less likely

185. DEL. CODE ANN. tit. 8, § 141(a) (2005); see also GEVURTZ, *supra* note 184, at 180–81.

186. This refers to the fact that both angels and VC funds invest in illiquid securities that require their holders to have long time horizons before they can reasonably expect to liquidate their investments.

187. See Dean A. Shepherd, et al., *New Venture Survival: Ignorance, External Shocks, and Risk Reduction Strategies*, 15 J. BUS. VENTURING 393, 394, 400–01 (2000).

188. See VAN OSNABRUGGE & ROBINSON, *supra* note 1, at 43.

to consult other people about the investment. Conversely, business angels are more likely to invest on 'gut feeling.'¹⁸⁹

Moreover, many angels apparently invest for non-financial reasons, as they will take "bigger risks or accept lower rewards when they are attracted by the nonfinancial characteristics of an entrepreneur's proposal."¹⁹⁰ So, how do angels decide which companies to invest in? The primary screening mechanism used by angels is to employ a network of trusted associates (a "network of trust") to source and recommend deals.¹⁹¹ For example, some angels simply will not consider deals that come directly from the entrepreneur.¹⁹² This network of trust typically includes business associates, other angels, entrepreneurs from companies formerly financed by the angel, VCs, investment bankers, lawyers and accountants.¹⁹³ An angel's perception of the quality of a particular deal varies greatly depending on the source of the deal.¹⁹⁴ For example, if angel X receives a deal recommendation from another trusted angel who will also be investing in the deal, angel X is likely to perceive the deal as a higher quality opportunity.¹⁹⁵ Consequently, angel X may be less likely to perform substantial screening of the opportunity and more likely to rely on the work conducted by the recommending angel. On the other end of the spectrum, deals recommended by lawyers and accountants are generally deemed to be of much lower quality.¹⁹⁶

In addition to their weaker screening mechanisms, angels also employ weaker monitoring mechanisms. Many angels are content to receive common stock, rather than convertible preferred stock and its added protections against agency problems.¹⁹⁷ Angels also regularly avoid detailed financing contracts. For less sophisticated angels, their investment contracts are likely to omit even the most basic protections against agency problems or poor managerial performance.¹⁹⁸ Finally, angels are likely to control a

189. Colin M. Mason & Richard T. Harrison, *Is It Worth It? The Rates of Return from Informal Venture Capital Investments*, 17 J. BUS. VENTURING 211, 220 (2002); see also Prowse, *supra* note 122, at 789 (reporting similar findings).

190. REPORT TO SBA, *supra* note 8, at 8.

191. LUCINDA A. LINDE & ALOK PHASAD, MIT ENTREPRENEURSHIP CENTER, VENTURE SUPPORT SYSTEMS PROJECT: ANGEL INVESTORS 26 (Release 1.1 2000).

192. *Id.*

193. *Id.* at 26–29.

194. *See id.*

195. *See id.* at 27–28.

196. *Id.* at 27.

197. Prowse, *supra* note 122, at 790; see also George W. Fenn et al., *The Role of Angel Investors in Financing High Tech Start-ups*, 4 (Dec. 1998) (unpublished manuscript, on file with author).

198. Prowse, *supra* note 122, at 788.

smaller percentage of board seats than VC-fund investors¹⁹⁹ and angels rarely use contractual management incentive schemes.²⁰⁰

Why angels employ weaker screening and monitoring mechanisms is not entirely clear. It could be due to lack of sufficient resources or lack of knowledge on how to conduct such activities. Unless there are unobservable governance mechanisms being employed by angels, it should be expected that a group of financial intermediaries would develop to provide such under-utilized mechanisms. Unlike the VC-fund market, where fund managers perform such services, there is no equivalent for the angel market. It is possible that angel syndicates may eventually, and partially, fill such an intermediary role, but that does not appear to be the case today with only approximately 170 angel syndicates operating²⁰¹ for a pool of over 225,000 active angels.²⁰² Even if angel syndicates do meaningfully fulfill such a role, additional intermediaries could also benefit the market. Finders appear to be a logical party to help serve in a meaningful intermediary role for the angel market.

E. Potential Failures of Financial Intermediaries

While financial intermediaries can perform very valuable market functions, it must be pointed out that such market participants are subject to their own deficiencies and can themselves cause market problems. Much has been written lately on conflicts of interest that plague many of the important intermediaries for public securities markets, including research analysts and financial auditors.²⁰³ One of the purposes of the Sarbanes-Oxley Act of 2002²⁰⁴ (“Sarbanes-Oxley”) was to address some of these financial intermediary conflicts of interest. For example, Sarbanes-Oxley (i) makes it unlawful for statutory auditors for registered companies to provide a wide range of non-auditing services to its clients,²⁰⁵ (ii) prohibits an

199. Fenn et al., *supra* note 197, at 4.

200. Prowse, *supra* note 122, at 790.

201. See Ewing Marion Kauffman Foundation, *supra* note 92.

202. Center for Venture Research, *supra* note 84.

203. See, e.g., Choi & Fisch, *supra* note 127 (examining financial intermediary conflicts that result when the recipient of the intermediaries’ services is not the direct payer for those services, such as occurs with financial auditors and research analysts); Orcutt, *supra* note 133, at 13–26 (discussing the conflicts of interest that plague sell-side research analysts).

204. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

205. Prohibited services include: bookkeeping services; financial information systems design and implementation; appraisal or valuation services (including fairness opinions); actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services

auditing firm from auditing a registered firm whose CEO, controller, CFO, Chief Accounting Officer, or person in an equivalent position had been employed by the auditing firm during the one-year period preceding the audit,²⁰⁶ and (iii) requires the SEC, including through the NASD and the NYSE, to adopt rules for the purpose of separating sell-side research analysts from the influences of investment banking.²⁰⁷

Pointing out that intermediaries are subject to serious conflicts of interest is not meant to suggest that intermediaries are not useful resources to securities markets. The critique is simply meant to provide a cautionary note. When confidence in intermediaries becomes such that investors rely on them too heavily (e.g., when investors rely on intermediaries without maintaining a proper level of skepticism), the role of the intermediaries can become detrimental. Overconfidence in intermediaries is not a desirable outcome. This Article proposes techniques that could be employed to reduce conflicts of interest that may arise if finders are allowed an expanded intermediary role in the private capital market setting.

III. CURRENT PERMISSIBLE ROLE OF FINDERS IN PRIVATE EQUITY TRANSACTIONS

The problems that exist for the angel market discussed in Part II.B of this Article are by no means unique to the angel market. In fact, the failures that plague the angel market are actually quite ordinary and plague every type of securities market to some extent. What is unique to the angel market is the lack of meaningful market intermediaries to help reduce the negative impact of these problems. One logical group that could potentially perform a meaningful intermediary role in the angel market would be an empowered class of finders.²⁰⁸ Federal and state securities regulations, however, currently place a serious burden on the ability of finders to play a meaningful role in the private capital raising process.

A. *Overview of Finders*

Viewing the term in its broadest sense, a finder in a securities market setting encompasses persons or entities who bring together buyers and sellers for a fee, but have no role, or at least a very limited role, in bringing

and expert services unrelated to auditing; and any other service that the company's board of directors determines, by regulation, is impermissible. 15 U.S.C. § 78j-1(g) (West Supp. 2005).

206. 15 U.S.C. § 78j-1(l).

207. See 15 U.S.C.A. § 78o-6 (West Supp. 2005).

208. See discussion *infra* Part V.

the ensuing transaction to closure.²⁰⁹ Finders are meant to provide introductions between potentially interested parties but not actively consummate transactions. There are four classic types of finders in securities markets: Private Placement Finders, M&A Finders, Investor-to-Investor Finders, and Broker-Dealer Finders.

1. Private Placement Finders

Private Placement Finders can come in many forms, but their binding purpose is to match investors with entrepreneurs seeking financing. The classic form of a Private Placement Finder is the individual who, for a fee, will help early-stage start-up companies find external sources of equity financing. Their role appears to be concentrated in the early-stage market, because they are the companies who have the greatest trouble locating capital.²¹⁰

When locating potential investors, it also appears that Private Placement Finders focus primarily on angels. VC funds, the other major source of external private equity, typically will not invest in the early-stage financing market.²¹¹ As well, VC funds generally tend to avoid the services of Private Placement Finders and will not invest in deals where a Private Placement Finder is present.²¹² Anecdotally, the VC funds' aversion to Private Placement Finders is based largely on the intermediary role of the VC-fund managers. These fund managers are investment professionals who feel capable of identifying and screening potential investment candidates without the need of a finder. As a result, there is little desire on the part of the VC funds to pay for the services of a Private Placement Finder either through a direct payment or through a fee that is deducted from the funds of the company that is the subject of the investment.²¹³ The angel market provides a very different environment for Private Placement Finders. Unlike the VC-fund market, the angel market is populated with a substantial number of individuals who are not professional investors. For these individuals, the services that a Private Placement Finder offers may very well justify a finder's fee.

209. Berkeley & Parisi, *supra* note 28, at 118; *see also* Polanin, *supra* note 28, at 789.

210. *See generally* discussion *supra* Part I.C.3.

211. *See* discussion *supra* Part I.C.1.

212. Based on the author's experience at Robertson Stephens, Inc.

213. The VC funds want to be certain that any funds invested in a company actually go to running the company, and not to paying fees to outside service providers (e.g., finders) unless those outside services are crucial (e.g., outside legal counsel).

Within the category of Private Placement Finders, technology (specifically the Internet) has led to the development of a new type of Private Placement Finder, often referred to as a matching service. Matching services are typically Internet-based systems that provide a purely passive conduit for entrepreneurs and “accredited investors”²¹⁴ to find each other. One of the more well known matching services is ACE-Net (Angel Capital Electronic Network). ACE-Net was initially established by the SBA to provide access to equity capital for entrepreneurs, but has since been spun off into a separate non-profit corporation and is now named Active Capital.²¹⁵ Although different matching services may vary in certain details, the typical format of a matching service is to develop a database of entrepreneurs who are seeking financing and make this database available to specific potential investors who have been prequalified to be part of the service. Once qualified, the potential investor will be able to peruse the database of companies seeking financing. Many of these matching services have been established as non-profit organizations, with the service limiting its compensation to flat fees to cover administrative costs.²¹⁶

2. Other Types of Finders

This Article focuses on Private Placement Finders. For the sake of completeness, however, it is worth mentioning that there are three other common types of finders: M&A Finders, Investor-to-Investor Finders, and Broker-Dealer Finders. M&A Finders are those individuals and entities that identify and introduce parties seeking to engage in various business combinations. Often referring to themselves as “business brokers,” a typical

214. See *infra* text accompanying note 418 (defining accredited investors). For a more detailed definition of an accredited investor, please refer to Rule 501(a) of Regulation D. 17 C.F.R. § 230.501(a) (2005). Because most start-up private equity offerings are conducted under Rule 506 of Regulation D, 17 C.F.R. § 230.506, one reason to limit the investor database to accredited investors is to avoid the disclosure requirements of Rule 502(b). 17 C.F.R. § 230.502(b). Rule 502(b)(1) provides:

If the issuer sells securities under § 230.505 or § 230.506 to any purchaser that is not an accredited investor, the issuer shall furnish the information specified in paragraph (b)(2) of this section to such purchaser a reasonable time prior to sale. The issuer is not required to furnish the specified information to purchasers when it sells securities under § 230.504, or to any accredited investor.

17 C.F.R. § 230.502 (b)(1).

215. Active Capital, About Us, <http://activecapital.org/aboutus.html> (last visited Oct. 5, 2005).

216. See discussion *infra* Part III.C.6. See generally Alan J. Berkeley, *Limitations on the Manner of Offering Under Regulation D*, SJ062 ALI-ABA 517, 533–34 (Mar. 11–13, 2004).

M&A Finder may work on behalf of a business that is seeking to sell itself by identifying potential buyers for the business.²¹⁷ Investor-to-Investor Finders help to arrange securities transactions between individual investors (rather than between a company and an investor). Such finders serve an intermediary role in transactions where the relevant securities are illiquid.²¹⁸ Finally, Broker-Dealer Finders assist registered broker-dealers to locate potential customers. Registered broker-dealers, like any business, have a need to acquire new customers on a regular basis.²¹⁹ Subject to federal and state securities law, Broker-Dealer Finders may play a role in helping such broker-dealers to locate new customers.²²⁰

This Article's proposal will not address the role of these other finders. The potential beneficial roles of M&A Finders and Investor-to-Investor Finders in the formation of companies, however, could be worthy of further research. While M&A Finders and Investor-to-Investor Finders do not have a direct role in financing new companies, they could possibly play a very substantial indirect role. The ability to liquidate an investment is a major factor in both an investor's decision to make an initial investment and at what price to make the investment.²²¹ With respect to equity shares of rapid-growth start-ups, these securities are highly illiquid until the company conducts its initial public offering. Prior to that time, there is no ready market for the securities and there are substantial regulatory impediments²²² to their sale. Illiquid securities trade at a discount to liquid securities, and highly illiquid securities trade at an even higher discount. In effect, less money goes to the rapid-growth start-ups since the investors are only willing to purchase these illiquid securities if the valuation of the company

217. Interestingly, the question of broker-dealer status is only relevant if the business combination involves a transaction that includes an issuance or transfer of securities, such as a merger, stock acquisition or stock-for-assets transaction. If the transaction is structured as a cash-for-assets transaction, there is no securities transaction, and consequently, there should be no concern about an M&A Finder's role as a broker-dealer since it is not "effecting securities transactions." See discussion *infra* Part III.C.

218. An illiquid security is one that is not easy to sell, either because it is thinly traded (i.e., the trading volume is so low that any sizable sale will disrupt the market for the securities and drive the price down substantially) or because there is no ready market.

219. See Polanin, *supra* note 28, at 795.

220. See *id.* at 795-813.

221. The liquidity of an investment refers to the ease with which an investor can sell the investment (e.g., convert it into cash). A highly liquid security is one that has both a ready market for trading and is regularly traded in such volumes that an investor wishing to exit the investment will not cause a substantial drop in the price by selling. An illiquid security is the inverse.

222. See, e.g., 17 C.F.R. § 230.502(d) (providing that securities acquired in a transaction under Regulation D are "restricted" securities and cannot be resold without registration under the Securities Act or an exemption therefrom).

is substantially reduced. It is possible that M&A Finders and Investor-to-Investor Finders could serve an intermediary role by helping investors in rapid-growth start-ups to reach desired liquidity events. An increased ability to liquidate investments in rapid-growth start-ups should increase both the frequency and valuation of private equity investments. If M&A Finders and Investor-to-Investor Finders could meaningfully play such a role, then contemplation should also be given to empowering them.

B. Private Placement Finders as Possible Broker-Dealers

How do federal and state securities regulations place a burden on the formation of a meaningful class of Private Placement Finders? The answer lies in the regulatory treatment of broker-dealers.²²³ Broker-dealers are some of the more heavily regulated actors in the U.S. capital market system. Being classified as a broker-dealer is not a trivial matter for a finder. If a finder is deemed to be acting as a broker-dealer, the finder will find herself subject to a daunting array of both federal and state regulation.

To begin with, broker-dealers who “make use of the mails or any means or instrumentalities of interstate commerce” are required to register with the SEC pursuant to section 15(a) of the Securities Exchange Act of 1934²²⁴ (the “Exchange Act”), subject to certain exemptions.²²⁵ Registration with the SEC subjects the broker-dealer to a substantial number of requirements under the Exchange Act, including:

- Compliance with basic standards of competency and training;²²⁶
- Extensive and detailed record keeping requirements;²²⁷
- Substantial financial reporting requirements;²²⁸ and
- Net worth and capital requirements.²²⁹

The Exchange Act also mandates, subject to limited exceptions,²³⁰ that broker-dealers become members of the NASD.²³¹ This membership

223. To be precise, the specific terminology under the Exchange Act is “broker” or “dealer.” 15 U.S.C. § 77c(a)(4) and (5). Because the provisions of the Exchange Act apply whether a party is a broker or a dealer, however, it is common to simply refer to a party that falls within these regulations as a broker-dealer.

224. 15 U.S.C. § 78o(a).

225. 15 U.S.C. § 78o(a)(2); 17 C.F.R. § 240.15a-1-11 (2005).

226. 15 U.S.C. § 78o(b)(7).

227. *Id.*; 15 U.S.C. § 78q(a)(1); 17 C.F.R. § 240.17a-3-4.

228. 15 U.S.C. § 78q(a)(1); 17 C.F.R. § 240.17a-5.

229. 15 U.S.C. § 78o(c)(3); 17 C.F.R. § 240.15c3-1.

230. 15 U.S.C. § 78o(b)(9); 17 C.F.R. § 240.15b9-1. A broker-dealer required to become a member of the NASD under 15 U.S.C. § 78o(b)(8):

shall be exempt from such requirement if it: (1) is a member of a national securities exchange, (2) carries no customer accounts, and (3) has annual gross

requirement brings a broker-dealer within the jurisdiction of the NASD, which is the primary private-sector regulator of the U.S. securities industry.²³² NASD members are subject to the NASD's rules regarding, among other matters, fair practice, inspections, and discipline.

In addition to the Exchange Act requirements, the Securities Investor Protection Act of 1970²³³ requires registered broker-dealers to participate in an insurance program to cover customer losses in the case of a brokerage house failure. Broker-dealers must also take care to comply with applicable state requirements, including, in many states, a requirement to register as a broker-dealer within a state if conducting broker-dealer activities with a resident of that state.

One additional concern is whether the finder's activities amount to providing investment advice, which would require the finder to register as an investment adviser under the Investment Advisers Act of 1940,²³⁴ which covers non-broker-dealers who are in the business of providing investment advice. This article will not be addressing the investment adviser's issue, except to point out that even if a finder avoids broker-dealer registration, under the current system the finder may also have to worry about investment adviser registration if it provides advice or analysis to potential investors.

C. Are Private Placement Finders Broker-Dealers?—The Finder's Exception

Whether someone is acting as a broker-dealer is one of the more nebulous questions in U.S. securities regulation.²³⁵ On its face, the question of who is a broker-dealer does not appear that difficult to answer. Under federal law, section 3(a)(4) of the Exchange Act²³⁶ defines a broker as any person, other than a bank,²³⁷ that is "engaged in the business of effecting

income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than \$1,000.

17 C.F.R. § 240.15b9-1(a).

231. 15 U.S.C. § 78o(b)(8).

232. NASD, ABOUT NASD, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=608&ssSourceNodeId=5 (last visited Sept. 22, 2005).

233. 15 U.S.C. §§ 78aaa–III.

234. 15 U.S.C. §§ 80b-1 to 80b-21.

235. See generally David A. Lipton, *A Primer On Broker-Dealer Registration*, 36 CATH. U. L. REV. 899 (1987) (analyzing this question in detail and reaching this conclusion).

236. 15 U.S.C. § 78c(a)(4).

237. 15 U.S.C. § 78c(a)(4)(B).

transactions in securities for the account of others.”²³⁸ Dealers are defined in section 3(a)(5) of the Exchange Act²³⁹ generally as any person, other than a bank,²⁴⁰ who is in the business of buying and selling securities for her own account as part of a regular business.²⁴¹ When applied to brokerage firms²⁴² and their personnel, these definitions work fine as there is a common understanding of what constitutes a broker-dealer. Namely, a broker-dealer “is someone who effects securities transactions for customers either on a commission or mark-up/mark-down basis.”²⁴³ Once one leaves the confines of brokerage firms, however, the analysis gets much more difficult. This common understanding does not prove very useful for determining the broker-dealer status of non-customary candidates such as finders.²⁴⁴

Are Private Placement Finders broker-dealers? That question does not provide for a simple answer. While Private Placement Finders’ activities should not fall under the definition of a dealer,²⁴⁵ their activities could fall within the definition of a broker as they arguably are “in the business of effecting transactions in securities for the account of others.”²⁴⁶ The Exchange Act, its regulations, and the courts have not provided a clear definition of exactly what this quoted language means with regards to Private Placement Finders. Private Placement Finders will argue that they are not “effecting transactions in securities for the account of others,” but instead are merely identifying potential purchasers of securities. The actual “effecting” of the transaction (e.g., convincing the purchaser to buy or negotiating the specific terms of the transaction) is left to others.²⁴⁷ The forum in which this argument is largely tested is through no-action letter correspondence with the staff of the SEC.

No-action letters are SEC staff responses to private inquiries for guidance on whether a specific transaction complies with federal securities

238. 15 U.S.C. § 78c(a)(4)(A).

239. 15 U.S.C. § 78c(a)(5).

240. 15 U.S.C. § 78c(a)(5)(C).

241. 15 U.S.C. §§ 78c(a)(5)(A)–(B).

242. There are a number of different types of brokerage firms, including insurance brokerage firms and real estate brokerage firms. All references to brokerage firms in this Article, however, are to securities brokerage firms.

243. Lipton, *supra* note 235, at 899.

244. *Id.* at 899–900.

245. 15 U.S.C. § 78c(a)(5). The definition of dealer focuses on whether a person is effecting securities transactions on behalf of herself, not on behalf of others. *Id.* Since finders serve in the role of middlemen, their activities are on behalf of other parties, which is the focus of the definition of brokers.

246. 15 U.S.C. § 78c(a)(4).

247. Lipton, *supra* note 235, at 927.

law when the laws in question are not entirely clear.²⁴⁸ They are referred to as no-action letters because the inquirer is seeking for the SEC staff to include this typical statement in the letter: “the staff will recommend no action to the Commission” if the transaction is carried out exactly in the manner specified in the letter. Because no-action letters are purely matters between the SEC staff and the party making the request, and because they are limited to the specific facts of the requesting letter, it is risky for other parties to draw general conclusions from these letters.²⁴⁹ Moreover, no-action letters carry little, if any, precedential value²⁵⁰ and are not to be viewed as having the force of law. Courts are not required to follow the rules or analysis set forth in them.²⁵¹ Nevertheless, the no-action letter process can provide valuable insight into the SEC’s views on certain issues and such letters are influential in forming federal securities law.²⁵²

Pursuant to this no-action letter process, a “finder’s exception” from federal broker-dealer registration has developed.²⁵³ In recent no-action letters, the SEC’s staff has provided a relatively detailed framework of how it views whether a party is “engaged in the business of effecting transactions in securities for the account of others,” and is therefore a broker requiring registration.²⁵⁴ The staff has divided the analysis into two parts. First, a person is “effecting transactions in securities” if he or she participates in such transactions “at key points in the chain of distribution.”²⁵⁵ The staff has indicated that such participation includes, among other things, “assisting an issuer to structure prospective securities transactions, helping an issuer to identify potential purchasers of securities, soliciting securities transactions, and participating in the order-taking or order-routing process.”²⁵⁶ Such participation would also include being “involved in negotiations between the issuer and the investor” and

248. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.4[4], at 31 (4th ed. 2002) [hereinafter HAZEN HORNBOOK].

249. HAZEN HORNBOOK, *supra* note 248, at 32.

250. *Id.* at 31.

251. *Id.*

252. *Id.* at 33.

253. *See generally* Polanin, *supra* note 28.

254. *See* Progressive Technology, Inc., SEC No-Action Letter, 2000 WL 1508655, at *5 (Oct. 11, 2000); Oil-N-Gas, Inc., SEC No-Action Letter, 2000 WL 1119244, at *6–7 (June 8, 2000).

255. Progressive Technology, Inc., *supra* note 254, at *5 (quoting *Mass. Fin. Serv., Inc. v. Sec. Investor Prot. Corp.*, 411 F. Supp. 411, 415 (D. Mass. 1976), *aff’d*, 545 F.2d 754 (1st Cir. 1976)).

256. Oil-N-Gas, Inc., *supra* note 254, at *6; *Accord* Progressive Technology, Inc., *supra* note 254.

providing advice regarding the valuation or “merits of the investment.”²⁵⁷ The second part of the analysis is to determine whether the person is “engaged in the business.” For this analysis, the staff has considered, among others things, whether the person received transaction-based compensation, held herself out as a broker (e.g., executes trades or assists others in settling securities transactions)²⁵⁸ or “participat[es] in the securities business with some degree of regularity.”²⁵⁹ A history of past disciplinary actions may also be considered.

In considering how this list of factors applies to Private Placement Finders, the factors can be divided into two basic categories. First, there are the factors that focus on determining whether the finder’s dealings with a customer expose the customer to potential abusive sales practices:²⁶⁰

- Whether the finder plays an active role in the securities transaction, which includes making recommendations, participating in negotiations or assisting with the structure of the transaction,²⁶¹
- Whether the finder receives transaction-based compensation;²⁶² and
- Whether the finder actively seeks investors or solicits securities.²⁶³

Second, there are the factors that attempt to determine whether the finder is an amateur who has accidentally approached the world of securities regulation (and therefore might warrant more leniency), or is a regular participant in the securities industry and, therefore, should be subject to normal regulatory oversight. It is unlikely that the SEC wants the finder’s exception to be used as a “back door” by securities professionals, including past violators, to avoid regulation.²⁶⁴ These factors are:

- Whether the finder holds itself out as a broker or participates in the mechanical execution of the securities transactions (e.g., handling funds or securities involved in a transaction);²⁶⁵ and
- Whether the finder has previously been involved in the sale of securities and/or disciplined for any prior securities related activities.²⁶⁶

257. SEC v. Zubkis, No. 97 Civ 8086 JGK, 2000 WL 218393, at *9 (S.D.N.Y. Feb. 23, 2000); see also THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 136 (Practitioner’s Edition 2000) [hereinafter HAZEN TREATISE]; Lipton, *supra* note 235, at 927–29.

258. Progressive Technology, Inc., *supra* note 254, at *5.

259. Oil-N-Gas, Inc., *supra* note 254, at *6.

260. See Lipton, *supra* note 235, at 927–28.

261. See discussion *infra* Part III.C.1.

262. See discussion *infra* Part III.C.2.

263. See discussion *infra* Part III.C.3.

264. See Hugh H. Makens, *Second Roundtable Discussion: Current Challenges to Smaller Companies Under Disclosure and Corporate Governance Rules—Capital Formation—Making “Finders” Viable*, GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION 27, Sept. 20, 2004, <http://www.sec.gov/info/smallbus/hmakens.pdf>.

265. See discussion *infra* Part III.C.4.

While a number of commentators have suggested that no single factor is determinative in whether or not a finder is acting as a broker,²⁶⁷ several of these factors are clearly more important than others.

1. Plays an Active Role in the Securities Transaction

Making investment recommendations or participating in negotiations surrounding the securities transaction appear to be “practically” dispositive factors. The staff of the SEC has consistently found finders that partake in such activities to require registration as broker-dealers.²⁶⁸ In fact, lack of investment recommendations or participation in negotiations is prominently listed as a factor in numerous no-action letters that have granted the finder’s exception to Private Placement Finders.²⁶⁹

For a period of time, Private Placement Finders appeared to have an ability to participate in negotiations based on a no-action letter issued by the staff to Dominion Resources, Inc. in 1985.²⁷⁰ While the finder in the 1985 Dominion No-Action Letter was not a classic Private Placement Finder,²⁷¹ legal counsel advising a Private Placement Finder that wished to take a more active role in a financing likely took this letter into consideration. In the 1985 Dominion No-Action Letter, the staff of the SEC, without discussion, granted a no-action position to Dominion that its activities would not require it to register as a broker-dealer under section 15(a) of the Exchange Act.²⁷² Dominion was to provide the following financial services to a limited number of tax-exempt corporate and government issuers: (a) analyze the financial needs of the issuers; (b) recommend or design

266. See discussion *infra* Part III.C.5.

267. *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, *supra* note 34, at 975; Virginia K. Kapner, *When Finders Bring Trouble, Avoiding Pitfalls of Working with Unlicensed Broker-Dealers*, 47 *Boston Bus. J.* Jan.-Feb. 2003, 14, 14-15; Lipton, *supra* note 235, at 928.

268. See *Capital Directions, Inc.*, SEC No-Action Letter, 1979 WL 14878, at *3-4 (Jan. 4, 1979); *Mike Bantuveris*, SEC No-Action Letter, 1975 WL 10654, at *3-4 (Oct. 23, 1975); *May-Pac Management Co.*, SEC No-Action Letter, 1973 WL 10806, at *2-3 (Dec. 20, 1973); *Fulham & Co., Inc.*, SEC No-Action Letter, 1972 WL 9129, at *2 (Dec. 20, 1972).

269. See, e.g., *Dana Investment Advisors, Inc.*, SEC No-Action Letter, 1994 WL 718968, at *14-17 (Oct. 12, 1994); *Paul Anka*, SEC No-Action Letter, 1991 WL 176891, at *4-6 (July 24, 1991); *Colonial Equities, Corp.*, SEC No-Action Letter, 1988 WL 234557, at *9-14 (June 28, 1988); *John DiMeno*, SEC No-Action Letter, 1979 WL 13717, at *1-2 (Apr. 1, 1979); *Samuel Black*, SEC No-Action Letter, 1977 WL 14905, at *2-3 (Jan. 20, 1977); *Mona/Kauai*, SEC No-Action Letter, 1974 WL 8804, at *3-5 (Aug. 25, 1974).

270. *Dominion Resources, Inc.*, SEC No-Action Letter, 1985 WL 54428, at *5-7 (Aug. 24, 1985).

271. See *id.* at *1-2.

272. *Id.* at *5-7.

financing methods and securities to fit each issuer's needs; (c) recommend lawyers to prepare the documentation and a broker-dealer to distribute the securities; (d) if the financing so required, introduce the issuer to a commercial bank to act as the initial purchaser of the securities and as a standby purchaser if the securities could not be readily marketed; and (e) make itself available in a consultative role to the issuer, including participating in negotiations and reviewing, but not preparing, the documentation associated with the financing.²⁷³

For these services, Dominion received a negotiated fee that would generally not be payable unless the financing closed.²⁷⁴ In the 1985 Dominion No-Action Letter, the staff characterized Dominion's fee as not being transaction-based.²⁷⁵ Presumably, this characterization by the staff was an oversight based on the fact that Dominion's compensation was not a variable commission. However, Dominion's compensation was contingent upon the successful closing of a financing²⁷⁶ and, therefore, should have been characterized as transaction-based compensation.

In 2000, the staff of the SEC formally revoked the 1985 Dominion No-Action Letter.²⁷⁷ The staff provided little insight into what motivated this highly unusual action, other than stating that "technological advances . . . as well as other developments in the securities markets, have allowed more and different types of persons to become involved in the provision of securities-related services."²⁷⁸ Presumably, the staff was concerned that these new entrants into securities-related services should not be granted the latitude permitted under the 1985 Dominion No-Action Letter. The staff also noted that it had denied no-action requests in situations that were similar to the arrangements described in the 1985 Dominion No-Action Letter.²⁷⁹ The withdrawal of the 1985 Dominion No-Action Letter appears

273. *Id.* at *5-6.

274. *Id.* at *6.

275. *Id.* at *5.

276. *Id.* at *6.

277. Dominion Resources, Inc., SEC No-Action Letter, 2000 WL 669838, at *1-2 (Mar. 7, 2000).

278. *Id.* at *1.

279. *Id.* ("[N]o-action request denied where person would solicit investments in real estate limited partnership interests from investors through their accountants and commercial real estate brokers and would receive a fee if any referred investors purchased those securities.") (describing John R. Wirthlin, SEC No-Action Letter, 1999 WL 34898 (Jan. 19, 1999)); *id.* ("[B]roker-dealer registration required where, among other things, business broker receives transaction fees and participates in negotiations.") (describing Davenport Management, Inc., SEC No-Action Letter, 1993 WL 120436 (Apr. 13, 1993)); *id.* ("[B]roker-dealer registration required where company acts as intermediary in negotiations between Treasury dealers until they reach agreement as to terms of the transaction, and receives a set fee contingent upon

to substantially narrow the permissible conduct of finders who are not registered as broker-dealers.²⁸⁰ Whether the primary motivation for this withdrawal was the very active role of the finder or the transaction-based compensation is not entirely clear. It is possible that either factor alone may have motivated the SEC.

Finally, the SEC staff's view that Private Placement Finders should be restricted to a passive role and not provide advice or assist in negotiations is further illustrated by the string of no-action letters the staff has issued relating to matching services.²⁸¹

2. Transaction-Based Compensation

Another factor that has garnered substantial attention is the compensation structure of the finder. Parties holding themselves out as finders who are compensated based on a transaction-based compensation structure (also referred to as success-based compensation), such as commissions or referral fees that are conditioned on a completed financing, are more likely to be found to be brokers. The concept is that transaction-based compensation could induce the finder to engage in abusive or sharp selling practices based on her stake in the outcome of the transaction, which favors the greater regulatory oversight imposed on registered broker-dealers. In a number of recent no-action letters, the staff of the SEC has explicitly expressed its concern with transaction-based compensation structures. For example, the SEC's June 4, 2002 Denial of No-Action to Herbruck, Alder & Co.²⁸² included the following statement from the staff:

The Division previously has noted that the receipt of compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer. Absent an exemption, an entity that receives securities commissions or other transaction-based compensation in connection with securities-based activities that fall within the definition of "broker" or "dealer" generally is itself required to register as a broker-dealer.

Registration helps to ensure that persons who have a "salesman's stake" in a securities transaction operate in a manner

consummation of the transaction.") (describing C & W Portfolio Management, Inc., SEC No-Action Letter, 1989 WL 258821 (July 20, 1989).

280. See Alan J. Berkeley & Alissa J. Altongy, *Use and Compensation of 'Finders' to Locate Purchasers in Private Placements*, SH013 ALI-ABA 245, 248 (July 18-20, 2002).

281. See discussion *infra* Part III.C.6.

282. Herbruck, Alder & Co., SEC No-Action Letter, 2002 WL 1290291, at *5-6 (June 4, 2002) (footnote omitted).

that is consistent with customer protection standards governing broker-dealers and their associated persons.²⁸³

It should be noted that the Herbruck No-Action Letter, as well as a few other no-action letters in which similar language has appeared, involved a Broker-Dealer Finder as opposed to a Private Placement Finder.²⁸⁴ Whether the staff would treat Private Placement Finders more leniently is not entirely clear.

Regarding Private Placement Finders specifically, the SEC's staff has been unfavorable at times to transaction-based compensation. In the Richard S. Appel No-Action Letter, the staff rejected a Private Placement Finder's request for no-action relief under the finder's exception where the finder was to receive transaction-based compensation.²⁸⁵ In that request, the Private Placement Finder, Richard S. Appel, proposed to act as a finder for investors in an oil and gas drilling corporation. Mr. Appel was to have a very passive role. "He would not advertise or engage in any other similar means of general solicitation in connection with identifying a potential investor."²⁸⁶ Instead, he would "identify potential investors from among business associates or social relationships" and he would contact them to gauge their interest.²⁸⁷ If an investor was interested, Mr. Appel, with the investor's permission, would provide the investor's contact information to the corporation and the corporation would follow up for further discussions and negotiations.²⁸⁸ Mr. Appel "would not engage in any negotiations between the investor and the corporation or make any recommendations to the investors."²⁸⁹ Mr. Appel was to receive a success-based fee of \$5,000 per well plus a 2.5% royalty interest on the proceeds from oil and gas produced by the well if any of his contacts were converted to investors.²⁹⁰ Based on those facts, the SEC was not able to recommend that Mr. Appel was not required to register as a broker-dealer under section 15(b) of the Exchange Act.²⁹¹

283. *Id.*

284. *Id.*; see also 1st Global, Inc., SEC No-Action Letter, 2001 WL 499080, at *14 (May 7, 2001); John R. Wirthlin, SEC No-Action Letter, 1999 WL 34898, at *3 (Jan. 19, 1999) (noting that the finder "would also receive transaction-based compensation, *one of the hallmarks of being a broker-dealer.*") (emphasis added); Birchtree Financial Services, Inc., SEC No-Action Letter, 1998 WL 652137, at *2 (Sept. 22, 1998).

285. Richard S. Appel, SEC No-Action Letter, 1983 WL 30911, at *4-5 (Feb. 14, 1983).

286. *Id.* at *5.

287. *Id.*

288. *Id.*

289. *Id.*

290. *Id.*

291. *Id.*

On other occasions, the staff of the SEC has granted no-action relief to Private Placement Finders where transaction-based compensation was present, but the finder maintained a purely passive role in the securities transactions.²⁹² In one of the more well-known no-action letters involving transaction-based compensation for a Private Placement Finder, singer/songwriter Paul Anka²⁹³ was granted no-action relief even though he was to receive a commission-based fee structure.²⁹⁴ In the Paul Anka No-Action Letter, the Ottawa Senators Hockey Club²⁹⁵ engaged Mr. Anka to find purchasers of limited partnership interests²⁹⁶ in the hockey club. The limited partnership interests were to be sold in the United States and Canada

292. See Dana Investment Advisors, Inc., *supra* note 269, at *14–17; John DiMeno, *supra* note 269, at *1–2; Mona/Kauai, *supra* note 269, at *3–5.

293. Paul Anka, the subject of the letter, is a famous singer/songwriter. Mr. Anka has over 900 songs to his credit, including notably “Put Your Head On My Shoulder,” “Lonely Boy,” “Puppy Love,” “A Steel Guitar And A Glass Of Wine,” “(You’re) Having My Baby,” and “Hold Me ‘Til The Morning Comes.” Mr. Anka has thirty-three top-40 songs to his credit. www.paulanka.com/html/about/index.php.

294. Paul Anka, *supra* note 269, at *4–6.

295. Technically, Mr. Anka was engaged by both The Ottawa Senators Hockey Club Limited Partnership, a limited partnership organized under the laws of the Province of Ontario, Canada, and Terrace Investments Limited, the managing general partner of the Senators. *Id.* at *1.

296. Whether a partnership interest is a security under federal law is determined by conducting a traditional *Howey* analysis of whether the partnership is an investment contract under section 2(a)(1) of the Securities Act. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) (construing Securities Act § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2000 & Supp. 2001)). Under the *Howey* test, “an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party.” *Id.* at 298–99.

With respect to limited partnership interests:

[T]he Uniform Limited Partnership Act requires that, at least to some extent, the investment be a passive one. Any significant degree of control or management in the enterprise may transform the limited partner into a general partner. Accordingly, any time there is a bona fide limited partnership interest, by definition, the investor puts his or her funds at risk depending primarily upon the efforts of others: *i.e.*, the managing partners. It follows that unless the limited partner exercises an unusual amount of control over the business, his or her limited partnership interest will be a security.

Since virtually all limited partnership interests involve the investment of money or some other property and further are geared to the expectation of a profit . . . , the traditional definition of a security is clearly fulfilled.

HAZEN HORNBOOK, *supra* note 248, at 56–57 (footnotes omitted).

If the limited partnership interest is a security, a person who effects transactions in the limited partnership interests would be a broker requiring registration.

in transactions that were exempt from registration. Mr. Anka had a purely passive role in the process.²⁹⁷

- Mr. Anka was to furnish the hockey club with the names and telephone numbers of persons in the United States and Canada with whom he had a bona fide, preexisting relationship who he thought might be interested in purchasing the limited partnership interests.²⁹⁸ Mr. Anka asserted that he reasonably believed each of the potential investors to be accredited investors;²⁹⁹
- Not only was Mr. Anka not to make any recommendations or participate in any negotiations, Mr. Anka was to have no contact at all with any of the potential investors. Instead, only directors, officers or employees of the hockey club would contact potential investors identified by Mr. Anka;³⁰⁰ and,
- Mr. Anka would not participate in the preparation of sales materials, perform any independent analysis of the investment, engage in any due diligence activities on behalf of investors, provide financing for any such purchases, or handle any funds or securities.³⁰¹

In exchange for the names, Mr. Anka was to receive a finder's fee equal to 10% of the sales price for limited partnership interests sold. Mr. Anka was also to receive a 10% finder's fee on any limited partnership interests that he purchased. Finally, Mr. Anka was to receive a 1% fee on all other sales of limited partnership interests made after the date of his engagement as a finder. Mr. Anka's fee structure was to be disclosed to all investors.³⁰²

The major difference between the Paul Anka situation and the Richard Appel situation, other than the celebrity of the finder, is that Mr. Anka was to have absolutely no contact with the potential investors, while Mr. Appel was to make the introductory contact. Notably, in the initial no-action request by Mr. Anka's attorneys,³⁰³ Mr. Anka was to make the initial contact with investors before handing over the relation to the hockey club, which was similar to the Richard Appel scenario. The SEC did not grant Mr. Anka approval under that scenario.³⁰⁴ Although the SEC did not state its reasoning for ultimately granting relief to Mr. Anka,³⁰⁵ but not to Mr. Appel, presumably the SEC was concerned that a finder's willingness to engage in

297. Paul Anka, *supra* note 269, at *5.

298. *Id.* at *5.

299. *Id.*

300. *Id.*

301. *Id.*

302. *Id.* at *6.

303. *Id.* at *1.

304. *See generally id.* at *3-6.

305. *Id.* at *4-6.

abusive or sharp selling practices when transaction-based compensation is present is so strong that the finder must be completely removed from contact with the potential investors.

In addition to the Paul Anka No-Action Letter, there have been a few other no-action letters that have permitted a transaction-based fee structure for a Private Placement Finder, but with substantial restrictions on the activity of the Private Placement Finder.³⁰⁶ Interestingly, these other letters have not been as explicit as the Paul Anka No-Action Letter about prohibiting any contact between the finder and the potential investors. In one letter, the Mona/Kauai No-Action Letter, the finders were permitted to

306. See Dana Investment Advisors, *supra* note 269, John DiMeno, *supra* note 269, and Mona/Kauai, *supra* note 269. In the Dana Investment Advisors No-Action Letter, *supra* note 269, a for-profit subsidiary of a hospital association was to serve as a finder for a private investment fund that was structured as a limited partnership (the “Limited Partnership”). *Id.* at *15. The finder was to disseminate information about the Limited Partnership to members of the hospital association that were eligible to invest in the Limited Partnership and introduce the registered investment advisor for the Limited Partnership to such investors. *Id.* Under the finder’s agreement, the finder was explicitly prohibited from (i) “discussing . . . the advantages or disadvantages of invest[ing]” in the Limited Partnership (or investing generally), (ii) “valuing, advising or recommending any investment, including an investment in” the Limited Partnership, (iii) providing investment analyses, formulas or guidelines, (iv) holding itself out as an investment advisor, (v) describing, recommending or endorsing the services of the investment advisor for the Limited Partnership or (vi) otherwise giving investment advice. *Id.* at *15–16. For its service, the Limited Partnership was to pay the finder a fee of up to 0.07% per annum of Limited Partnership assets. *Id.* at *15. In the John DiMeno No-Action Letter, *supra* note 269, the finder proposed to act on behalf of a spaghetti sauce manufacturer who was seeking “investors in connection with a contemplated expansion of operations to be financed” by a private equity offering “pursuant to Rule 146 [the predecessor for Regulation D] under the Securities Act of 1933.” *Id.* at *1. Mr. DiMeno was to put the spaghetti sauce manufacturer in contact with potential investors who were known to Mr. DiMeno based on his associations. *Id.* at *2. In exchange, Mr. DiMeno was to receive an approximately 5% commission on funds raised from such investors. *Id.* Mr. DiMeno would not (i) be involved in any negotiations with investors, (ii) make any valuations, or (iii) give any advice to prospective lenders relative to the success or failure of the proposed venture. *Id.* Mr. DiMeno had not previously been engaged in any private or public offerings of securities. *Id.* It is unclear from the John DiMeno No-Action Letter whether Mr. DiMeno was permitted to have any meaningful contact with the prospective investors, such as making introductory phone calls or being present to make in-person introductions. In the Mona/Kauai No-Action Letter, *supra* note 269, the staff issued a no-action position despite the finders for the sale of condominium units (coupled with participation in a mandatory limited partnership that operates the rental pool) receiving success-based referral fees equal to between 2% and 3% of the sale price. *Id.* at *3–4. The finders were Hawaii real estate agents who were limited exclusively to referring the names of prospective purchasers to the issuer and notifying the prospective purchasers that they would be contacted by representatives of the issuer. *Id.* at *4. The finders were not authorized to deliver a copy of the prospectus, offer or solicit offers, participate in any manner in the negotiations, or prepare any of the documents required to consummate the transaction under Hawaii state law. *Id.*

contact the potential investors, but only to notify them that they would be contacted by representatives of the issuer.³⁰⁷

It is unclear whether the Paul Anka letter, and the other letters that permitted transaction-based compensation, are consistent with the SEC's current position on transaction-based compensation. With the revocation of the 1985 Dominion No-Action Letter, which may have been partly due to transaction-based compensation, at least one commentator has expressed the belief that the SEC "may also be reconsidering its position in the Paul Anka [No-Action] Letter situation and might not issue such a letter today."³⁰⁸

Finally, flat-fee structures, as opposed to transaction-based fee structures, have been approved by the staff of the SEC on a few occasions.³⁰⁹ In one such letter, the Colonial Equities, Corp. No-Action Letter,³¹⁰ the staff of the SEC granted no-action relief for an arrangement whereby a realty company and a number of independent insurance agencies were to act as finders and identify potential investors of limited partnership interests in real estate partnerships that were syndicated by a registered broker-dealer ("Colonial"). As with other successful no-action letters,³¹¹ the finders' permissible contact with these potential investors was severely restricted.³¹² Specifically, the finders in the Colonial Equities, Corp. No-Action Letter were contractually restricted to identifying clients or contacts who might be potential investors, requesting the client/contact complete an investor profile questionnaire, disclosing to the client/contact the use by Colonial of the elicited information, reviewing the questionnaire for completeness and providing the names of potential investors so screened (together with biographical and general financial information) to Colonial.³¹³ As well, the finders were contractually prohibited from "engaging in brokerage services," "offering any investment advice or recommendations" (or assisting anyone to make an investment decision), or "receiving or handling any securities or funds to be used in connection with

307. *Mona/Kauai*, *supra* note 269, at *1.

308. *Makens*, *supra* note 264, at 25. The quoted language was "[b]ased on [SEC] staff comments at a recent [ABA] Business Law Section meeting." *Id.* at 24–25.

309. *Moore and Schley, Cameron & Co.*, SEC No-Action Letter, 1989 WL 246684, at *8–9 (May 19, 1989) (involving a Broker-Dealer Finder rather than a Private Placement Finder); *Colonial Equities, Corp.*, *supra* note 269, at *13 (involving a Broker-Dealer Finder rather than a Private Placement Finder).

310. *Colonial Equities, Corp.*, *supra* note 269, at *9–14.

311. *See, e.g., Dana Investment Advisors, Inc.*, *supra* note 269, at *14–17; *Paul Anka*, *supra* note 269, at *4–6; *John DiMeno*, *supra* note 269, at *1–2; *Mona/Kauai*, *supra* note 269, at *3–5.

312. *See Colonial Equities, Corp.*, *supra* note 269, at *10–12.

313. *Id.* at *10–11.

the purchase of the limited partnership interests.”³¹⁴ For this service, a finder was to receive a flat screening fee of \$500 for each questionnaire that identified a potential investor, regardless of whether the investor actually invested.³¹⁵ Colonial would then review the questionnaires to determine if any of the potential investors warranted contact.³¹⁶ For those investors that Colonial wished to contact, the finder that provided the questionnaire would arrange an introduction, which would entitle the finder to an additional \$1,000 introduction fee, which was once again not subject to actual investment by the investor.³¹⁷ In the no-action request, Colonial represented that these fees would be fixed and would “not vary in relation to the net brokerage commissions generated from sales to the identified prospects, but may be adjusted upward or downward . . . to take into account Colonial’s cost-benefit analyses of the services provided.”³¹⁸ Colonial also represented that the fixed fees would apply uniformly to all finders at any one time.³¹⁹ Evidencing the importance of the flat fee structure to the staff of the SEC, it did not approve Colonial’s original no-action request,³²⁰ which provided that each finder was to be compensated with a percentage of the net brokerage commissions generated from sales to investors who were referred to Colonial by such finder.³²¹

3. Solicitation of Investors

A third factor for determining whether a finder is a broker that is sometimes mentioned by the staff of the SEC surrounds the means by which the finder contacts potential investors. Namely, is the finder contacting investors with which it has a preexisting relationship or is it soliciting unknown third parties? Actively locating potential investors is generally considered to be an activity within the definition of a broker.³²² As well, actively locating potential investors could be construed as a “general solicitation”, which would cause the issuer to lose its section 5 exemption

314. *Id.* at *11. Colonial also committed to the staff of the SEC that it would monitor the finders’ compliance with these procedures. *Id.*

315. *Id.* at *13.

316. *Id.*

317. *Id.* at *12–13.

318. *Id.* at *13. The adjustment could take place “only once in each twelve-month period, and only on a prospective basis.” *Id.*

319. *Id.* at *13.

320. *See id.* at *1–2.

321. *Id.* at *6.

322. *See HAZEN TREATISE, supra* note 257, at 136; *see also* Lipton, *supra* note 235, at 914.

for the private capital offering.³²³ The staff of the SEC has noted as a favorable element in a few successful no-action letters that the finder was restricting its communication about the potential investment opportunity to investors with whom the finder had a preexisting relationship.³²⁴

4. Holds Itself Out as a Broker

Holding oneself out as a broker has also been cited by the staff of the SEC as a meaningful factor in determining whether the finder's exception is available. Holding oneself out as a broker generally refers to conducting the types of activities that are the hallmark of a traditional securities broker, such as executing trades or assisting others in settling securities transactions. In the matching services no-action letters that are discussed below in Part III.C.6, the staff of the SEC made a point to emphasize in its approval letters that such matching services would be purely passive conduits for investors to locate issuers and such matching services would not partake in any further securities-related services.³²⁵ For example, in the Angel Capital Electronic Network (ACE-Net) No-Action Letter, which was approved by the SEC staff, the matching service represented that it would not (i) "directly assist investors or listing companies with the completion of any transaction," (ii) "handle funds or securities involved in completing a transaction," or (iii) "hold [itself] out as providing any securities-related services other than a listing or matching service."³²⁶

With respect to non-matching service Private Placement Finder no-action letters, the finder specifically represented that it would not be handling any funds in the proposed transactions in a few successful letters.³²⁷ More importantly, handling of funds or otherwise executing the transactions has not been present in any of the successful letters.

323. For example, offerings conducted pursuant to Rules 505 and 506, SEC General Rules and Regulations, Securities Act, 17 C.F.R. §§ 230.505(b), .506(b) (2005), "must" comply with Rule 502(c), *id.* at § 230.502(c), which provides that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation," *id.* Offerings conducted pursuant to Rule 504, *id.* at §230.504, will likely need to comply with Rule 502(c). See generally Sjostrom, *supra* note 120 (discussing the prohibition against general solicitation in offerings that are exempt from section 5 of the Securities Act).

324. See Paul Anka, *supra* note 269, at *5; John DiMeno, *supra* note 269, at *2; *cf.* Dana Investment Advisors, Inc., *supra* note 269, at *15 (presenting a closed-pool of potential investors that were already known to the Private Placement Finder).

325. See discussion *infra* Part III.C.6.

326. Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094, at *8-10 (Oct. 25, 1996).

327. See, e.g., Paul Anka, *supra* note 269, at *5; Colonial Equities, Corp., *supra* note 269, at *11.

5. Previously Involved in Sale of Securities and/or Disciplined for Prior Securities Related Activities

The final major factor for determining whether a finder is a broker examines whether the finder has been previously involved in the sale of securities and/or disciplined for any prior securities related activities. Such previous involvement or disciplinary history increases the likelihood that the finder will be required to register as a broker-dealer.

This final factor attempts to address two separate issues. First, the definition of broker includes the phrase “engaged in the business” of securities transactions.³²⁸ The final factor seeks to determine whether there is sufficient regularity of participation in securities transactions by the finder to qualify that person as being “in the business of” effecting securities transactions. Second, the final factor considers whether past disciplinary problems demonstrate that a finder is not trustworthy of the finder’s exception. It is unlikely that the SEC wants the finder’s exception to be used as a “back door” by past violators to be involved in the securities industry in what amounts to a less regulated manner than if they were registered broker-dealers.³²⁹

Lack of previous involvement in the sale of securities has been cited by the staff of the SEC in a number of no-action letters that granted the finder’s exception.³³⁰ In one telling no-action letter, the staff of the SEC refused to grant no-action relief to a finder whose activities were very similar to those of other finders whose no-action requests were approved, but the finder was formerly a broker-dealer with a history of disciplinary actions.³³¹ Specifically, the finder in the Rodney B. Price No-Action Letter would have been engaged, in connection with an offering of limited partnership interests, to contact broker-dealers who might serve as potential underwriters for a public offering of the limited partnership interests or participate in a private placement of the interests.³³² The finder was also to contact “registered investment advisers, financial planners, accountants, attorneys and other investment advisers to discuss with them [the potential offerings] with the anticipation . . . they would discuss the investments with their clients.”³³³ The finder would not have had the authority to offer or sell

328. 15 U.S.C. § 78c(a)(4)(A) (2000 & Supp. 2001).

329. See Makens, *supra* note 264, at 27.

330. See, e.g., Paul Anka, *supra* note 269, at *5; John DiMeno, *supra* note 269, at *2; cf. Richard S. Appel, *supra* note 285, at *5 (citing lack of previous involvement in the sale of securities as a positive factor, although the request for “no action” was ultimately denied).

331. See Rodney B. Price, SEC No-Action Letter, 1982 WL 30390 (Nov. 11, 1982).

332. *Id.* at *6.

333. *Id.*

any securities and would have had no contact with any actual purchaser or offeree of securities. In addition, the finder's compensation was not based on the sale of the limited partnership interests.³³⁴ While the staff did not explain its refusal, it is logical to infer that the finder's prior activities in the securities industry and particularly his history of disciplinary actions were the primary motivation. Approximately one-third of the staff's refusal letter focused on those issues.³³⁵

In another notable no-action letter, the staff of the SEC determined after a first letter of inquiry that the finder's activities were such that he needed to register as a broker-dealer.³³⁶ After a follow-up letter from the finder's attorney stated that the finder had "not previously been engaged in other private placements wherein he received commissions as a finder or broker,"³³⁷ the staff changed its position and issued a favorable no-action letter.³³⁸

Finally, the SEC brought an action in 1998 against Michael Milken and MC Group³³⁹ for, among other things, failing to register as broker-dealers in violation of section 15(a) of the Exchange Act.³⁴⁰ In the complaint, the SEC alleged that Milken and MC Group (which was directly and indirectly controlled by Milken) engaged in finders activities that amounted to broker-dealer activities.³⁴¹ Specifically, the complaint alleged that MC Group, through Milken and others, "introduced companies, suggested business arrangements between them, participated in negotiations regarding the structure of such transactions and securities issued in connection with these transactions, and received transaction-based compensation in the amount of \$42 million."³⁴² Milken and MC Group consented to settle the action, "without admitting or denying the allegations," and "agreed to pay disgorgement of \$42 million and prejudgment interest of \$5 million."³⁴³ The Milken action is mentioned because at least one commentator has suggested that the SEC "was motivated in part by Milken's violation of the SEC's

334. *Id.* The finder's primary activity was the marketing of energy management systems, for which he was compensated. The finder was seeking to expand the scope of his activities by assisting his clients in obtaining financing for the installation of the systems. Apparently, the finder was not seeking any additional payment for his finder services. *Id.*

335. *Id.* at *5-6.

336. John DiMeno, *supra* note 269.

337. *Id.* at *1.

338. *Id.* at *1-2.

339. SEC v. Michael R. Milken, Litigation Release No. 15654, 66 SEC Docket 1302, 1998 WL 78775 (Feb. 26, 1998).

340. Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o(a) (2000).

341. Milken, *supra* note 339.

342. *Id.*

343. *Id.*

1991 order that disciplined Milken for previous violations of the securities laws.³⁴⁴ In reality, the activities of Milken and MC Group strongly resembled those that the staff of the SEC has consistently found to require broker-dealer registration. Namely, they involved giving advice, participating in negotiations, and receiving transaction-based compensation. As a result, little, if any, inference should be drawn from the Milken/MC Group action regarding the importance of previous involvement in the sale of securities and/or prior disciplinary actions in determining the broker-dealer status of finders.

6. Matching Services

A separate analysis is helpful to understand how the finder's exception specifically applies to the growing number of matching services that have arisen since the mid-1980s. As earlier noted, matching services are typically Internet-based systems that are meant to link entrepreneurs seeking financing with interested investors.³⁴⁵ Just as with finders generally, if a matching service is deemed to be "engaged in the business of effecting transactions in securities for the account of others,"³⁴⁶ it will be required to register as a broker-dealer under section 15(a).

A long series of no-action letters have been issued regarding matching services and their ability to operate without broker-dealer registration.³⁴⁷

344. Makens, *supra* note 264, at 27.

345. See discussion *supra* Part III.A.1.

346. Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4)(A) (2000 & Supp. 2001).

347. See, e.g., Angel Capital Electronic Network, *supra* note 326; Center for Environmental Policy, Economics and Science, SEC No-Action Letter, 1996 WL 29083 (Jan. 26, 1996); Venture Listing Services, SEC No-Action Letter, 1994 WL 326769 (June 15, 1994); Mid-Atlantic Investment Network, SEC No-Action Letter, 1993 WL 173768 (May 18, 1993); Technology Capital Network, Inc., SEC No-Action Letter, 1992 WL 175694 (June 5, 1992); Petroleum Information Corp., SEC No-Action Letter, 1989 WL 246625 (Nov. 28, 1989); Kansas Venture Capital Network, SEC No-Action Letter, 1988 WL 234793 (Aug. 8, 1988); Venture Match of New Jersey, SEC No-Action Letter, 1987 WL 108917 (June 11, 1988); The Board of Directors of Venture Capital Network of New York, Inc., SEC No-Action Letter, 1988 WL 234098 (Feb. 13, 1988); Private Investor Network, SEC No-Action Letter, 1987 WL 108869 (Nov. 2, 1987); Mississippi Research and Development Center and Mississippi Venture, SEC No-Action Letter, 1987 WL 108449 (July 18, 1987); VCN of Texas, SEC No-Action Letter, 1987 WL 108250 (June 18, 1987); Heartland Venture Capital Network, Inc., SEC No-Action Letter, 1987 WL 108286 (June 7, 1987); Wyoming Small Business Development Center, SEC No-Action Letter, 1987 WL 108298 (May 13, 1987); Atlanta Economic Development Corp., SEC No-Action Letter, 1987 WL 107835 (Mar. 19, 1987); University of Arkansas, SEC No-Action Letter, 1986 WL 67539 (Nov. 6, 1986); Investment Contacts Network, SEC No-Action Letter, 1986 WL 67534 (Oct. 8, 1986); Venture Capital Exchange, Inc., SEC No-Action Letter, 1986 WL 66613 (Apr. 23, 1986); The Indiana Institute for New Business Ventures, Inc.,

Broadly stated, the staff has not required matching services to register as broker-dealers so long as the service remains a passive conduit for entrepreneurs and interested investors to find each other.³⁴⁸ The Angel Capital Electronic Network (ACE-Net) No-Action Letter is relatively typical of the no-action letters that have been issued for matching services.³⁴⁹ The staff's conclusion that it would not recommend an enforcement action if the matching service did not register as a broker-dealer under section 15(a) of the Exchange Act was based on ACE-Net's representations that it would not engage in any of the following activities: (a) "provide advice about the merits of particular opportunities or ventures"; (b) "receive compensation from . . . users [of the service] other than nominal, flat fees to cover administrati[on] costs and that such fees will not be made contingent upon the outcome or completion of any securities transaction resulting from a listing on the" service; (c) "participate in any negotiations between investors and listing companies"; (d) "directly assist investors or listing companies with the completion of any transaction" (e.g., "through the provision of closing document[s] or paid referrals to attorneys or other professionals"); (e) "handle funds or securities involved in completing a transaction"; or (f) "hold [itself] out as providing any securities-related services other than [acting as] a listing or matching service."³⁵⁰

ACE-Net further represented that persons affiliated with ACE-Net would not "participate as entrepreneurs or investors in any company listed on the [service], except in compliance with the federal securities laws and unless such participation [was] disclosed to users of the [service]."³⁵¹ Such affiliated persons who serve as entrepreneurs or investors may not discuss any matters with companies listed on the service, "investors, or other persons that might require familiarity with securities or the exercise of judgment concerning securities activities."³⁵² Finally, no transactions or negotiations are to actually take place across ACE-Net's network.³⁵³

SEC No-Action Letter, 1986 WL 65138 (Jan. 10, 1986); Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Nov. 25, 1985).

348. See sources cited *supra* note 347.

349. See Angel Capital Electronic Network, *supra* note 326.

350. *Id.* at *8.

351. *Id.*

352. *Id.*

353. *Id.*

Of particular note, recent no-action requests to operate matching services for a profit (i.e., for fees beyond those required to simply cover administration costs) have been denied by the staff.³⁵⁴

D. Finder's Exception for Associated Persons of an Issuer

In addition to the finder's exception provided for by SEC no-action letters, there also exists an explicit finder's exception that is set forth in Rule 3a4-1 for associated persons of an issuer.³⁵⁵ Rule 3a4-1 provides "a nonexclusive safe harbor from the broker-dealer registration provisions of the [Exchange] Act for certain associated persons of issuers."³⁵⁶ Rule 3a4-1 defines an "associated person of an issuer" as a "partner, officer, director or employee" of the issuer or certain companies affiliated with the issuer.³⁵⁷ Prior to Rule 3a4-1, which was enacted in 1985, questions arose frequently as to the status of officers, directors, or employees who assisted in the sale of their companies' securities.³⁵⁸

In addition to being an associated person of the issuer, for a finder to qualify under Rule 3a4-1 she also must meet three preliminary conditions and any one of three alternative additional conditions.³⁵⁹ The three preliminary conditions are that the associated person:

- Is not subject to a statutory disqualification, as that term is defined in section 3(a)(39) of the Exchange Act³⁶⁰ (which deals with various disciplinary actions and securities regulation abuses that a person may have encountered);³⁶¹

354. See Progressive Technology, Inc., *supra* note 254; Oil-N-Gas, Inc., *supra* note 254. In each case, the staff's denial may have been motivated by factors in addition to the compensation issue. For example, in the Oil-N-Gas No-Action Letter, the staff was troubled by the fact that the service was to actively solicit investors to purchase securities and "provide[] advice to issuers on preparing offering materials for posting to the web site." *Id.* at *7. However, the compensation structure also appeared to trouble the staff. *Id.* at *6-7.

355. General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.3a4-1 (2005).

356. Persons Deemed Not To Be Brokers, Exchange Act Release No. 34-22172, 33 SEC Docket 652 (June 27, 1985).

357. 17 C.F.R. § 240.3a4-1(c)(1).

358. Persons Deemed Not to Be Brokers, *supra* note 356.

359. *Id.*

360. Securities Exchange Act of 1934 § 3(a)(39), 15 U.S.C. § 78c(a)(39) (2000).

361. 17 C.F.R. § 240.3a4-1(a)(1).

- Is not compensated in connection with her participation in the offering with commissions or other transaction-based compensation (either directly or indirectly),³⁶² and
- Is not at the time of her participation in the offering an associated person of a broker or dealer.³⁶³

In addition to these threshold conditions, to qualify under Rule 3a4-1 the finder must also satisfy one of the three following alternative conditions.³⁶⁴

- The first alternative severely restricts the contacts the associated person might make,³⁶⁵ such as by limiting her to dealing only with potential investors that are registered broker-dealers, registered investment companies, insurance companies, banks, or the like.³⁶⁶
- The second alternative generally requires that the associated person primarily perform substantial duties for the issuer other than in connection with securities transactions.³⁶⁷ Agents hired specifically to assist with securities transactions are therefore not covered under the safe harbor. In addition, the associated person must not have been a broker or dealer, or been an associated person of a broker or dealer, within the preceding twelve months,³⁶⁸ and the associated person may

362. 17 C.F.R. § 240.3a4-1(a)(2). Just as with the finder's exception developed through no-action letters, the SEC is concerned that "[c]ompensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection which require application of broker-dealer regulation under the [Exchange] Act." *Persons Deemed Not to Be Brokers*, *supra* note 356.

363. 17 C.F.R. § 240.3a4-1(a)(3). An "associated person of a broker or dealer" is defined as:

any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial and any person who is required under the laws of any State to register as a broker or dealer in that State solely because such person is an issuer of securities or associated person of an issuer of securities shall not be included in the meaning of such term for purposes of this section.

17 C.F.R. § 240.3a4-1(c)(2).

364. 17 C.F.R. § 240.3a4-1(a)(4).

365. 17 C.F.R. § 240.3a4-1(a)(4)(i).

366. 17 C.F.R. § 240.3a4-1(a)(4)(i)(A).

367. 17 C.F.R. § 240.3a4-1(a)(4)(ii)(A).

368. 17 C.F.R. § 240.3a4-1(a)(4)(ii)(B). The concern is that broker-dealers, or recently former broker-dealers, "may have the incentive to solicit former clients and to capitalize on any trust relationship that had been established with those persons in connection with securities transactions." *Persons Deemed Not to Be Brokers*, *supra* note 356.

“not participate in selling an offering of securities for any issuer more than once every twelve months,” subject to certain exceptions.³⁶⁹

- The third alternative restricts the associated person’s participation to “passive” sales efforts,³⁷⁰ such as (i) preparing and delivering written communications about the offering (provided “the content [of these written] communications is approved by a partner, officer or director of the issuer”), but not making any oral solicitations of potential investors,³⁷¹ (ii) responding to unsolicited inquiries by potential investors (“provided the content of such responses [is] limited to [the] information contained in a registration statement filed under the Securities Act of 1933 or other offering document”)³⁷² or (iii) “[p]erforming ministerial and clerical work involved in effecting any transaction.”³⁷³

In total, Rule 3a4-1 is a relatively narrow safe harbor for avoiding broker-dealer registration. Apparently, however, Rule 3a4-1 has lent itself to abuse by less scrupulous companies and finders who hire finders as employees for a short period of time around the time of the offering and who only facially comply with the requirements of Rule 3a4-1. At least one commentator has suggested that Rule 3a4-1 “is probably honored more in violation than in compliance.”³⁷⁴

E. Ramifications of Violating the Finder’s Exception

What we have then, is a relatively complex Private Placement Finder’s exception that can easily be misinterpreted by potential issuers and finders and by inexperienced securities counsel, and an explicit, but oft-violated, codified exception for associated persons of the issuer. Such an environment is ripe for having unregistered broker-dealers participate in sales of securities by early-stage rapid-growth start-ups. A recent roundtable discussion by the Government-Business Forum on Small Business Capital Formation came to the conclusion that “[p]roblems relating to unregistered finders have been particularly prominent in the raising of early stage capital for smaller business[es].”³⁷⁵ Specifically, the author of the report stated:

369. 17 C.F.R. § 240.3a4-1(a)(4)(ii)(C).

370. See 17 C.F.R. § 240.3a4-1(a)(4)(iii); see also *Persons Deemed Not to Be Brokers*, *supra* note 356 (discussing these activities as “passive” sales efforts).

371. 17 C.F.R. § 240.3a4-1(a)(4)(iii)(A).

372. 17 C.F.R. § 240.3a4-1(a)(4)(iii)(B).

373. 17 C.F.R. § 240.3a4-1(a)(4)(iii)(C).

374. William D. Evers, *Finding the Finders*, LOS ANGELES/SAN FRANCISCO DAILY JOURNAL, Nov. 12, 2003.

375. Makens, *supra* note 264, at 3.

I believe that there is a vast “gray market” of unregistered brokerage activity where the funding for these companies, who generally can’t access traditional brokerage firms for underwritings, is often obtained through unregistered financial intermediaries. This opinion is based on discussions with many lawyers, accountants and issuers, as well as my experience with many of these individuals or entities who propose to act as “finders” without broker-dealer registration.³⁷⁶

The participation of such unregistered broker-dealers in start-up financings could have substantial negative consequences to both the Private Placement Finders and the issuers seeking financing. Rather than improving the financing market for rapid-growth start-ups, involvement with these unregistered broker-dealers may substantially worsen a start-up’s situation.

1. Consequences to a Private Placement Finder who is an Unregistered Broker-Dealer

Under federal law, the most obvious consequences to an unregistered broker-dealer stem from section 15(a)(1) of the Exchange Act, which provides that:

It shall be unlawful for any broker or dealer . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered in accordance with [section 15(b) of the Exchange Act³⁷⁷].³⁷⁸

A Private Placement Finder whose activities are deemed to be those of a broker violates section 15(a)(1), which opens the finder up to a number of regulatory responses. For example, the SEC may seek a civil injunction in federal court against unregistered broker-dealers enjoining them from partaking in such activities.³⁷⁹ The SEC may also seek civil monetary penalties³⁸⁰ and issue cease-and-desist orders³⁸¹ against violators of section

376. *Id.*

377. 15 U.S.C. § 78o(b) (2000).

378. Securities Exchange Act of 1934 § 15(a)(1), 15 U.S.C. § 78o(a)(1) (2000).

379. Section 21(d) of the Exchange Act provides the SEC with the power to seek injunctions in federal court against any person that is violating, or is about to violate, the provisions of the Exchange Act, which would include the broker-dealer registration requirements. 15 U.S.C. § 78u(d).

380. Securities Exchange Act of 1934 § 21B, 15 U.S.C. § 78u-2 (2000 & Supp. 2001).

381. Section 21C of the Exchange Act provides the SEC with the power to issue cease-and-desist orders if the SEC “finds, after notice and opportunity for hearing, that any person is

15(a)(1). If the violation is willful, the SEC may also decide to refer the case over to the Justice Department to bring a criminal action against the offending finder.³⁸² Federal law may also provide an issuer that has hired an unregistered broker-dealer with the ability to escape its contractual liability to the finder.³⁸³

violating, has violated, or is about to violate any provision of [the Exchange Act].” 15 U.S.C. §78u-3(a).

382. Section 32(a) of the Exchange Act provides that:

[a]ny person who willfully violates any provision [of the Exchange Act] . . . or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of [the Exchange Act] . . . shall upon conviction be fined not more than \$5,000,000 or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding \$25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

15 U.S.C.A. § 78ff(a) (West 1997 & Supp. 2005).

383. Section 29(b) of the Exchange Act provides in relevant part that every contract made in violation of the Exchange Act (or any rule or regulation thereunder) “shall be void” as regards the rights of the violator. 15 U.S.C. § 78cc(b)(2000). This section has rarely been invoked since its enactment in 1934. Samuel H. Gruenbaum & Marc I. Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 GEO. WASH. L. REV. 1, 1 (1979); see also *Reg’l Props., Inc. v. Fin. & Real Estate Consulting Co.*, 678 F.2d 552, 557 (5th Cir. 1982) (citing Gruenbaum & Steinberg, *supra*). Section 29(b) could potentially be used by the issuer against a finder that turns out to be an unregistered broker-dealer in a number of ways. First, the issuer could use section 29(b) defensively to defend against an action by the finder seeking to enforce its agreement with the issuer. See, e.g., *Couldock & Bohan, Inc. v. Société Generale Sec. Corp.*, 93 F. Supp. 2d 220, 234 (D. Conn. 2000) (holding Société Generale was entitled to rescind its contractual agreement to act as a clearing broker with Couldock & Bohan on the grounds that Couldock & Bohan was an unregistered broker-dealer); see also HAZEN HORNBOOK, *supra* note 248, at 684. Second, the issuer might also be able to use section 29(b) proactively and seek to rescind its contract with the improper finder. While section 29(b) does not provide an explicit private right of action, in *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979), the Supreme Court held that section 215 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-215 (2000), which is nearly identical to section 29(b), supports a private right of action by an advisee to void an investment advisers contract. *Transamerica Mortgage*, 444 U.S. at 24–25. Section 215 provides in relevant part that every contract made in violation of the Investment Advisers Act (or any rule or regulation thereunder) “shall be void” as regards the rights of the violator. 15 U.S.C. § 80b-15(b). Some commentators have concluded that a correlative implied private right of action for rescission must also apply to the innocent party to a contract that triggers section 29(b). See generally Gruenbaum and Steinberg, *supra*; see also HAZEN HORNBOOK, *supra* note 248, at 684. In *Regional Properties*, the Fifth Circuit expressly recognized such an implied private right of rescission under section 29(b). 678 F.2d at 558. Interestingly, *Regional Properties* involved an issuer rescinding its contract with an unregistered broker-dealer. *Id.* at 554–56. Finally, a party seeking relief under section 29(b) may also be entitled to sue for monetary damages, although that issue has yet to be firmly settled. See Gruenbaum and Steinberg, *supra*, at 26; see also HAZEN HORNBOOK, *supra* note 248, at 684–85.

In addition to these federal law consequences, the unregistered broker-dealer may also face substantial state law consequences.

2. Consequences to the Issuer that Uses an Unregistered Broker-Dealer

The consequences to the issuer that uses a Private Placement Finder that should have been registered as a broker-dealer are not as clear. It does not appear that prosecuting issuers who have done nothing more than to employ an unregistered broker-dealer to assist with a capital raising transaction is very high on the SEC priority list.³⁸⁴ Instead, SEC enforcement actions against issuers that have employed unregistered broker-dealer have typically involved additional circumstances that warranted an enforcement action, such as the issuer was involved in a fraudulent scheme or the transaction violated the registration provisions of section 5 of the Securities Act.³⁸⁵ Nevertheless, the SEC should be empowered to take very similar regulatory actions against the issuer as it could against the unregistered broker-dealer. For example, the SEC should be able to seek civil monetary penalties³⁸⁶ or issue a cease-and-desist order³⁸⁷ against the issuer as an aider and abettor of the unregistered broker-dealer's violation of section 15(a)(1) of the Exchange Act.³⁸⁸ If the issuer's violation is willful, the issuer could also be subject to criminal aiding and abetting charges by the Justice Department.³⁸⁹ In each case, it is possible that the SEC or Justice Department could also choose to individually pursue the directors and officers of the issuers that were responsible for hiring the unregistered broker-dealer.

From a private remedy standpoint, the use of an unregistered broker-dealer could trigger anti-fraud or breach of fiduciary duty claims by investors. In addition, a number of states provide investors with a broad right of rescission for securities transactions that involved unregistered broker-dealers.³⁹⁰ A rescission right, if applicable, would allow investors to

384. See *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, *supra* note 34, 997–98; see also Marcia L. MacHarg, Kenneth J. Berman & Rachel H. Graham, *Forever Unregulated? A Primer for Private Fund Sponsors: Part II*, *INSIGHTS*, Nov. 2001, at 1, 13.

385. *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, *supra* note 34, 997–98.

386. Securities Exchange Act of 1934 § 21B(a), 15 U.S.C. § 78u-2(a) (2000).

387. 15 U.S.C. § 78u-3.

388. 15 U.S.C. § 78o(a)(1).

389. 18 U.S.C. § 2 (2000).

390. See Gerald F. Rath, David C. Boch & Timothy P. Burke, *Selected Issues in Broker/Customer Litigation*, SK080 ALI-ABA 207, 238 (Apr. 28–29, 2005).

return the shares purchased in a tainted offering and receive their money back. The presence of a possible rescission right can have a chilling effect on later financing rounds for an issuer. In a typical scenario, the issuer may have unknowingly used an unregistered broker-dealer to assist with an early-stage financing. As the company grows, it seeks later-stage financing from VC funds or may even attempt to conduct an initial public offering (“IPO”). The due diligence investigation by investors and their counsel in these later financings will typically be thorough, and it is highly likely that the involvement of the unregistered broker-dealer will be discovered. From the perspective of the VC funds, who likely have multiple investment opportunities to consider, having a potential rescission action hanging over the company is a very negative factor in deciding whether or not to invest in that company.³⁹¹ In the IPO setting, such possible rescission rights would have to be disclosed in detail in the issuer’s prospectus.³⁹²

F. A Viable Market of Reputable Private Placement Finders has not Developed

To date, a viable market of reputable Private Placement Finders has not developed and the current regulatory treatment of Private Placement Finders appears to be the likely culprit. While anecdotal evidence strongly suggests that a substantial number of issuers desire the services of Private Placement Finders, this demand is not being adequately supplied by reputable parties. For example, some industry commentators have stated that many of the current breed of Private Placement Finders are of dubious reputation.³⁹³ Some of these finders appear to have adverse regulatory histories (or are affiliated with parties with such histories), including having been barred or suspended as broker-dealers or convicted of financial fraud.³⁹⁴ They may take actions that violate federal and state antifraud provisions³⁹⁵ as well as prevent private financings from properly qualifying under an exemption to

391. For a company whose value appears to be increasing at a substantial rate, investors may choose to ignore potential rescission rights based on the rationale that investors would not exercise rescission rights in a security that has increased in value since the date of the investment. As an example, Google Inc. was able to raise substantial VC investments and conduct a \$1.7 billion IPO even though it faced rescission rights due to employee stock offerings that may have been made in violation of section 5 of the Securities Act. 15 U.S.C. § 77e (2000). See GOOGLE INC. 2004 PROSPECTUS 424(b)(3) (Rescission Offer) and GOOGLE INC. 2004 PROSPECTUS 424(b)(4) (IPO).

392. See SEC Registration Statement and Prospectus Provisions, 17 C.F.R. § 229.503(c) (2005).

393. See Makens, *supra* note 264, at 1, 7, 11–12.

394. *Id.* at 1.

395. *Id.* at 7.

section 5 of the Securities Act.³⁹⁶ Moreover, a substantial number of the current breed of Private Placement Finders also appear to be operating outside of the finder's exception and are in fact operating as unregistered broker-dealers.³⁹⁷

Neither the existence of a significant number of disreputable finders nor the presence of a substantial number of unregistered broker-dealers should be surprising given the current regulatory treatment of Private Placement Finders. For reputable parties wishing to serve as Private Placement Finders, they face an uncertain regulatory environment that substantially restricts their compensation arrangements and their ability to provide value-added services beyond their rolodex. And, the consequences for misjudging the limits on their compensation arrangements or their permissible activities carry substantial potential penalties. That does not make for a very attractive operating environment. Because there appears to be substantial demand for the services of Private Placement Finders from issuers, however, it should be expected that any void created by reputable players avoiding the market would simply be filled by less reputable players who are less concerned about complying with securities regulations.

IV. SHOULD ANGELS BE ENCOURAGED TO INVEST IN EARLY-STAGE RAPID-GROWTH START-UPS?

If Private Placement Finders were to begin to act more freely in the private capital setting, it should be expected that early-stage rapid-growth start-ups would be the issuers most likely to engage them, since they are the issuers who face the most serious difficulties in obtaining investment capital.³⁹⁸ As well, since angel investors are the primary source of external financing for these early-stage rapid-growth start-ups,³⁹⁹ they would be the most likely target of Private Placement Finders' finding activities. Such a situation leads to a fundamental question—is it appropriate for government policy to implicitly encourage angel investors (who are largely amateur investors, in particular when latent angels are factored into the equation) to

396. *Id.* at 7. See *supra* notes 114–22 and accompanying text for a discussion of the registration requirements of section 5 of the Securities Act, 15 U.S.C. § 77e (2000), and the most commonly used exemption to avoid the registration requirements. One way for Private Placement Finders to prevent a private financing from qualifying for an exemption to section 5 is to make general solicitations of investors during the offering. See *generally* Sjostrom, *supra* note 120 (discussing the prohibition against general solicitations in most private financing transactions).

397. See *supra* notes 375–76 and accompanying text.

398. See *supra* Part I.C.3.

399. See *supra* Parts I.C.3, I.B.2.

invest in the high-risk world of early-stage rapid-growth start-ups?⁴⁰⁰ Viewed another way—until the mid-1980s, VC funds were primary investors in the early-stage market.⁴⁰¹ Beginning in the mid-1980s, VC funds have largely left the early-stage investment market to focus on the later-stage market.⁴⁰² Is it possible that VC funds left the early-stage market because the returns were not justified by the level of risk and the required screening and monitoring expenditures?⁴⁰³

This Article does not purport to have an answer to that question. In fact, there is a dearth of reliable information regarding the returns for angel investors. There have been only a small number of studies on the performance of angel investments and they do not provide much of a foundation for drawing broad conclusions.⁴⁰⁴ Regardless of the historical returns for angel investors, the concern raised is not one to be taken lightly. While the public good of helping early-stage rapid-growth start-ups to raise needed capital is evident, it should not be accomplished by inappropriately encouraging the less sophisticated angel investors to invest in high-risk investments where they do not properly understand the risks and are not making intelligent investment decisions. Any proposal that anticipates increasing angel investment must take into account this potential exposure to less sophisticated investors and how to cope with it.

V. PROPOSAL TO EXPAND THE PERMISSIBLE ROLE OF PRIVATE PLACEMENT FINDERS

The current approach to Private Placement Finders has developed with almost a singular view towards protecting investors from the potential harm

400. See, e.g., Lerner, *supra* note 37, at 779–81.

401. See *supra* Part I.C.1.

402. *Id.*

403. See Paul A. Gompers, *A Note on Angel Financing*, HARVARD BUSINESS SCHOOL 5 (2001) (on file with author).

404. See, e.g., Mason & Harrison, *supra* note 189, at 211 (analyzing the returns to angel investors “using data on 128 exited investments from a survey of 127 angel investors in the [United Kingdom]”). The study compared these angel returns to those of formal VC funds and the data suggests that:

angels have fewer investments that lose money, a higher proportion of poor or moderately performing investments and a similar proportion of high-performance investments. This is consistent with the view of Benjamin and Margulis . . . that . . . angels are more concerned with avoiding bad investments than “hitting a home run” because of their limited ability to diversify. Nevertheless, . . . angels are capable of generating exceptional gains from their investments.

Id. at 233 (citing GERALD A. BENJAMIN & JOEL MARGULIS, *FINDING YOUR WINGS: HOW TO LOCATE PRIVATE INVESTORS FOR YOUR VENTURE FUND* 221 (1996)).

that could result from interacting with unregulated actors in the securities markets. The overarching theme behind the regulatory approach to Private Placement Finders has been to prohibit their presence (or, more accurately, require broker-dealer registration which appears to render their roles uneconomical) if their activities bear a significant resemblance to those of a traditional securities broker. There are a number of valid rationales for securities regulation.⁴⁰⁵ One of the original rationales, and the one that appears to be behind the current regulation of Private Placement Finders, is the concept that the securities industry needs to be regulated in order to protect the common investor.⁴⁰⁶ Under this rationale, securities law is treated as a form of consumer protection law. Applied to Private Placement Finders, the idea is that investors need to be protected from potential abuses that could flow from unregulated Private Placement Finders' involvement in potential sales of securities. Unfortunately, such an approach is both too narrow in its view of investors and not creative enough in its treatment of Private Placement Finders. Such an approach misses the substantial public good that Private Placement Finders could perform if allowed a more active role in the private capital raising process. Moreover, it is unclear whether the current approach to Private Placement Finders actually shields investors from unscrupulous characters. If anything, the uncertainty that surrounds the current approach appears to encourage questionable actors wishing to act as finders, while discouraging more reputable actors that would be desirable, but hesitate to become involved in an activity that can be second-guessed as inappropriate.⁴⁰⁷

Protecting investors from fraud and misrepresentation are valid goals for regulation.⁴⁰⁸ Where investors are incapable of understanding the risks they face in dealing with certain actors in the securities industry, it is appropriate for regulators to intervene in these dealings. However, investors are not a homogenous group. Different investors have different levels of sophistication, including in their ability to have dealings with Private

405. The most commonly cited rationales for securities regulation are investor protection and enhancing market efficiency. *See, e.g.*, Franklin Allen & Richard Herring, *Banking Regulation versus Securities Market Regulation* 2 (Wharton Fin. Inst. Ctr., Working Paper No. 01-29, 2001).

406. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation* 3-4 (Columbia Law Sch., The Ctr. for Law and Econ. Studies, Working Paper No. 259, 2004). The authors assert that protection of the common investor is an antiquated goal of securities regulation and that attaining efficient markets is the more appropriate goal of securities regulation. *Id.*

407. *See supra* Part III.F.

408. *See* GEORGE J. BENSTON, REGULATING FINANCIAL MARKETS: A CRITIQUE AND SOME PROPOSALS 52 (1999).

Placement Finders. The current approach to Private Placement Finders does not adequately differentiate between which investors might need substantial protection, and which investors likely do not.

The current approach to regulating Private Placement Finders has also lacked creativity. Faced with a party that does not clearly fit in the traditional securities industry scheme, Private Placement Finders have been unceremoniously stuffed into the broker-dealer category. While much of the broker-dealer regulatory system is not truly applicable to the function that Private Placement Finders wish to play, Private Placement Finders that choose to register as broker-dealers are required to bear the full regulatory costs that go along with being a broker-dealer. Based on estimates that the “vast majority” of Private Placement Finders are acting as unregistered broker-dealers,⁴⁰⁹ broker-dealer registration appears to render the finder role uneconomical.

It is possible that the lack of creativity that has gone into regulating Private Placement Finders has been due to regulators not appreciating the substantial public good that Private Placement Finders could perform if allowed a more active role in the private capital raising process. With the growing awareness of the importance of rapid-growth start-ups and the role that Private Placement Finders could play in improving their financing environment, now is an opportune time to consider how to properly regulate Private Placement Finders.

A. Creation of a New Class of Registered Placement Finders

Under the current regulatory system, a potential Private Placement Finder faces two choices that are truly at opposite ends of the spectrum – either (i) take an extremely passive role (and potentially without compensation) or (ii) register as a broker-dealer and have the ability to engage in a wide-array of securities activities, many of which have nothing to do with serving as a finder, and bear the substantial regulatory and cost burden of being a registered broker-dealer. Instead of trying to fit Private Placement Finders into a broker-dealer system that does not adequately accommodate the service that they provide, a new system that fits the needs created by Private Placement Finders should be developed. Private Placement Finders could serve a sufficiently material role in the private capital markets to warrant their own tailored regulatory scheme.

To begin with, this Article proposes that a new system for registering Private Placement Finders as “finders,” rather than broker-dealers, should

409. Makens, *supra* note 264, at 1.

be developed. This proposal envisions a new federal classification of Private Placement Finders whose activities would be exempt from federal broker-dealer registration and its corresponding requirements. In order to minimize the regulatory burden of registration, this Article further proposes that any such federal registration of Private Placement Finders largely preempt state regulation of Private Placement Finders. Such preemption could be akin to the preemption of state law that was instituted to cover many areas of securities regulation under the National Securities Markets Improvement Act of 1996.⁴¹⁰ Namely, this Article proposes that states would be precluded from regulating federally-registered Private Placement Finders beyond permitting states to require notice filings if a Private Placement Finder were to have contact with its residents. That means that states would be required to honor the federally-registered finders and would not be permitted to require their own state broker-dealer or finder registration or impose additional state regulatory requirements on the federally-registered Private Placement Finders. States should be allowed to preserve, however, their ability to bring actions against Private Placement Finders that violate state laws regarding fraud or deceit,⁴¹¹ as there could be a substantial benefit from having additional fraud watchdogs available. Finally, federally-registered Private Placement Finders should be exempted from regulation as investment advisers to the same extent as broker-dealers.⁴¹²

A more tailored registration system provides a number of benefits to either the current broker-dealer registration system or to a system that encourages the growth of Private Placement Finders without any meaningful government oversight. In comparison to the current broker-dealer registration system, a more tailored approach would reduce the

410. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

411. Preserving states' ability to bring regulatory fraud actions could be based on section 18(c)(1) of the Securities Act, 15 U.S.C.A. §77r(c)(1) (West 2001 & Supp. 2005). One aspect of the National Securities Markets Improvement Act of 1996 was to substantially limit the ability of states to regulate federally-registered broker-dealers. *See* 15 U.S.C.A. § 77r(a). Section 18(c)(1) specifically provides, however, that:

the securities commission (or any agency or officer performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

15 U.S.C.A. § 77r(c)(1).

412. *See* section 202(a)(11)(C) of the Investment Advisers Act of 1940, 15 U.S.C. §80b-2(a)(11)(C) (2000), which precludes from the definition of investment adviser, "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." *Id.*

regulatory and cost burden of registration, but should not reduce the effectiveness of the regulatory oversight. A tailored approach would allow the regulation of Private Placement Finders to focus on a more defined purpose (e.g., reducing private capital market problems) without including a multitude of additional (and costly) regulatory requirements that are not relevant to the specific case of Private Placement Finders.

In comparison to a purely market-based system that does not require registration of Private Placement Finders, a tailored registration system provides the benefit of discouraging Private Placement Finders from exacerbating existing, or creating wholly new, market problems. For example, a tailored registration system could:

- Shield the least sophisticated investors;
- Address conflicts of interest that arise in a finder setting;
- Reduce information problems by creating a collective source of useful information for potential investors about Private Placement Finders and private capital investing;
- Reduce the risk of Private Placement Finders causing violations of federal and state securities laws; and
- Provide a mechanism to both reduce and address incidents of fraud.

While this author believes that markets are generally self-correcting organisms and that the preferred approach to most market problems is to allow the market to work the problem out itself, Private Placement Finders operate in a particularly sensitive area of securities regulation. Namely, Private Placement Finders will be expected to locate investors for high risk investments. For a number of reasons, including the intangible nature of securities and the high level of complexity for many types of securities, it is generally accepted that the sale of securities “invites unscrupulous people to attempt to cheat or mislead investors and traders.”⁴¹³ Due to the high-risk nature of rapid-growth start-up investments and the extreme lack of liquidity in such investments, the environment for fraudulent activities by “unscrupulous people” is extremely ripe. An overabundance of fraudulent activities in the angel market would likely cause a chilling effect on rapid-growth start-up investment, as it would worsen, rather than improve, the lemons problem that impacts rapid-growth start-ups.

B. Limit Pool of Potential Investors for Private Placement Finders

One of the most significant concerns about empowering Private Placement Finders under a reduced regulatory regime should be whether

413. HAZEN HORNBOOK, *supra* note 248, at 10.

their presence exposes potential investors in private capital transactions to undue risk of fraud or abuse by the finders. One way to reduce this concern is to regulate the type of investors that could be exposed to the services of Private Placement Finders. More specifically, the regulatory system should restrict the type of investors who could be “found.” If the type of investor that could be found was narrowed to those that are relatively sophisticated and “able to fend for themselves,”⁴¹⁴ concerns about potential nonfeasance and malfeasance by Private Placement Finders should diminish since these more sophisticated investors should be able to protect their own financial interests, at least in part, and therefore require less regulatory protection.

Private capital investors are not a homogenous group. While some may need substantial regulatory protection, many do not. Rather than create a regulatory approach that focuses on the least sophisticated investors, which necessitates the greatest regulatory oversight (and consequently generates the greatest regulatory burden on Private Placement Finders), this Article proposes that Private Placement Finders be restricted to dealing with only those potential investors that are highly sophisticated. How to establish this subset of sophisticated investors can be as creative as one wants to make it. For example, a common approach taken to establishing investor sophistication is to restrict investment opportunities to wealthy investors. A classic example of this approach is the “accredited investor” standard which is most famously employed by Rule 506.⁴¹⁵ Rule 506 is a non-exclusive safe harbor rule adopted under the non-public offering exemption of section 4(2) of the Securities Act.⁴¹⁶ Rule 506 permits sales only to accredited investors and up to thirty-five non-accredited investors.⁴¹⁷ With respect to natural persons, the term “accredited investor” refers to those natural persons who have (i) an individual net worth, or joint net worth including a spouse, in excess of \$1 million at the time of purchase or (ii) individual income in excess of \$200,000 in each of the last two years, or joint income with a spouse in excess of \$300,000 in each of those years, and reasonably expects

414. Quoting the famous terminology from *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). In *Ralston Purina*, the Supreme Court determined for purposes of section 4(2) of the Securities Act, 15 U.S.C. § 77d(2) (2000), which at the time of the case was actually section 77d(1), what constituted a transaction that does not involve any public offering. *Ralston Purina*, 346 U.S. at 120. The Court held that “[a]n offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’” *Id.* at 125.

415. General Rules and Regulations, Securities Act, 17 C.F.R. § 230.506 (2005). The accredited investor standard also applies to 17 C.F.R. §230.505 and section 4(6) of the Securities Act of 1933, 15 U.S.C. § 77d(6) (2000).

416. 15 U.S.C. § 77d(2) (2000).

417. 17 C.F.R. §§ 230.506(b)(2)(i), 230.501(e).

to reach the same income level in the current year.⁴¹⁸ Under Rule 506, all eventual purchasers must be sophisticated.⁴¹⁹ For accredited investors, sophistication is proven by their status as an accredited investor.

The rationale for this treatment of accredited investors is that if they are lacking in investment sophistication, their financial resources are such that (i) they can seek assistance with their investment decisions and (ii) they can bear more risk. Interestingly, the \$1 million net worth threshold and the \$200,000 individual income threshold were established in April 1982⁴²⁰ and the \$300,000 joint income threshold was established in April 1988.⁴²¹ In this author's experience, the thresholds for accredited investor status for natural persons do not necessarily equate to investment sophistication. This may be due in part to the fact that the nominal value of the thresholds has never changed in spite of the effect of inflation. Taking into account inflation, \$1 million in 1982 would be the equivalent of close to \$2 million today and \$200,000 would be the equivalent of close to \$400,000.⁴²² If a financial resources test is employed for establishing which investors can be found, serious thought should be given to setting appropriate financial thresholds and to including an inflation adjustment provision.

At the same time, a financial resources test is really nothing more than a proxy to demonstrate investment sophistication. While the use of a financial resources standard can be a convenient regulatory standard to administer, this author has trouble with the concept that the vast majority of Americans are largely excluded from certain general categories of investments based solely on their annual income and net worth. Even under the inflation eroded \$1 million and \$200,000 thresholds, only a tiny percentage of Americans qualify. It seems wrong to so broadly prejudge the vast majority of the U.S. population as unsophisticated based on arbitrary financial metrics. While the \$1 million, \$200,000 and \$300,000 thresholds do not necessarily equate to investment sophistication, neither does the failure to achieve these thresholds automatically demonstrate a lack of investment

418. 17 C.F.R. § 230.501(a)(5)–(6).

419. For each non-accredited investor, she must, either alone or with a “purchaser representatives, [as defined in 17 C.F.R. § 230.501(h)], have such knowledge and experience in financial and business matters that [s]he is capable of evaluating the merits and risks of the prospective investment.” 17 C.F.R. § 230.506(b)(2)(ii).

420. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 24 SEC Docket 1166 (Mar. 8, 1982) (adopting Regulation D).

421. Regulation D Revisions, Securities Act Release No. 33-6758, 40 SEC Docket 449 (Mar. 3, 1988).

422. Based on an application of the average Consumer Price Index for a given calendar year from 1982 through 2004.

sophistication. A more creative solution could be to allow Private Placement Finders to find investors that have either (i) satisfied a financial resources standard or (ii) who have passed some form of financial acumen test (collectively, these investors will be referred to as “Eligible Investors”). The specifics of such a test are beyond the scope of this Article, but the basic concept would be to allow investors to demonstrate their sophistication in an alternative and empirically verifiable manner. The use of an examination would be preferable to a purely subjective standard for determining sophistication, because for the most reputable Private Placement Finders, it would provide them certainty that such investors are in fact Eligible Investors. There would be no fear of regulatory second-guessing. Regarding less reputable Private Placement Finders who are willing to risk regulatory retribution, the examination would eliminate a grey area that could be exploited by using questionable techniques to determine sophistication in hopes that the regulatory review of such sophistication determinations was weak.

At this point, the sophistication level of the Eligible Investors should be sufficiently increased to justify a less burdensome regulatory approach for Private Placement Finders.

C. Regulation of Private Placement Finders Should be Developed with the Goal of Improving the Efficiency of the Private Capital Markets

Once Private Placement Finders are restricted to dealing with Eligible Investors, the regulatory treatment of Private Placement Finders should be focused on encouraging their ability to reduce market problems in the private capital markets (e.g., reduce information and agency problems and transaction costs), while discouraging their ability to increase existing, or create new, market problems (e.g., commit fraud). By improving the market efficiency of the private capital markets (with a particular focus on the angel market) in such a manner, this approach should improve the allocation of resources that are dedicated to creating and nurturing rapid-growth start-ups, while not exposing less sophisticated investors to undue investing dangers since Private Placement Finders would not be permitted to find them. Private Placement Finders should be regulated in a manner that should increase their utility as financial intermediaries for the private capital markets generally, and the angel finance market specifically. Investor protection remains a critical focus, as confidence in the market is critical to the market’s overall efficiency. It is simply that investor protection is not the only concern.

1. Discouraging Private Placement Finders from Exacerbating Existing, or Creating Wholly New, Market Problems

In the current environment of Wall Street scandals and regulatory actions, it is probably useful to begin the discussion of the tailored regulatory system by focusing on how such a system could be developed in a manner that discourages Private Placement Finders from exacerbating existing, or creating wholly new, market problems. Namely, let us address how to minimize, or avoid, the negatives before getting to the positives of this proposal.

a. Establish a Duty of Suitability for Private Placement Finders

One potential advantage to the current system of encouraging Private Placement Finders to register as broker-dealers is that broker-dealers have “special duties” to their customers.⁴²³ These duties can be wide-ranging and may, in certain instances, include some form of fiduciary relationship between a broker-dealer and its customers.⁴²⁴ One specific duty that exists between a broker-dealer and its customers is the duty of suitability. The duty of suitability requires, in short, that a broker-dealer not make investment recommendations to an investor unless the broker-dealer has “a reasonable basis for believing that the recommendation is suitable for [the investor].”⁴²⁵ This duty does not stem directly from federal statutes or regulations, but instead is imposed by the self-regulatory organizations (i.e., the NASD, NYSE, and AMEX). Specifically, NASD Rule 2310(a)⁴²⁶ provides:

In recommending to a customer the purchase, sale or exchange of any security, a member [broker-dealer] shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.⁴²⁷

423. HAZEN HORNBOOK, *supra* note 248, at 833–34.

424. *Id.* at 828–33.

425. SEC, Suitability, <http://www.sec.gov/answers/suitability.htm> (last visited Sept. 21, 2005) (summarizing NASD Rule 2310 and NYSE Rule 405).

426. While the NASD is a non-governmental organization, broker-dealers fall under the jurisdiction of the NASD because section 15(b)(8) of the Exchange Act, 15 U.S.C. § 78o(b)(8) (2000), mandates that registered broker-dealers also become members of the NASD, subject to the limited exemptions set forth in the General Rules and Regulations of the Securities Exchange Act of 1934, 17 C.F.R. § 240.15b9-1 (2005).

427. NASD, Rule 2310(a) (Aug. 20, 1996), available at <http://nasd.complinet.com/nasd/display/index.html>.

NYSE Rule 405⁴²⁸ and AMEX Rule 411⁴²⁹ have also been interpreted to require some form of suitability requirement on broker-dealers.

This duty of suitability can be divided into two distinct aspects:⁴³⁰ (i) a duty of the broker-dealer to “know its customer,” which requires the broker-dealer to affirmatively collect information⁴³¹ about its customers to support a determination of what types of investment would be appropriate for each customer based on that customer’s other security holdings and financial situation and needs,⁴³² and (ii) a duty of the broker-dealer to “know the security,” which focuses on the specific features of the recommended security and requires that the broker-dealer understand the potential risks and rewards of the investment strategy and how it could impact the investor. Together, this duty is meant to prevent broker-dealers from recommending inappropriate investments to vulnerable investors. For example, it would be unsuitable for a broker-dealer to recommend a highly-speculative investment that includes a substantial risk of principal erosion to an 85-year-old widow with limited retirement funds whose sole means of income is such retirement funds.

Because of the largely amateur investment status of most angel investors and the possibility that Private Placement Finders may engage in sharp sales practices if given a more active role, Private Placement Finders should also

428. NYSE Rule 405 requires that a firm “[u]se due diligence to learn the essential facts relative to every customer [and] every order.” NYSE, Rule 405(1) (Mar. 26, 1970), *available at* <http://rules.nyse.com/nysetools/nyse/help/map/rules-sys513.html>.

429. AMEX Rule 411 requires that a firm “use due diligence to learn the essential facts relative to every customer and to every order or account accepted.” AMEX, Rule 411 (Oct. 3, 2005), *available at* http://wallstreet.cch.com/AMEXtools/PlatformViewer.asp?SelectedNode=chp_1_3&manual=/AMEX/rules/amex-rules/.

430. Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1557 (1999).

431. This affirmative duty is well-established for non-institutional customers. NASD Rule 2310(b) provides that:

Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer’s financial status; (2) the customer’s tax status; (3) the customer’s investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

NASD, Rule 2310(b) (Aug. 20, 1996), *available at* <http://nasd.complinet.com/nasd/display/index.html>.

It is not so clear there is such an affirmative duty for institutional customers. Since angel investors are almost by definition non-institutional customers, this potentially differing treatment between institutional and non-institutional customers is not relevant to this article.

432. *Id.* at 2310(a) and (b).

be subject to a duty of suitability in order to better align their interests with those of the Eligible Investors. Specifically, Private Placement Finders should be prohibited from pursuing an Eligible Investor about a possible investment opportunity unless the Private Placement Finder has a reasonable basis for believing that the investment opportunity is suitable for the investor. In order to demonstrate this “reasonable basis,” a Private Placement Finder should be charged with an affirmative duty to both:

- *Know its potential investors:* Private Placement Finders should be required to affirmatively conduct due diligence on any potential Eligible Investor to determine what types of investments would be appropriate for that particular investor; and
- *Know its securities:* Private Placement Finders should also be required to investigate and understand the specifics of the securities that are the subject of the offering.

b. Mandate a Single, Unified Web-Based Database of all Registered Private Placement Finders

A tailored regulatory regime for Private Placement Finders should also consider mandating a single, unified, web-based database of all registered Private Placement Finders. The purpose of this database would be to provide Eligible Investors with convenient access to useful information about both the specific Private Placement Finder with whom they are dealing and Private Placement Finders and private capital investing generally.

This Private Placement Finders database, which hereinafter will be referred to as “FinderCheck,” could be modeled after the NASD’s BrokerCheck system. Created by the NASD in 1988, the BrokerCheck system “provides investors with an easy, free way to learn about the professional background, business practices, and conduct of NASD-registered firms and their brokers.”⁴³³ BrokerCheck, which contains information on over 660,000 persons that are actively registered to conduct securities business with the public and 5,300 NASD registered firms,⁴³⁴ allows any interested individual to request information about an individual broker or firm for no charge. By visiting the BrokerCheck website⁴³⁵ or calling the BrokerCheck hotline,⁴³⁶ one can request a report that provides

433. NASD, NASD BROKERCHECK 2 (2005), http://www.nasd.com/web/groups/corp_comm/documents/home_page/nasdw-009888.pdf (last visited Sept. 22, 2005) [hereinafter BROKERCHECK BROCHURE].

434. *Id.*

435. www.nasdbrokercheck.com.

436. The toll-free hotline is (800) 289-9999.

very detailed information about an individual broker or firm, including information regarding criminal events, regulatory proceedings, civil judicial and arbitration actions, written investor complaints, revocations or suspensions, bankruptcies and employment terminations.⁴³⁷ BrokerCheck performs an important public notice function for potential broker-dealer customers. This public notice function both helps to inform customers of which brokers may be less scrupulous and also helps to incentivize the behavior of brokers, since they know that customer complaints will be reflected in this public forum.

Overall, a FinderCheck system should be a relatively inexpensive, but effective, way to help to protect Eligible Investors through a public notice function.⁴³⁸ Specifically, a FinderCheck system could be designed to take into consideration the following concepts:

- *Disclose potentially troubling conduct by finders:* Any customer complaints, should be posted to FinderCheck, which should provide a strong incentive for Private Placement Finders to be responsive to potential investors. As well, any other troubling behavior or events that might indicate a potential problem with the Private Placement Finder (such as criminal records, regulatory proceedings, civil judicial and arbitration actions, written investor complaints, revocations or suspensions, bankruptcies, and employment terminations) should also be posted to FinderCheck.
- *Disclose the performance of each investment for which a Private Placement Finder has found Eligible Investors:* One possible concern about the involvement of Private Placement Finders is that their primary loyalty will be to the issuers and not to the Eligible Investors, since it is the issuers that hire the finders. In addition to imposing a duty of suitability, the interests of Private Placement Finders and Eligible Investors could further be aligned by requiring Private Placement Finders to publicly disclose the performance of each investment in which they place investors. The disclosure will help to align these interests by incentivizing a Private Placement Finder to offer successful investment opportunities to Eligible Investors. The concept is to provide useful and empirical information that will help to establish a Private Placement Finder's reputation, which reputation is likely to be critical in its ability to attract clients and generate fees. A Private Placement Finder should be less inclined to accept finding assignments for weak companies, since consistent (and publicly disclosed) negative returns on

437. BROKERCHECK BROCHURE, *supra* note 433, at 4–7.

438. Thought would need to be given regarding who would administer FinderCheck. The SEC would be a logical candidate.

its proposed investments would diminish the Private Placement Finder's reputation and consequently its earning capacity.

- *Disclose risks involved with private capital investments:* As repeatedly noted throughout this Article, many Eligible Investors will not be highly sophisticated investors. As well, questions have been raised whether the risk of early-stage investments in rapid-growth start-ups is justified by the returns.⁴³⁹ The basic cure for such deficiencies under federal securities law is full and fair disclosure. As Louis Brandeis so eloquently put it, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."⁴⁴⁰ The idea would be to provide disclosure on the risks involved with private capital investments (e.g., high risk of business failure, fact that private capital investments are largely illiquid investments) in a forum that is easily accessible by private capital investors.⁴⁴¹

The result should be a FinderCheck system that helps to reduce informational problems that would otherwise arise regarding Private Placement Finders. When Eligible Investors ponder whether the Private Placement Finder with whom they are speaking is a reputable person or whether they should be considering private equity investments at all, FinderCheck should provide useful tools to allow the Eligible Investors to make more informed decisions. Regarding the trustworthiness/track record of the Private Placement Finder, FinderCheck would help to alleviate a collective action problem⁴⁴² that would otherwise discourage the optimal level of information gathering due to the inherent lack of coordination and

439. See *supra* Part IV.

440. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Augustus M. Kelly 1971) (1914).

441. Because this disclosure would be aimed primarily at less sophisticated Eligible Investors, it is crucial that the disclosure be clear and concise. New disclosure requirements often focus primarily on producing large volumes of raw data rather than providing easily digestible information. See Joseph Bartlett, *Sarbanes-Oxley: Too Much Disclosure?*, VC EXPERTS, Dec. 10, 2002, <http://vcexperts.com> (examining the issue of too much disclosure) (subscription required) (article on file with author). In the article, Joseph Bartlett ponders whether new disclosure requirements are motivating companies to produce so much disclosure that it becomes virtually "unreadable to anybody other than a financial professional." *Id.* To illustrate his point, Mr. Bartlett discussed a recent public disclosure filing by AT&T in connection with the merger of AT&T Broadband with Comcast which was 800 pages long. *Id.* See also Orcutt, *supra* note 133, at 74–76 (arguing that the new disclosure requirements related to research analysts are likely to produce information that will be largely incomprehensible to retail investors).

442. See *supra* notes 127–30 and accompanying text for a discussion of the "collective action problem" phenomenon.

cooperation between individual investors.⁴⁴³ Individual investors are unlikely to dedicate adequate resources to obtain detailed information regarding a Private Placement Finder's trustworthiness or track record because it would be very costly. Because information has a public good quality,⁴⁴⁴ it would be very difficult for an individual investor to reap the full benefit from substantial expenditures in such an endeavor due to the inherent problem with free riders, which discourages the effort. FinderCheck would eliminate this collective action problem by providing such information in a collective manner.

c. Affirmative Duty to Disclose by Issuers that Employ Private Placement Finders

An additional safeguard for potential investors could be implemented by placing a portion of the regulatory burden on the issuer itself.⁴⁴⁵ Specifically, any issuer who obtains an investor by way of a Private Placement Finder should be required to promptly notify the investor of the existence of FinderCheck and that the investor should refer to FinderCheck for information about (i) the specific Private Placement Finder with whom she is dealing and (ii) Private Placement Finders and private capital investing generally. Such disclosure by the issuer should increase any informational benefits that would be derived from FinderCheck as it should increase the likelihood that investors will use FinderCheck as a meaningful source of information. If not widely used, the value of FinderCheck would be greatly diminished.

d. Qualification and Follow-up Examinations

Thought should also be given to requiring would-be Private Placement Finders to pass a qualification examination as part of their registration process. The qualification exam should be designed with the following purposes in mind:

443. Professor Choi conducted a similar analysis regarding securities investors generally. Choi, *supra* note 138, at 45–46.

444. In economic theory, public goods are distinguished from ordinary goods or services based on a few peculiar characteristics: (1) the cost of providing the good does not depend on the number of persons who benefit from it; (2) consumption of the good by one person does not interfere with its consumption by another person; and (3) it is generally not possible to exclude persons who have not paid for the good from enjoying its benefits (i.e., free riders).

445. Such an approach could be similar to the quasi-requirement placed on issuers in a Regulation D financing to disclose to investors that the shares being purchased are "restricted" securities. 17 C.F.R. § 230.502(d) (2005).

- Ensuring that registered Private Placement Finders have a fundamental understanding of federal and state securities regulation. Missteps by a finder can cause an issuer to violate a number of different securities laws, including anti-fraud provisions (e.g., material misstatements or fraud by the Private Placement Finder could be attributed to the issuer) and the registration requirements of section 5 of the Securities Act (e.g., a general solicitation by the Private Placement Finder would likely cause the issuer to lose its section 5 exemption).
- Ensuring that registered Private Placement Finders have sufficient financial and investment sophistication to be able to meaningfully comply with their duty of suitability.⁴⁴⁶

In addition to the qualification examination, it might be useful to require Private Placement Finders to take follow-up examinations periodically to ensure that they are keeping up on relevant changes in securities law and remain competent to fulfill their suitability obligation.

e. Remaining Regulatory Requirements Should be Minimal

At this point, the tailored regulatory approach should have helped (i) to filter out the more vulnerable potential investors or provided them with sufficient information to help them to overcome their lack of investment sophistication, (ii) to filter out inappropriate potential Private Placement Finders, and (iii) to better align the interests of Private Placement Finders and Eligible Investors. As a result, any remaining regulatory requirements for Private Placement Finders should be minimal. In developing this tailored approach, it is important not to implement so many regulatory requirements that the cost of compliance to Private Placement Finders is so burdensome that serving as a finder is uneconomical (just as it is now under the broker-dealer regime) thereby eliminating the potential benefit that can be generated by Private Placement Finders.

2. Permitted Activities for Private Placement Finders –
Encouraging Private Placement Finders to Reduce Market
Problems

Now that the safeguards have been addressed, the scope of the permissible activities for Private Placement Finders should be guided by their ability to reduce market problems in the private capital markets, with a particular focus on the angel market since it will likely be where they concentrate their efforts. Based on such a principle, and taking into account

446. See discussion, *supra* Part V.C.1.a.

the structural protections discussed *supra* in Part V.B and V.C.1 (the “Structural Protections”), these Private Placement Finders should be permitted to undertake a much broader range of activities than is currently allowed. If allowed a more active role, Private Placement Finders could potentially reduce a number of the market problems that plague the angel market. Specifically, active Private Placement Finders should be able to reduce the transaction costs for issuers and angels to find each other, to perform a meaningful screening function for angel investors and to serve as a meaningful supplier of information for both issuers and angels.

a. Permit Transaction-Based Compensation

The most obvious benefit of empowering Private Placement Finders is that it will make it easier and less expensive for issuers and angels to find each other. As earlier noted, angels’ general desire for anonymity coupled with federal securities law prohibitions against general advertising and general solicitation in private capital offerings impose very substantial impediments to issuers locating angel investors. At the same time, angels have difficulties themselves obtaining appropriate deal flow opportunities.

Private Placement Finders, as professional participants in the angel market, could bridge the gap between issuers who cannot find investors and angels that cannot find investment opportunities. In theory, Private Placement Finders can currently serve in such a role. The problem is that under the current regulatory regime, it is difficult to compensate the Private Placement Finders without running the risk of rendering them broker-dealers. For a meaningful, professional industry of Private Placement Finders to develop, they must be adequately compensated. Since the reason that the entrepreneurs are seeking outside equity financing is generally because they are lacking funds, the regulation of Private Placement Finders must allow for flexibility in payment, including allowing the payment to be based on successful completion of a financing. Private Placement Finders should be permitted to collect transaction-based compensation.

b. Perform Screening Function for Angels

One could easily argue that the problem with issuers and angels being able to find each other already has been largely resolved with the creation of the various electronic matching services, such as Active Capital (formerly known as ACE-Net).⁴⁴⁷ In theory, these matching services are a wonderful idea. Issuers can electronically post their business plans and financing needs, and interested angels can peruse the database for interesting

447. See discussion, *supra* Part III.C.6.

companies in which to invest. Unfortunately, these databases have not met with huge success and appear to be largely underutilized services.⁴⁴⁸

This author believes such an outcome should have been expected because these matching services all offer a very incomplete solution to the angel market's problems. Such services do little more than provide unfettered deal flow to angels. They do not serve any meaningful screening function. While a purely passive matching service should marginally reduce the transaction costs for angels to locate potential issuers, it does nothing to address the lemons problem. What is needed is a player to certify the information that is provided by the issuer to potential investors, so that potential investors can determine whether it is worth their time to conduct further investigation of the company for the purpose of a potential investment. As a result, this Article suggests that rather than constrain the role of Private Placement Finders, their role should be expanded to allow them to serve as an effective screening mechanism of start-up companies seeking capital. Such an intermediary role should improve the efficiency of the angel market, as it would allow angel investors to concentrate their information gathering and assessment resources on deals that have already met some minimum level of investment worthiness.

How Private Placement Finders would serve as such "certifiers" is worthy of discussion. One possibility would be to allow Private Placement Finders to conduct due diligence on issuers and issue some kind of due diligence report. As a repeat player in the angel financing process, Private Placement Finders could also help to establish best practices for the due diligence process. If Private Placement Finders were allowed to conduct due diligence, serious thought would need to be given to: (i) who could receive the results of the Private Placement Finder's due diligence (e.g., only the issuer, or also potential investors)?; (ii) if potential investors are allowed to receive the results of the due diligence, what would be the permissible form of communicating those results (e.g., could the Private Placement Finder issue a formal report)?; and (iii) what level of liability would apply to a Private Placement Finder for its due diligence? Even if a Private Placement Finder's role is limited to conducting a due diligence investigation that is reportable only to the issuer, the fact that a knowledgeable party is helping in the process should be beneficial.

c. Participate in Negotiations and Document Preparation

The current lack of repeat players in the angel finance market also supports allowing Private Placement Finders to participate in negotiations

448. See SANDLER, *supra* note 8, at 472–75.

and to assist with the preparation of financing documentation. Often, neither the entrepreneur nor the angels in a given angel financing will be truly experienced private equity financiers. As a result, both the negotiation and documentation process are likely to be more time consuming and costly, and less likely to achieve optimal results, as the involved parties do not necessarily know what they are doing. Each financing becomes a learning process for the involved parties, rather than a meaningful discussion among informed and experienced persons. Inserting a repeat player into this process should help to promote best practices and more reasonable terms and reduce the cost of negotiations. While lawyers working on these early-stage financings could, in theory, serve this role, it does not appear to be occurring.

D. Addressing Conflict of Interest Concerns

Transaction-based compensation, serving as an active deal screener and participating in the negotiations and document preparation for deals would all raise substantial “conflict of interest” concerns for Private Placement Finders. Admittedly, this is a real risk. However, such a risk should be substantially mitigated by the Structural Protections. First, the Structural Protections should filter out the more vulnerable potential investors or provide them with sufficient information to help them to overcome their lack of investment sophistication. Any “found” Eligible Investors who eventually invest should have a level of sophistication and available information that allow them to de-bias inappropriate sales efforts employed by a Private Placement Finder.

Second, the Structural Protections attempt to better align the interests of Private Placement Finders and Eligible Investors. The suitability duty would impose a specific duty on the Private Placement Finders to take into consideration the interests of Eligible Investors. In addition, the proposed disclosure requirements under FinderCheck would be aimed largely at providing empirical data that would help to establish the reputations of Private Placement Finders (e.g., disclosure of investment performance and potentially troubling conduct). As Private Placement Finders become more established in the market, their good reputations should become critical to their ability to attract clients and earn fees.⁴⁴⁹ A Private Placement Finder’s honesty and reliability should be one of its most important assets. As such,

449. See *supra* note 132 and accompanying text for a discussion of the importance of reputation to an investment bank’s ability to serve as an underwriter for public securities offerings and thereby earn underwriting fees.

Private Placement Finders should be expected to work hard to preserve their reputations, which would include not cheating or otherwise abusing Eligible Investors. So long as the present value of their future income stream with a good reputation is greater than the adjusted income stream with a reduced reputation plus the one-time benefit from cheating/abusing, Private Placement Finders will be strongly incentivized to act appropriately with Eligible Investors.

VI. CONCLUSION AND QUALIFICATIONS

This Article has attempted to provide a principled approach to the regulation of Private Placement Finders. Namely, if Private Placement Finders are limited to finding investors who are able to fend for themselves and do not need substantial protection from regulators, then the regulation of Private Placement Finders should be guided based on a goal of improving the efficiency of the private capital markets. By improving the efficiency of the private capital markets (with a particular focus on the angel market), this approach should improve the allocation of resources that are dedicated to creating and nurturing rapid-growth start-ups. Although investor protection remains a critical focus, it is simply not the only concern. Investor protection may even be improved, since a more efficient market will benefit investors generally with more accurate securities pricing and lower transaction costs.

This Article's proposal to create a new class of registered Private Placement Finders and encourage their development as meaningful intermediaries in a multi-billion dollar per year financing market should close with qualifications. As careful as this author has tried to be at coping with each of the moving parts that is impacted by this proposal, there are bound to be unexpected outcomes. This author's biggest concern involves the initial formation of the Private Placement Finders. Where will they come from? How long will it take them to develop expertise in the angel finance market? Much of this Article's proposal of empowering Private Placement Finders as intermediaries in the angel finance market is based on their eventual status as professionals and repeat-players in the market, where their reputations will be critical to their ability to generate fees. Such a setting, however, will take years to develop.

Another substantial concern involves the monitoring mechanisms for the angel market. While this Article's proposal could substantially improve the information and transaction cost problems that plague the angel market, it is not likely to substantially improve the angel market's weak monitoring systems. The primary impact of Private Placement Finders would be at the

preinvestment stage. One possible, and troubling, outcome from this proposal could be for Private Placement Finders to convert currently latent angel investors to active investors by prescreening deals and reducing the transaction costs for investing, but only to lead these virgin angel investors to companies that struggle due to a lack of monitoring. During any phase-in period for Private Placement Finders, substantial attention should be given to whether proper monitoring mechanisms are being developed throughout the angel market. If monitoring mechanisms are not adequately developing, thought should be given to even further increasing the investment sophistication level of potential investors that Private Placement Finders are permitted to find. In that manner, found investors would be more likely capable of conducting their own monitoring.

This author freely admits to his discomfort about the transition period for an empowered class of Private Placement Finders, which will likely require a good deal of patience. The final outcome, a more efficient financing market for early-stage rapid-growth start-ups, however, should be worth the pain of the transition.
