Smaller Businesses

Finders Keepers

The SEC is hearing new demands to make it easier for small companies to raise capital.

Ronald Fink - CFO Magazine
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It's no secret that small businesses have an especially hard time raising capital. But risk-averse banks and investors don't deserve all, or perhaps even most, of the blame, according to some observers. The real culprit, they charge, is federal regulation — in particular, a 70-year-old rule that bars companies from hiring unregistered intermediaries, or "finders," to help them raise money.

The rule, part of the Securities Exchange Act of 1934, was obviously designed to keep middlemen from engaging in securities fraud and other unsavory financial activities (see "Under the Radar," at the end of this article). But critics believe the rule has outlived its usefulness. One is Bill Evers, a retired attorney in San Francisco who is trying to start a chain of weight-management clinics but is unsure where to turn for financing. Evers complains that traditional sources for start-ups, such as venture capitalists, are now more interested in providing second- or even third-round financing, or in refinancing better-established but struggling companies.

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Meanwhile, says Evers, small, federally registered broker-dealers that might once have provided capital have either gone under or merged into larger investment banks that don't consider start-ups worth their time. "The system starves start-ups," he insists. While Evers says legitimate but unregistered finders are common, he complains that the rules make them publicity-shy. As a result, he says, "small-business guys can't find the finders."

Support for Evers's views comes from the CEO Council, a group representing some 200 senior executives of public companies whose stocks trade in the over-the-counter market and 150 broker-dealers that back their deals and execute their transactions. In recommendations recently delivered to the Securities and Exchange Commission, the council noted that "a major difficulty facing small business is obtaining equity capital," and that the current regulatory environment, including registration rules for broker-dealers, "unfairly restricts capital formation for small businesses."

Such groups have sought relief from the SEC for years, most recently at a forum on small-business capital formation that the commission held last September. But so far, their demands have fallen on deaf ears. Brian Bussey, assistant chief counsel for the SEC's division of market regulation, told the forum that "the possibility of lesser regulation...is a massive undertaking," and indicated that the commission has yet to receive hard evidence of how companies are being hurt by its broker-dealer registration rules.

A License to Deal

Now, however, the SEC is facing new pressure to reconsider its stance. A task force of the American Bar Association (ABA) has been studying the issue since 2002, and is expected to offer its recommendations to the SEC around the time of the ABA's spring meeting next month. Although details weren't available as this article went to press, experts familiar with the task force's deliberations expect it to recommend that the SEC ease its registration requirements under certain circumstances.

"It is time to seek out a way to permit the capable, honest financial intermediaries who are not presently registered to find a means to attain compliance," stated Hugh Makens, a former securities commissioner for the state of Michigan and a partner in law firm Warner Norcross & Judd LLP in Grand Rapids, in a report he presented at the SEC forum.

Under federal securities law, anyone can become a broker-dealer of securities by obtaining a license from the National Association of Securities Dealers (NASD) and registering with the SEC and state authorities. But because of rising costs and competition, the industry is now dominated by large

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investment banks.

At the minimum, Makens contends, the commission should ease the registration requirements for finders that limit their services to asset sales. "A significant number of M&A transactions [use] unregistered finders who receive transaction-based compensation," he noted in his report. Yet Makens says many of the deals are legitimate and that more would take place if finders didn't have to obtain a Series 7 license, as NASD and the SEC require, for purposes of promoting stocks. "These finders act more like business brokers" than dealers in securities, he observes.

Makens contends the test involved is essentially irrelevant to M&A transactions. Not to mention time-consuming and costly: the Series 7 exam lasts six hours and typically requires months of preparation. Also, an examinee must be sponsored by a member firm of the NASD.

Take Money, Run

But as Bussey makes clear, the SEC is unconvinced that its registration rules are overly onerous and thus hinder capital formation. Of course, the SEC's priority is to protect investors from fraud, but while it's also required by law to consider the interests of companies, the latter, too, are often victimized by unregistered brokers.

The SEC isn't alone in its defense of registering broker-dealers. In line with the 1934 act, state laws generally prohibit finders that aren't registered with the SEC from accepting payment for transactions. "It's not that difficult to find a broker-dealer willing to raise capital for small business," insists Joe Borg, director of the Alabama Securities Commission and chairman of the enforcement section of the North American Securities Administrators Association. "A lot of issuers don't want to go to the trouble of finding a licensed finder," he adds.

But he warns that they're taking a big risk in not doing so, since deals arranged by such finders can run afoul of regulators, sending companies in need of capital back to square one. Nonetheless, says Borg, "a lot of issuers want to get the money in a hurry, and worry about the problem later."

Also, lawyers who specialize in this area report that companies often pay unregistered brokers big upfront fees only to see the brokers abscond. Steven Hecht, a partner in the Roseland, New Jersey, law firm of Lowenstein Sandler PC, says he is litigating a number of cases on behalf of small companies seeking to recover at least some of the money they've lost in this fashion. Hecht declines to identify any of these clients by name, but explains that in one case, a finder who claimed to be helping his client actually used his position to drive down the price of the company's stock in hopes of taking over control. "Unfortunately," says the attorney, "you get what you pay for."

Despite the SEC critics' arguments, Hecht and other attorneys believe that the regulators should not bow to pressure for easier registration requirements. He notes that broker-dealer registration "goes hand in hand with corporate governance" and that the SEC cannot relent on such issues in light of the widespread fraud revealed in the wake of the failure of Enron and other companies. "They're still trying to reinstill confidence in the public markets," says Hecht.

The Singing Rolodex

What's more, the SEC has already made exceptions to registration possible through a number of "no-action" letters. The most widely cited letter involved the singer Paul Anka, whom the SEC allowed in 1991 to receive payment in return for introducing the general partner of the Ottawa Senators hockey team to several acquaintances who became limited partners in the franchise. Essentially, the SEC ruled that Anka's payment complied with the 1934 act so long as he confined his involvement to the introduction and didn't make a practice of such activities. "He was able to sell his Rolodex once," explains Bruce MacKenzie, a partner in the Minneapolis office of Dorsey & Whitney LLP.

Makens contends that the exception the SEC made for Anka is far too narrow to address the needs of small businesses. But recent actions by the SEC suggest that it's trying to narrow its scope even further. In 2000, the commission withdrew a no-action letter that it had issued to Dominion Resources 15 years earlier allowing the utility to arrange a wide array of securities transactions without registering as a broker-dealer. (That makes it more onerous for CFOs to cut out the middleman by issuing securities themselves.)

Also, as a result of Sarbanes-Oxley, the SEC has amended its auditor-independence rules to include a specific prohibition against certified public accounting firms acting as promoters or underwriters of an audit client's securities, whether or not the CPA firm was registered as a broker-dealer.

In light of all this, MacKenzie predicts that lobbying efforts to get the SEC to loosen its registration rules will amount to "an uphill battle." And even if the SEC or lawmakers were inclined to change course, either would most likely run into stiff resistance from a lobby more influential than the CEO Council — the NASD polices broker-dealers for the SEC. As a government-sanctioned monopoly, observers say, the NASD would surely oppose any move to ease registration requirements, since that would invite smaller, less-well-capitalized brokers into the business, threatening its members' market share and profit margins. "Why would the NASD welcome the competition?" wonders attorney Hecht.

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For that reason, Bill Evers says that the federal regulatory regime needs fundamental reform to benefit start-ups. "We need a small-business alternative to the NASD," he insists.

But he isn't counting on one in time to help get his weight-management clinics off the ground.

Ronald Fink is a deputy editor of CFO.

Under the Radar

Just how many unregistered finders try to fly under the regulatory radar is anyone's guess. But the Securities and Exchange Commission can cite plenty of fraud cases in support of its current regulatory requirements for broker-dealers. One recent case involved Vector Medical Technologies Inc., a biotech company based in Boca Raton, Florida. The commission sued several of Vector's stock promoters in late 2001 on charges of defrauding 450 investors — primarily individual physicians from around the country — of roughly $16 million in 1999 and 2000. The SEC claimed that Michael H. Salit, Vector's chairman and CEO, along with other individuals, sold the investors stock in the company based on false claims that their capital would help Vector market a "breakthrough" transdermal patch it had developed that was capable of delivering insulin and similar drugs.

Since neither Salit nor any of the other individuals named in the complaint were registered broker-dealers, the SEC argued that they acted as illegal finders when they pocketed hefty commissions from the money they raised instead of using it as promised. A federal district court in Florida agreed in October 2004, barring Salit from ever again serving as an officer or director of a publicly held company, and all of the defendants from participating in penny-stock offerings.

The SEC may see the Vector case as one more reason not to loosen its registration rules. But representatives of small business contend the commission should draw the opposite conclusion. These critics argue that a looser regime would help the SEC oversee activity that is now widespread but unregulated. The current rules, they say, have the unintended effect of discouraging scrupulous brokers from registering, leaving more of the field to those inclined toward fraud.

Meanwhile, the potential abuse of investors by unregistered finders is by no means limited to the promotion or sale of securities. Consider the case of Frank E. Walsh Jr., former lead director and compensation-committee chairman of Tyco International Inc. Walsh received a $20 million finder's fee for recommending that Tyco acquire financial-services firm CIT Group, and for arranging an initial meeting between the companies' CEOs. Within a year of buying CIT for $9.2 billion in June 2001, however, a series of corporate-governance scandals rocked Tyco, forcing it to unload CIT for less than half of the purchase price.

In this case, however, the SEC went after the payment to Walsh not because he wasn't registered as a broker-dealer, but because the fee wasn't publicly disclosed, and the SEC considered it a material event. Walsh settled with the SEC in December 2002 by agreeing to disgorge the $20 million and never again serve as an officer or director of a publicly held company. —*R.F.*

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