Fundraise with care

The pitfalls of hiring intermediaries to find additional investment

INTERVIEWED BY JAYNE GEST

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When companies start running out of capital and executives are pulled in a million different directions, they often look to an outside party — a person who is well-connected but is not a licensed broker/dealer — to support the fundraising. The two parties may come to an arrangement where he or she will make introductions, help secure additional investment and only be paid a commission if the financing round successfully closes.

The problem is, this scenario is illegal under the rules of Securities and Exchange Commission (SEC). And the excuse — everyone else is doing it — will not work if you are caught, says Sara M. Antol, shareholder at Babst Calland.

"When it comes to broker-dealer territory, many times businesses do not realize how strict the current regulatory environment is, or how extreme the consequences can be when you violate the law," she says.

Smart Business spoke with Antol and Christian A. Farmakis, shareholder and chairman of the board at Babst Calland, about fundraising compensation.

How common are these arrangements?

Raising money is difficult — it takes time and can be frustrating. Because fundraising is relationship-driven, it is easy to want to bring in a well-connected person in some capacity. And if a company is on a tight budget, it may seem logical to just pay someone if they have success. However, only registered broker-dealers are allowed to engage in this type of activity. And, it is illegal for persons who have not undergone the steps to be registered to act as brokers.

What is permissible?

A company can work with a finder as a consultant, hired under certain narrowly defined conditions. The company must pay a flat or monthly fee that might include helping the organization develop investment materials and making introductions, without negotiating or aiding in the investment's completion. The compensation cannot be tied to fundraising success.

The other option is to work with a registered broker-dealer. Plenty of firms do this, but it will come at a cost.

How should companies handle these situations with their own employees?

Businesses cannot make someone's employment or compensation contingent upon raising capital. For example, a CFO who gets equity or a bonus if he or she is successful at fundraising is not allowed. A salesperson paid on commission for finding investors is also not permitted.

Raising capital can be part of an employee's duties, but it cannot be their sole job function, and they cannot get compensated directly for bringing in investors.

What can be the consequences of incorrectly using a finder or employee to raise capital?

Any companies — whether private or public — that improperly use a nonregistered finder or employee may have to rescind their offer to investors and refund the entire investment monies paid, even when those funds have already been spent.

If the company and its executives are sanctioned, they may not be allowed to do a private placement in the future, such as a Regulation D offering. The individuals named in a sanction may be labeled as "bad actors." These bad boys, as they are often called, come under regulatory scrutiny for a number of years. There is also the potential of criminal penalties against the individual and the company. The reputational damage to a startup and founder can be severe, even if the violation was unintentional.

When fundraising, what else is important?

Many startups do not put together adequate disclosure documents that lay out all of the upside and downside of an investment. That is why, at least under the current regulatory landscape, it can be a good idea to only raise money from accredited investors. These investors have earned income exceeding $200,000 ($300,000 with a spouse), or a net worth of $1 million, excluding the value of the primary residence. The requirements must be met for the prior two years, with an expectation of the same for the current year.

Remember, fundraising rules are not black and white. The regulations and rules of the road have developed through court cases and on a case-by-case basis with the SEC, so check with your attorney before putting an intermediary between you and potential investors. ●