Hunton & Williams
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When Perfectly Good Cash Isn't Perfectly Good

With the recent credit crisis and extreme financial market turbulence, many entities are desperately seeking to raise additional capital through the private placement of their securities and, as a result, are often willing to work with anyone who appears able to introduce them to potential financing sources. Unfortunately, if a corporation secures capital with assistance from an unregistered broker, the corporation may find that the liabilities and risks associated with such capital greatly outweigh the initially perceived benefits.

Background - Rule 506 Safe Harbor

To avoid the cost and expense of "registering" a capital raising transaction with the SEC, corporate issuers typically seek to structure their offerings to meet the requirements of SEC promulgated Rule 506 of Regulation D, an exemption from the SEC and state registration requirements. Subject to the conditions of Regulation D, Rule 506 permits an issuer to sell equity to up to 35 "non-accredited investors." However, if sales are made to "non-accredited investors," to qualify under the Rule 506 safe harbor, the issuer is required to provide these non-accredited investors with very detailed information about the issuer and the offering, akin to the types of disclosure generally required in a registration statement filed with the SEC.

Use of Unregistered Brokers

There is no federal or state law that clearly and directly prohibits a corporation from utilizing an unregistered broker for purposes of capital raising. Many erroneously assume that only the unregistered broker faces the risk of regulatory or civil action. For a corporation at risk of becoming insolvent, the risk of regulatory or civil action against the unregistered broker may seem improbable or inconsequential and, accordingly, a "risk that they are willing to take."

However, there are a number of potential negative consequences to a corporation that utilizes an unregistered broker to raise capital in a private placement, and, unfortunately, ignorance of this murky area of the law will not provide any defense. Such consequences include:

- In light of the strict disclosure requirements of Rule 506 when securities are sold to "non-accredited investors," an issuer's failure to disclose to "non-accredited investors" its payments of brokerage commissions to an unregistered broker potentially destroys the issuer's ability to claim the Rule 506 exemption and triggers a toxic chain reaction:
  - Without the ability to claim a Rule 506 or other Regulation D exemption, an issuer must demonstrate why the capital raising transaction is otherwise exempt from both U.S. and the subject State registration requirements. If no other exemption is available, the "private placement" may be deemed to be a public offering that was required to be registered with the SEC, and the corporation may become the subject of regulatory action for conducting an unregistered offering;
  - The investors in the unregistered public offering may need to be offered the right to rescind their purchase or "put" their securities back to the issuer at cost, plus potentially interest and expenses, and the corporation and certain control persons may be liable for returning the purchase consideration to the investor; and
  - The unregistered public offering may be "integrated" with otherwise "private" capital raising transactions of the corporation, and the investors in such transactions may also need to be

offered the right to rescind their purchase of securities.

- The corporation may fail to adequately disclose the risks and contingent liabilities associated with the foregoing consequences and, accordingly, it and its directors and officers may become the subject of regulatory, civil and, in certain cases where intent is evidenced, criminal actions; and
- Payments made to unregistered brokers in connection with a private placement may be disallowed by many state securities agencies.

In light of these potentially severe consequences and considering the grave consequences associated with not raising capital when needed, it is important for corporations to understand how they can work with unregistered brokers when raising capital.

Some unregistered brokers attempt to convince their corporate clients that they are in fact not acting as "brokers," but simply as a person who identifies potential investors as a "finder." Such statements are usually accompanied by claims that "everyone does it," "it's ok if you hire me as an employee," "you don't need a broker's license to receive a commission one time," and "there is no law that prohibits the receipt of compensation for introductions." Although the distinction between "finders" and "brokers" is not readily discernable without studying various securities laws and a myriad of SEC enforcement actions, no-action letters and compliance guides, the SEC has demonstrated a clear pattern of enforcement against unregistered brokers — generally, persons who received transaction contingent compensation and who are in the "business" of effecting any important element of securities transactions (i.e., handling funds, soliciting a transaction, negotiating a transaction, or assisting in the execution of documents). In other words, if transaction-based commissions are paid and the service provided is more than a simple introduction, the person providing the service will likely require a broker's license, even if such person is an "employee" of the "issuer."

That is not to say that there are no exceptions to the general rule. For instance, directors, officers and employees who perform "substantial other duties" for the issuer, were not recently employed by a broker, and do not receive transaction based compensation may be eligible to claim an exemption from broker licensure; provided, however, that registration as an "issuer agent" may be required under certain circumstances.

Since issuers bear the burden of demonstrating how their securities transactions qualify for an exception from the SEC and state registration requirements, issuers should understand and clearly document each fact they are relying upon to meet a registration exemption. This process will, at a minimum, be more challenging if an unregistered broker is assisting in some form with the capital raising.

In this period when cash is king, it is important to structure the king's arrival so that its reign is not short lived and the kingdom thrown into further disarray.

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