

BEWARE OF INTERNET MATCHMAKING NETWORKS IN RAISING CAPITAL

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INTRODUCTION

In recent years, the internet has been a popular means of communication for companies and investors. The internet can provide early stage companies with broad access to a large number of potential investors. Many companies seeking to raise capital utilize internet-based matchmaking or angel services that pool prospective investors across the United States and the globe. Because these sites have a membership of individual investors who have expressed a desire to invest in early stage companies, they are often a successful means of bridging the funding gap between friends and family and traditional venture capital investment.

Any company seeking to raise capital in a private offering must tread lightly when using internet matchmaking networks to attract investors. Solicitation of investors through a broad-based medium such as the internet may constitute a “general solicitation” or “advertisement” prohibited for private offerings under the Securities Act of 1933, as amended (the “Securities Act”). In addition, unless the operator of the matchmaking network is a registered broker-dealer or is affiliated with a registered broker-dealer, its business may violate the prohibition on unlicensed securities activities. This would have a direct negative impact on the company utilizing the matchmaking network as well as the network operator.

State and federal laws, as well as guidance issued by the Securities and Exchange Commission (SEC), have established fairly clear rules under which a company may lawfully utilize internet matchmaking networks in its capital raising efforts.

LEGAL LANDSCAPE

Prohibition on General Solicitation and Advertisement

Regulation D, promulgated under the Securities Act, provides a “safe harbor” for private offerings of securities. Rule 506 is the most commonly relied upon safe harbor under Regulation D. Rule 506 requires, among other things, that the offering not involve a “general solicitation” of investors or “advertisement” of the offering.

If there is a “substantial and pre-existing relationship” between the company seeking capital and a prospective investor, generally no general solicitation or advertisement has occurred. To be “substantial,” the company should have accurate and reliable knowledge of the prospective investor’s investment goals and objectives. To be “pre-existing,” the relationship must be in place before the terms of the company’s offering are developed and the offering commences. In availing itself of the Regulation D safe harbor, a company may also rely on the substantial, pre-existing relationship its placement agent or broker has with prospective investors.

Many companies raising capital unwisely attempt to artificially create pre-existing relationships with prospective investors. For instance, companies seeking capital may send out mass e-mails describing recent developments to persons with whom it has no prior dealings. In other instances, companies may issue press releases announcing recent developments. Other times, companies seeking capital will design their websites with emphasis on positive announcements and statements that they are poised for success.

Although companies engaged in these communication methods usually avoid explicitly soliciting investment, such broad based communications while engaged in the capital raising process likely will constitute a general solicitation. In Securities Act Release No. 7233 (Oct. 6, 1995), the SEC made it clear that a company’s use of its website and other electronic communications in connection with a purported private offering would constitute a general solicitation.

The Use of Unregistered Matchmakers in Raising Capital

A company that does not have adequate pre-existing relationships to fund its offering often engages a placement agent to facilitate the solicitation of investors. In exchange for payment of a commission, the placement agent will open up its contact list and solicit the investment on the company’s behalf to a broad range of potential investors.

These placement agents are required to be broker-dealers registered with the SEC. A “broker” is defined under Section

3(a)(4) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as “any person engaged in the business of effecting transactions in securities for the account of others.” Section 15(a) of the Exchange Act makes it unlawful for a broker or dealer “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” with the SEC. State laws essentially restate this prohibition.

Many matchmaking networks believe they are not required to register as a broker-dealer with the SEC by merely facilitating introductions between investors and companies raising capital. There are relatively clear methods by which matchmakers and finders may introduce prospective investors without violating Section 15 of the Exchange Act. A thorough discussion of these methods can be found at: <http://www.procopio.com/assets/011/6444.pdf>. Essentially, the more information and assistance a matchmaker provides the company seeking capital, it will likely run afoul of Section 15 and state law equivalents. In any event, if the matchmaker receives a fee based on the company’s success in raising capital (also known as “transaction-based compensation”), the SEC will presume a violation has occurred.

This is not an esoteric rule that has no practical application. It is not a rule that goes un-enforced by the SEC. Violation of the prohibition on unlicensed brokerage activities poses significant risks to both parties involved. The company could face regulatory action and monetary sanctions by the SEC and state authorities, including a possible prohibition from future reliance on Regulation D. It may also face private actions by investors for damages or to rescind their investments under state law.

Any company considering engaging a matchmaking network to assist in its capital raising efforts should understand and ensure compliance with the SEC’s clear mandates on the use of such networks.

THE SEC’S POSITION ON INTERNET MATCHMAKING NETWORKS

In a series of “no-action” letters and interpretive releases, the SEC has established fairly clear rules under which companies may utilize internet matchmaking services. A no-action letter is a letter issued by the staff of the SEC (the “Staff”) in response to a request by a party contemplating particular activities that the activities will not result in enforcement action by the SEC. It is important to note that an SEC no-action letter is not a rule, regulation or statement of the SEC and binds only the Office of the Chief Counsel, Division of Investment Management with respect to the persons addressed by the letter and the specific facts presented.

IPOnet, SEC No-Action Letter (July 26, 1996)

In 1996, the Staff addressed the use of internet matchmaking networks and provided a favorable no-action determination. In *IPOnet*, IPOnet facilitated investment in private offerings on behalf of companies. Its website allowed prospective investors to register as accredited investors to gain access to IPOnet’s various investment opportunities. A prospective investor could register with IPOnet as an accredited investor only after completing a detailed investor questionnaire soliciting information necessary to verify his or her status as an accredited investor under Rule 501(a) of the Securities Act.

IPOnet engaged a registered broker-dealer to verify a prospective investor’s status, and if approved by the broker-dealer, IPOnet permitted that prospective investor to view available investment opportunities on a password-protected page on IPOnet’s website. The investor would then be allowed to participate in the offerings posted by IPOnet, but only those posted after the prospective investor’s status was confirmed.

The Staff found that this arrangement did not constitute a general solicitation or advertisement. The Staff based its position on the principle that there is no general solicitation where a substantive, pre-existing relationship with prospective investors exists. Key to the Staff’s determination was (1) the questionnaire did not refer to any particular investment opportunities, (2) the password-protected page was only made available after a prospective investor’s status was confirmed, and (3) the prospective investor, once qualified, could only participate in those offerings posted after accredited status was confirmed by IPOnet’s affiliated broker-dealer.

Although *IPOnet* is often cited by companies and matchmaking services as wholesale authority for their activities, it is important to note that the Staff only addressed the issue of whether use of the service constituted a general solicitation in violation of the Securities Act. It did not address the issue whether a matchmaking network is required to be registered as a broker-dealer. The Staff did not have to address this issue in part because IPOnet was owned and managed by a registered representative of a registered broker-dealer, and the broker-dealer established and maintained a system to supervise the activities of IPOnet.

Lamp Technologies, Inc., SEC No-Action Letter (May 29, 1997)

In 1997, the Staff issued a no-action letter which affirmed its position in *IPOnet* that a company may use an internet matchmaking network to *create* the necessary substantial, pre-existing relationship with its offerees. Like IPOnet, Lamp

Technologies operated a matchmaking network that offered investment opportunities to its members. Like IPOnet, Lamp Technologies pre-screened investors through an online questionnaire and gave those who qualified a password to access the page discussing its various opportunities. Unlike IPOnet, however, Lamp Technologies imposed a 30-day waiting period before a qualified investor could invest in any opportunity and allowed investors to participate in offerings posted before or after qualification. The Staff granted no-action relief, and confirmed that the 30-day waiting period would allow investors to participate in offerings posted before or after registration.

The Staff in *Lamp Technologies* specifically warned that it was not addressing the issue of whether the matchmaking network would violate the prohibition on unregistered brokerage activities. In footnote 2 to the no-action letter, the Staff noted that unlike the facts presented in *IPOnet*, Lamp Technologies was neither a registered broker-dealer nor affiliated with a registered broker-dealer. The Staff made it clear that Lamp Technologies was not seeking assurance as to whether it is required to be registered as a broker-dealer, and noted that its “activities could raise issues concerning broker-dealer registration.”

Post-IPOnet and Lamp Technologies Guidance

In 2000, the SEC issued a clarifying release based on its concern that companies were too broadly interpreting the guidance from *IPOnet* and *Lamp Technologies*. In SEC Release No. 33-7856 (April 28, 2000), the SEC noted that certain entities (notably those who were not broker-dealers) were operating matchmaking websites in reliance on the SEC staff’s previous guidance which constituted general solicitation of offerings in violation of Regulation D.

The SEC reaffirmed the Staff’s guidance from *IPOnet* and *Lamp Technologies*, stating that “a third party, other than a registered broker-dealer, could establish a ‘pre-existing, substantive relationship’ sufficient to avoid a ‘general solicitation’”. With respect to the issue of broker-dealer registration, the SEC concluded that “while it is permissible for these web-sites to accept a fee for their listing services, these sites may not act as broker-dealers by attempting to induce sales of the securities of others without being licensed to do so.”

Months later, in *Progressive Technology, Inc.*, SEC No-Action Letter (October 11, 2000), the Staff addressed the issue of whether a matchmaking network must be registered as a broker-dealer. Progressive Technology planned to operate a website to make introductions between companies seeking capital and accredited investors. In accordance with the procedures in *IPOnet* and *Lamp Technologies*, it would pre-qualify investors as accredited and then provide them with access to a database where they could search for opportunities and review offering materials.

Progressive Technology sought assurance that it would not have to register as a broker-dealer because it would not make any recommendations or give advice concerning any offering listed on its website. In addition, it would not participate in negotiating the terms of any investment, handle funds or securities, or directly assist investors in completing the transaction. Finally, Progressive Technology assured the Staff it would not receive transaction-based compensation but only receive a flat, monthly fee payable by members for use of the website.

Based on Progressive Technology’s description of its activities, the Staff determined that its proposed business would constitute brokerage activities under Section 15 and Section 3(a)(4) of the Exchange Act. The Staff reasoned that a person effects transactions in securities for purposes of Section 15 of the Exchange Act if he or she participates in securities transactions “at key points in the chain of distribution.” The staff was troubled by the fact that Progressive Technology planned to actively solicit investors on behalf of its customers and would provide “advice to issuers on preparing offering materials for posting to the web site.”

Not-For-Profit Angel Networks

The Staff’s determination in *Progressive Technology* is to be contrasted with angel networks that do not operate their networks for profit. In *Angel Capital Elec. Network (“Ace-Net”)*, SEC No-Action Letter (October 15, 1996), the Staff provided no-action relief based on the assumption that the not-for-profit matchmaking network would not receive compensation other than nominal flat fees to cover administrative costs.

CONCLUSION

Based on existing no-action letters and SEC interpretive guidance, a company’s use of an online matchmaking network likely will not constitute a general solicitation or advertisement in violation of Regulation D if the following facts are present:

- (1) the network or its registered broker-dealer operates a password-protected site;
- (2) the network uses a generic investor questionnaire that elicits information sufficient to determine a prospective investor.

tor's accredited status (not a "check-the-box" certification); and

(3) prospective investors are not given access to offering materials and information until his or her accredited status is confirmed.

In addition, matchmaking networks are well-advised to provide a "cooling off" period preventing an investor from investing in any offering until 30 days has elapsed from the time the investor submits his or her completed questionnaire.

In addition, it is recommended that companies only utilize matchmaking networks offered by registered broker-dealers. Even if a non-broker network refrains from recommending an investment opportunity, the Staff has indicated that matchmaking networks more often than not involve the solicitation of investors which requires registration. Essentially, the more advice and assistance a matchmaking network provides investors or companies, the more likely the SEC will deem it to be "effecting transactions in securities" as defined in Section 3(a)(4) of the Exchange Act.

However, based on the Staff's no-action letters and SEC guidance, it would appear an unregistered matchmaking network would have at least a viable argument that it is not required to register as a broker-dealer provided that it does not:

- (1) provide advice about the merits of particular opportunities or recommend investment;
- (2) actively solicit investors for opportunities (rather than merely acting as an introducing agent);
- (3) receive transaction-based compensation;
- (4) participate in any negotiations between investors and companies;
- (5) directly assist investors or companies with the completion of any transaction including, for example, providing closing documentation;
- (6) handle funds or securities involved in completing a transaction;
- (7) provide assistance to companies in structuring their offerings;
- (8) advise on or prepare offering materials; or
- (9) hold itself out as providing any securities-related services other than a listing or matching service..

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