

# Brokered and Finders in Startup Offerings

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## In 2019, 40% of all IPOs were by VC backed companies

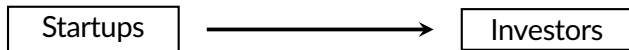
- How did the other 60% of companies raise pre-IPO funding?
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- What role do brokers play in the market for startup funding?
  - How do brokers match with startups?
  - Which investors participate in brokered offerings?
  - Do brokers mitigate issuers' financing constraints?
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  - How do issuers in brokered offerings perform post-funding?
- How does the broker's role fit with existing theories of financial intermediation?

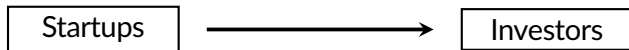
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Direct Offering:

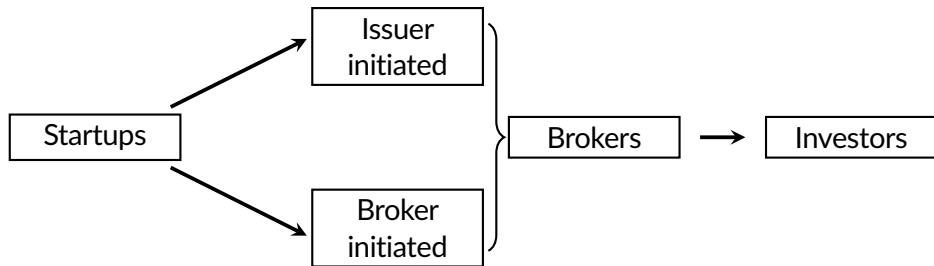


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## Direct Offering:

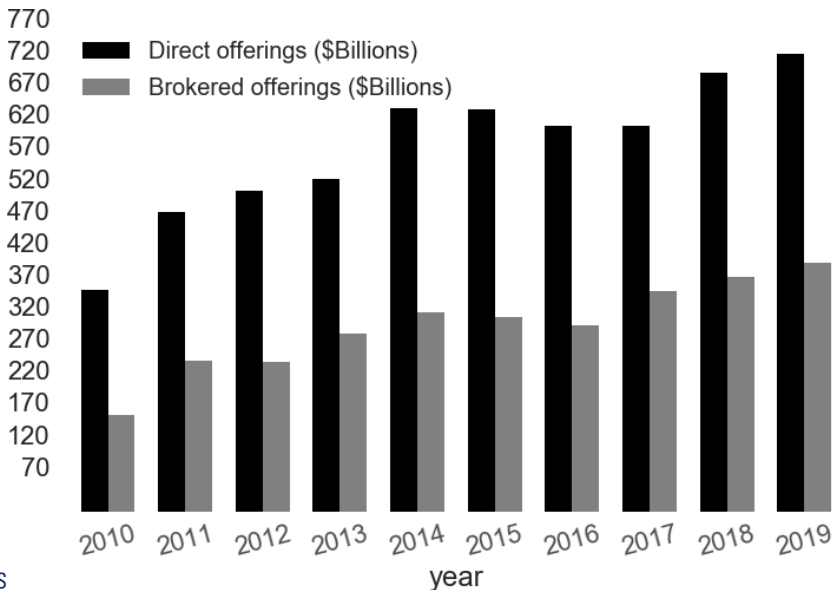


## Brokered Offering:



How much private funding is raised by brokers?

# Brokers raise one in three dollars in the private placement market



What types of brokers participate in private offerings?



# Firms do not list broker registration status on Form D

## 12. Sales Compensation

Recipient

Andrew Laver

(Associated) Broker or Dealer ☐ None

Wilson-Davis & co.

Street Address 1

236 South Main Street

City

Salt Lake City

State(s) of Solicitation (select all that apply)  
Check "All States" or check individual States ☐ All States

UTAH

Recipient CRD Number ☐ None

4971312

(Associated) Broker or Dealer CRD Number ☐ None

3777

Street Address 2

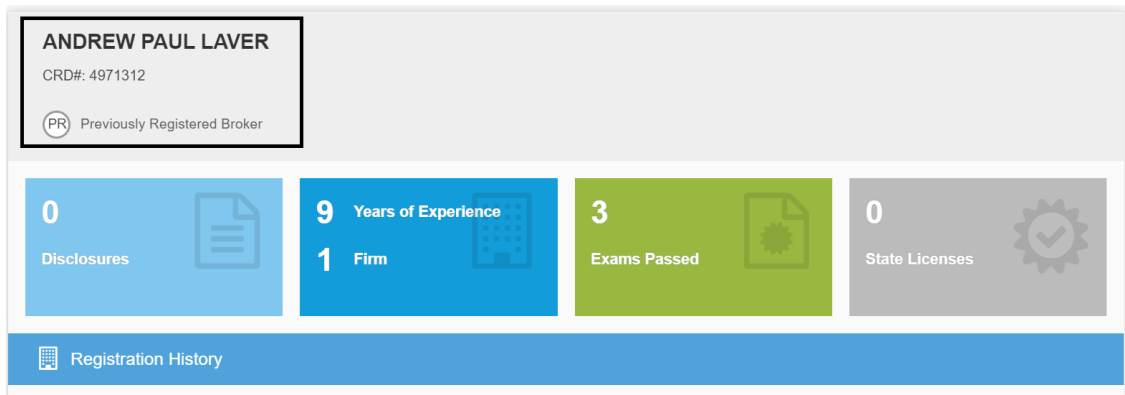
State/Province/Country

UTAH

☐ Foreign/non-US

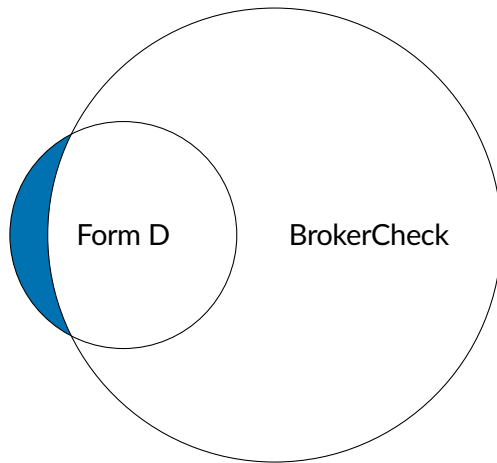
**Figure:** [https://www.sec.gov/Archives/edgar/data/1396156/000139615611000001/xslFormDX01/primary\\_doc.xml](https://www.sec.gov/Archives/edgar/data/1396156/000139615611000001/xslFormDX01/primary_doc.xml)

# Classification uses IAPD and BrokerCheck data on 1.3 millions advisers



**Figure:** <https://brokercheck.finra.org/individual/summary/4971312>

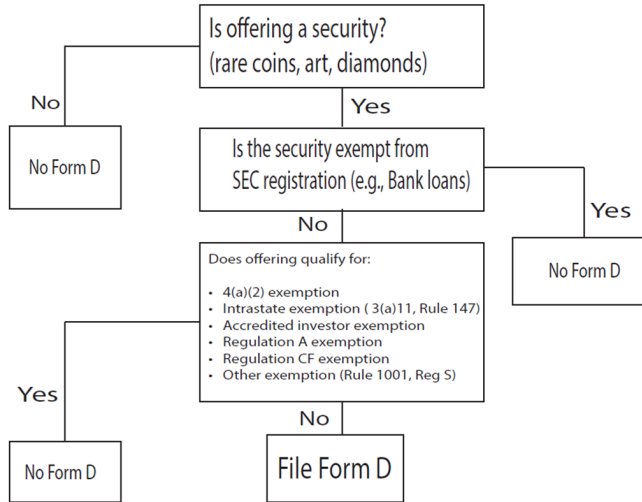
## 40% of brokered offerings involve unregistered brokers



## Selling private shares is one of many revenue streams

	Other B. firms	Form D B. Firms	
	N = 40,284	N = 15,927	
	Mean	Mean	T-stat
Sells equity OTC	0.40	0.52	7.88***
Sells mutual fund	0.42	0.52	6.75***
Sells private shares	0.47	0.87	34.07***
Underwriter	0.19	0.40	14.73***
# Brokers Employed	47.54	377.27	6.11***
Flow Misconduct	0.76	1.08	4.75***
Stock Misconduct	3.15	5.17	8.44***
Age	15.28	15.79	1.27

# Securities sales must be registered or rely on exemption



## Issuers filing Form D are scalable startups

	No FormD N = 16,699	Has Form D N = 28,820	
	Mean	Mean	T-stat
I(Acquisition or IPO)	0.15	0.20	14.71***
I(Raised Future Round)	0.22	0.47	56.74***
I(Has Patent)	0.17	0.31	35.43***
# Service Providers	0.38	0.72	34.15***
Unique Investor States	2.25	3.21	45.97***
Form D Filing Fees	425.95	410.28	-4.73***
PE Hub	0.57	0.47	-20.02***
# Unique Investors	5.23	7.72	33.68***

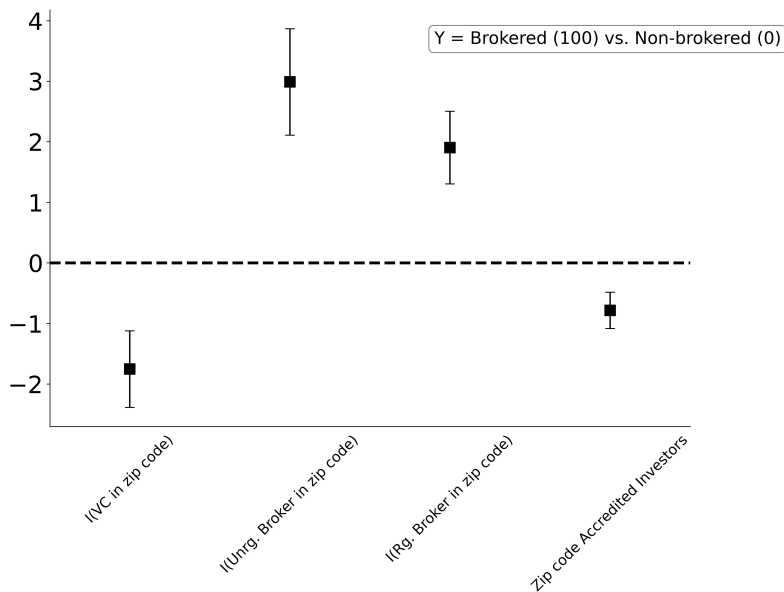
## From 2010 to 2019, 28,000 first-time startups raising equity

	DIRECT	BROKER	UR. BR	R. BR
% Sample (Number of Issuers)	92.75 (26,051)	7.25 (2,036)	2.87 (806)	4.38 (1,230)
	A Mean	B Mean	C Mean	D Mean
I(Acquisition or IPO)	0.23	0.17	0.11	0.21
I(Raised Future Round)	0.17	0.11	0.09	0.13
I(Raised Funding)	0.87	0.69	0.64	0.73
I(Rg. Broker Zip)	0.41	0.48	0.41	0.53
I(Unrg. Broker Zip)	0.15	0.21	0.23	0.20
I(VC Zip)	0.54	0.45	0.39	0.49
I(Non-PE Hub)	0.60	0.66	0.69	0.65
I(VC Investment)	0.19	0.08	0.05	0.11
I(Non Accredited Investor)	0.11	0.15	0.23	0.09

Which issuers use brokered offerings

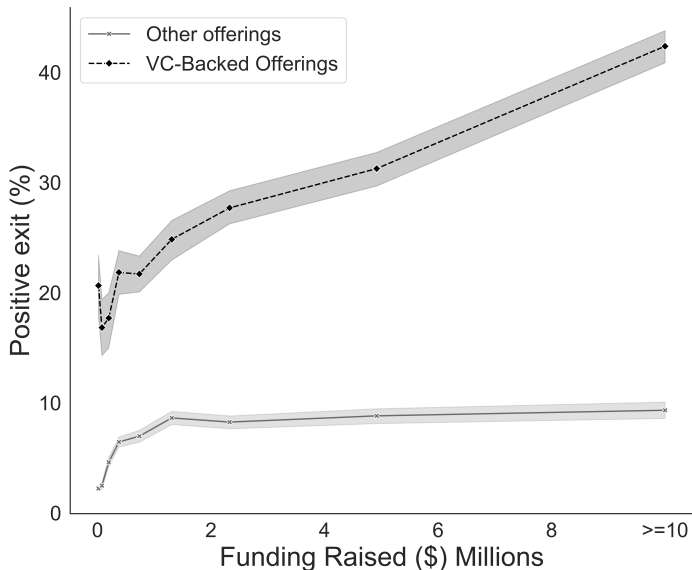


# Issuers close to brokers and far from VCs

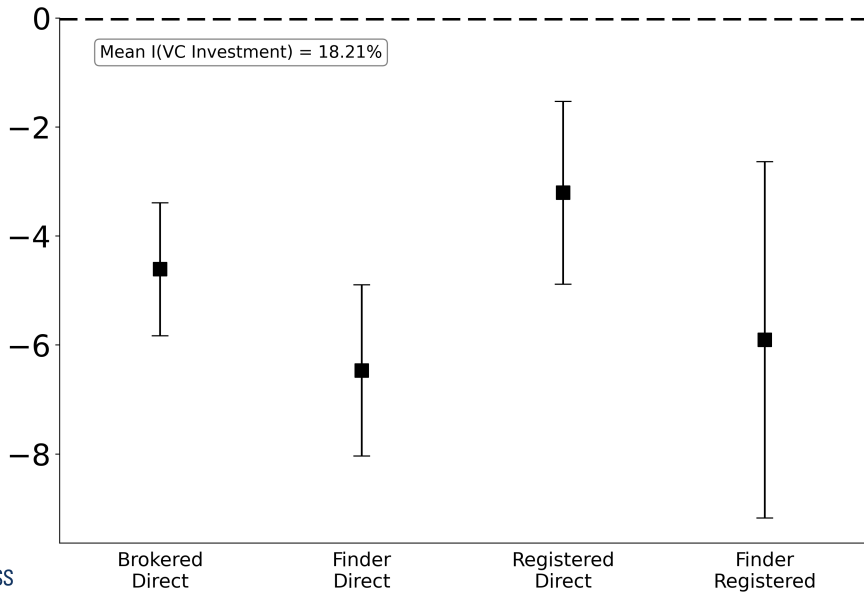


Which investors participate in brokered offerings?

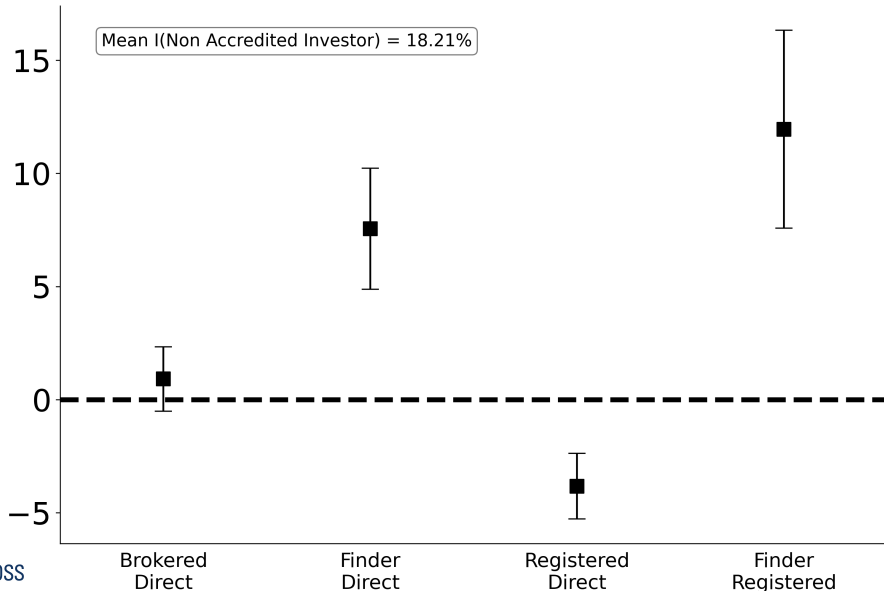
# Sophisticated investors select the best deals



# VCs rarely participate in brokered offerings



# Unregistered brokers sell to non-accredited investors



Do brokers mitigate issuer's financial constraints?

# Testing the relationship between broker intermediation and outcomes

$$Outcome_{fst} = \beta_1 \text{Used Broker}_{fst} + \Gamma X_{fst} + \lambda_{stj} + \epsilon_{fst}.$$

**Data:** SEC Form D filings, BrokerCheck and IAPD, PitchBook, SDC, and Crunchbase

**Unit of analysis:** Issuer: First Form-D filing for each issuer (operating firm)

**Main explanatory variable:** Indicator for brokered offering

**Outcomes:** Funding raised, Raising a follow-on round, closure, and IPO or acquisition

**Other explanatory variables:** Firm age, firm size, promoters, accredited investors, state-year-industry FE.

# Which omitted variables might lead to inconsistent estimates?

$$\text{Ln(Offering Proceeds)}_{fjst} = \beta_1 \text{I(Unrg. Broker)}_{fjst} + \beta_2 \text{Search costs}_{fjs} + X_{fjst} + \lambda_{stj} + \epsilon_{fjst}$$

$$\text{Ln(Offering Proceeds)}_{fjst} = \delta_1 \text{I(Unrg. Broker)}_{fjst} + X_{fjst} + \lambda_{stj} + \epsilon_{fjst}$$

$$\text{I(Unrg. Broker)}_{fjst} = \gamma_1 \text{Search costs}_{fjs} + \epsilon_{fjst}$$



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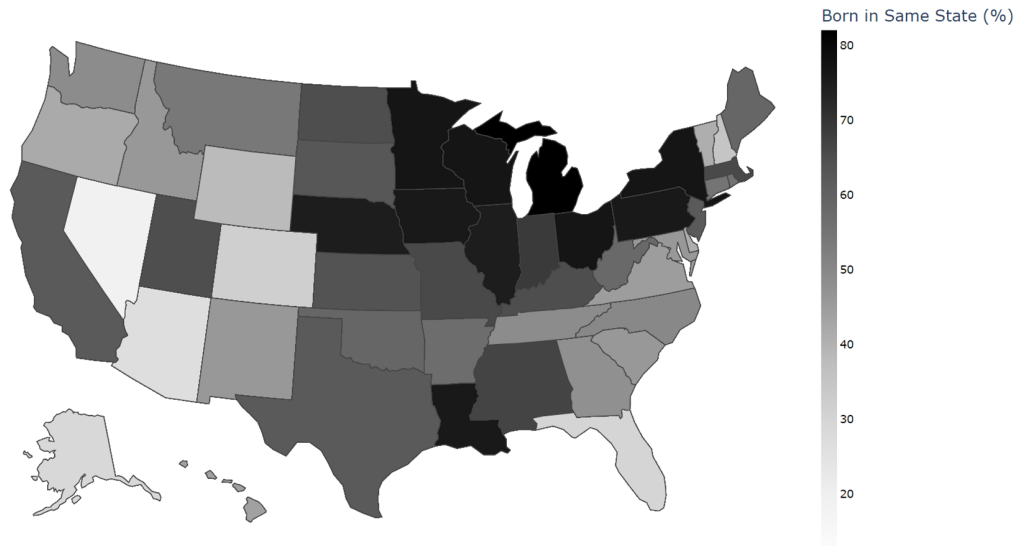
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$$\underbrace{\delta_1}_{-} = \underbrace{\beta_1}_{+} + \underbrace{\left( \overbrace{\beta_2}^{-} \times \overbrace{\gamma_1}^{+} \right)}_{-}$$

## Exclusion Restriction: Distance to broker is unrelated to outcomes

Dependent Variable:	I(Acquisition or IPO)		I(Raised Future Round)	
	(1)	(2)	(3)	(4)
I(Unrg. Broker Zip)	0.002 (0.008)	-0.008 (0.008)	0.004 (0.006)	0.002 (0.006)
I(Rg. Broker Zip)	0.020*** (0.006)	0.003 (0.006)	0.001 (0.004)	-0.002 (0.005)
I(VC Zip)		0.062*** (0.006)		0.012** (0.005)

## Exclusion Restriction: Entrepreneurs tend to start businesses where they are born



## All brokers lead issuers to raise more funding

Dependent Variable:		Ln(Offering Proceeds)		
Used Broker = 1 Used Broker = 0	Any broker Direct	Unregistered Direct	Registered Direct	Unregistered Registered
	(1)	(2)	(3)	(4)
l(Used Broker)	1.610*** (0.430)	2.250*** (0.805)	2.564*** (0.738)	-0.507 (0.819)
Cragg-Donald Wald F	71.04	51.24	41.41	8.28

How do exits for brokered offerings compare to direct offerings?

## Issuers in unregistered broker offerings are less likely to exit

Dependent Variable:	I(Acquisition or IPO)			
Used Broker = 1 Used Broker = 0	Any broker Direct	Unregistered Direct	Registered Direct	Unregistered Registered
	(1)	(2)	(3)	(4)
I(Used Broker)	0.009 (0.010)	-0.040*** (0.014)	0.043*** (0.014)	-0.072*** (0.027)
I(VC Investment)	0.214*** (0.010)	0.214*** (0.010)	0.213*** (0.010)	0.268*** (0.059)
Ln(Proceeds Raised)	0.050*** (0.003)	0.051*** (0.003)	0.050*** (0.003)	0.032*** (0.009)

## OR raise a follow-on round of funding – (Selection effect)

Dependent Variable:		I(Raised Future Round)		
Used Broker = 1 Used Broker = 0	Any broker Direct	Unregistered Direct	Registered Direct	Unregistered Registered
	(1)	(2)	(3)	(4)
I(Used Broker)	-0.027*** (0.009)	-0.041*** (0.013)	-0.018 (0.012)	-0.009 (0.023)
I(VC Investment)	0.071*** (0.009)	0.070*** (0.009)	0.071*** (0.009)	0.031 (0.056)
Ln(Proceeds Raised)	0.023*** (0.002)	0.024*** (0.003)	0.023*** (0.003)	0.011 (0.008)

## And are more likely to close (Selection effect — see Table 10 in paper)

Dependent Variable:	I(Inactive)			
Used Broker = 1 Used Broker = 0	Any broker Direct	Unregistered Direct	Registered Direct	Unregistered Registered
	(1)	(2)	(3)	(4)
I(Used Broker)	0.050*** (0.009)	0.068*** (0.013)	0.039*** (0.012)	-0.014 (0.025)
I(VC Investment)	-0.054*** (0.006)	-0.055*** (0.006)	-0.054*** (0.006)	-0.100** (0.047)
Ln(Proceeds Raised)	-0.017*** (0.002)	-0.016*** (0.002)	-0.017*** (0.002)	-0.022** (0.010)



# Brokers' Role and Theories of Intermediation

# Unregistered and registered brokers are regulated differently

Unregistered brokers cannot:

- Advice firm on deal structure
- Or condition fees on offering proceeds
- No designated regulator for unregistered brokers

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## Registered brokers must:

- Make sure investment is suitable
- Investigate the issuer and its management
- Have a dedicated regulator: Financial Industry Regulatory Authority (FINRA)

# Theory has differing predictions on issuer-broker match

- Search models: Brokered offerings  $\nRightarrow$   $\uparrow$  issuer quality  
(Rubinstein and Wolinsky (1987); Yavaş (1994); Garmaise and Moskowitz (2003))
  - Consistent evidence:
    - Issuers with few VCs and accredited investors nearby use brokers
    - Post offering outcomes for registered broker similar to outcomes for direct offerings
  - Inconsistent evidence:
    - Unregistered brokers underperform registered broker and direct offerings
- Certification models: Brokered offerings  $\Rightarrow$   $\uparrow$  issuer quality  
(Booth and Smith II (1986), Biglaiser (1993), Chemmanur and Fulghieri (1994))
  - Consistent evidence:
    - Registered broker offerings outperform unregistered-broker offerings
  - Inconsistent evidence:
    - Unregistered brokers offerings underperform direct offerings

# Sophisticated Investors cream-skim the best deals

- Why do unregistered broker offerings less likely to successfully exit?

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- Why do unregistered broker offerings less likely to successfully exit?
  - Bolton et al. (2016): sophisticated investors cream-skim the best deals weakening the pool of issuers that other investors see
    - Registered brokers amplify this cream-skimming by placing the offerings they screen with other sophisticated investors
    - There is adverse selection in the pool of issuers approaching unregistered brokers
    - Even though unregistered brokers might mitigate search costs, the offerings they place are less successful because of this adverse selection

## Conclusion: Brokers' role play depends on their registration status

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- Why are some startup offerings brokered?
  - To mitigate search costs (Unregistered brokers)
    - Outcomes for issuers in unregistered broker offerings are worse than outcomes for issuers in direct offerings (cream-skimming by sophisticated investors)
    - Issuers far from VCs or with fewer local accredited investors are more likely to use unregistered brokers
  - For certification and to reduce search costs (Registered brokers)
    - Outcomes for issuers in registered-broker offerings are better than outcomes for issuers in registered broker offerings
    - Issuers far from VCs are more likely to use registered brokers



# Recent changes are expanding brokers' role in private markets

- Expanding definition of accredited investors

*" ... add a new category to the definition... **based on certain professional certifications**, ... the Commission designated by order holders in good standing of the **Series 7, Series 65, and Series 82** licenses as qualifying natural persons. "*
- Expanding the role of finders

*" ... the proposed exemption would permit natural persons to engage in certain limited activities without registering with the Commission as brokers"*
- Funding Portals (Regulation CF)

*" ... Crowdfunding investments can only be made through an online platform operated by an intermediary (a registered broker-dealer or funding portal)"*

Thanks for your attention!

# References I

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