

October 20, 2020

# SEC Proposes Exemption from Broker-Dealer Registration for “Finders”

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## Many Conditions Would Attach to the Proposed Exemption, Including a Requirement That Finders Be Natural Persons

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### SUMMARY

On October 7, 2020, the Securities and Exchange Commission proposed a limited, conditional exemptive order from broker-dealer registration requirements for certain “finders” who assist with raising capital for private companies.<sup>1</sup> The exemptive order would permit certain natural persons – and only natural persons – to engage in, and be compensated for, a narrow range of solicitation activities involving accredited investors. The SEC indicated that, by removing certain triggers for broker-dealer registration, the proposal is intended to assist small businesses in raising capital. The SEC is accepting public comment on the proposal until November 12, 2020.

### BACKGROUND

Section 3(a)(4) of the Securities Exchange Act of 1934 (the “Exchange Act”) defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” Section 15(a)(1) of the Exchange Act generally makes it unlawful for any broker to “effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security” unless the broker is registered with the SEC in accordance with Section 15(b) of the Exchange Act.

The Exchange Act does not define what it means to be “engaged in the business” or to “effect[] transactions” in securities. Consequently, whether a person is a broker is a facts-and-circumstances analysis. Courts and the SEC have identified certain activities as indicators of broker status, including:

- actively soliciting or recruiting investors;

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- participating in negotiations between the issuer and the investor;
- advising investors as to the merits of an investment;
- handling customer funds and securities;
- having a history of selling the securities of other issuers; and
- receiving commissions or other “transaction-based compensation” for participating in the offering.

The courts and the SEC generally have taken a broad view of “solicitation” to include any effort meant to induce a securities transaction, including, but not limited to, telephone calls, mailing, advertising, and conducting investment seminars. The SEC has taken the position that efforts to induce even a single securities transaction can constitute solicitation.<sup>2</sup> Accordingly, a person who identifies and solicits potential investors for an issuer could be viewed as engaging in broker activity.

A person who engages in broker activity without being registered can face severe consequences, including civil monetary penalties, disgorgement, industry bars, and criminal penalties. Issuers who engage unregistered brokers also may be subject to SEC enforcement actions for causing or aiding and abetting violations of the Exchange Act, and sales of issuer securities through an unregistered broker could be subject to a right of rescission by investors, giving investors the right to mandate a return of their money invested.<sup>3</sup> The SEC has enforced these registration requirements aggressively for many years.

The SEC has not previously recognized a “finder” exemption to the registration requirements and has not addressed whether and under what circumstances a person may “find” or solicit potential investors on behalf of an issuer without being required to register as a broker. Nor has the SEC addressed whether and to what extent such activities implicate the Exchange Act in the first place. Yet, a number of SEC staff no-action letters since the early 1990s have recognized situations where a finder could conduct certain activities and earn transaction-based compensation without registration as a broker-dealer. In the *Paul Anka* no-action letter, for instance, the SEC staff indicated that it would not pursue enforcement action against an individual who merely provided a list of names and contact information of accredited investors with whom the person had a pre-existing business relationship to an issuer for a success-based fee, without having had further contact with potential investors concerning the issuer.<sup>4</sup> This precedent has led many to believe that an uncodified exemption from the registration requirement may exist for finders. The SEC states in the Notice of Proposed Exemptive Order (the “Notice”), however, that the *Paul Anka* no-action letter was based on the solicitation being the finder’s first solicitation and that the finder would not be entitled to the relief for any subsequent offering.<sup>5</sup>

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## DISCUSSION

The proposed exemption attempts to provide clarity to issuers and finders by exempting two classes of finders – Tier I and Tier II Finders – from Section 15(a)(1) registration requirements. The Notice explicitly states that the exemption is to be narrowly drawn to continue to balance investor protection concerns with

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greater flexibility for issuers and finders. The proposed exemption is styled as a non-exclusive safe harbor, however, and the SEC emphasizes in the Notice that no presumption will be created that a person is a broker if the Tier I and Tier II conditions are not satisfied.

### Conditions on Both Tiers of Finders

A person will be permitted to act as a finder under the proposed exemption only if all of the following seven conditions are met:

- the issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;
- the issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act of 1933, such as Section 4(a)(2) thereof or Regulation D thereunder;
- the finder does not engage in general solicitation;
- the potential investor is an “accredited investor” as defined in Rule 501 of Regulation D, or the finder has a reasonable belief that the potential investor is an “accredited investor”;
- the finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
- the finder is not an associated person of a broker-dealer; and
- the finder is not subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, at the time of his or her participation.

### Tier I

A Tier I Finder would be permitted to provide, and receive compensation for providing, the contact information of potential investors in connection with one capital raising transaction by one issuer in a 12-month period, provided the Finder does not have any contact with a potential investor about the issuer. The contact information may include, among other things: name, telephone number, e-mail address, and social media information. A Tier I Finder who complies with all of the conditions of the exemption would be permitted to receive transaction-based compensation for the limited services described above without being required to register as a broker-dealer.

### Tier II

A Tier II Finder would be permitted to engage in a broader range of activities, subject to more extensive documentation requirements. A Tier II Finder would be permitted to solicit, and receive compensation for soliciting, investors on behalf of an issuer, provided the solicitation-related activities are limited to:

- identifying, screening, and contacting potential investors;
- distributing issuer-offering materials to investors;
- discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and
- arranging or participating in meetings with the issuer and the investor.

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A Tier II Finder, unlike a Tier I Finder, is not limited to one transaction every 12 months. A Tier II Finder would need to disclose to the potential investor prior to or at the time of solicitation:

- the names of and the relationship between the Tier II Finder and the issuer;
- a description of the Tier II Finder's compensation;
- any material conflicts of interest; and
- a statement that the Tier II Finder is acting as the issuer's agent, is not associated with a broker-dealer, and is "not undertaking a role to act in the investor's best interest."

Further, the finder must obtain a dated written acknowledgment of receipt of these disclosures prior to or at the time of the investment in the issuer's securities.

The proposal would allow a Tier II Finder to provide such disclosures orally, provided that the oral disclosure is supplemented by written disclosure that satisfies all of the disclosure requirements listed above no later than the time of any related investment in the issuer's securities. A Tier II Finder who complies with all of the conditions of the proposed exemption would be permitted to receive transaction-based compensation for services provided in connection with the activities described above without being required to register as a broker.

### Limitations on Activities of Tier I and Tier II Finders

The SEC emphasizes in the Notice that Tier I and Tier II Finders could engage only in very limited solicitation activities. The Finder could not, consistent with the proposed exemption:

- handle customer funds or securities;
- have the power to bind the issuer or the investor;
- participate in the preparation of sales materials;
- engage in due diligence activities;
- perform an independent analysis of the sale;
- provide or arrange financing; or
- provide advice as to the valuation or financial advisability of the investment.

The proposed exemption is also limited to primary offerings and would not cover secondary sales of securities by affiliates or others.

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## IMPLICATIONS

Previously, the lack of a clear framework for what activities, if any, finders may conduct without having to register as a broker, coupled with severe enforcement consequences for noncompliance, has, according to the SEC, served as a major obstacle for smaller issuers and early-stage businesses to utilize finders in raising capital. The Notice contends that finders can play an important role for these issuers, for many of whom securing venture capital financing or the services of a registered broker-dealer to raise relatively

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small sums of capital may not be practical or cost efficient. The SEC's proposal, while limited and relatively inflexible, could nonetheless provide helpful clarity to issuers and finders. The SEC requested comment on numerous aspects of the proposal, including whether the proposed finder exemption should be limited to natural persons.<sup>6</sup>

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### ENDNOTES

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- 1 [Notice of Proposed Exemptive Order Granting Conditional Exemption From the Broker Registration Requirements of Section 15\(a\) of the Securities Exchange Act of 1934 for Certain Activities of Finders](#), 85 FR 64542 (Oct. 13, 2020).
- 2 See Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 27017 (Jul. 11, 1989), [54 FR 30013 (Jul. 18, 1989)] at 30018.
- 3 Exchange Act, § 29(b), 15 USC § 78cc(b).
- 4 *Paul Anka*, SEC No-Action Letter (issued July 24, 1991).
- 5 In fact, the SEC staff has expressed some reservations about the *Paul Anka* no-action letter over the years. See, e.g., Comments by Kristina Fausti, Special Counsel, Office of Chief Counsel, SEC Division of Trading and Markets, at the Private Placement Broker and M&A Broker Panel at the SEC Forum on Small Business Capital Formation (Nov. 20, 2008) (suggesting that the letter should not be relied upon). Other subsequent staff no-action letters have also implicitly rejected the reasoning of the *Paul Anka* no-action letter, or at least narrowed the circumstances under which that letter might plausibly be applied. For example, the SEC staff suggested in one no-action letter that a Finder who did any work to tailor a list of potential investors to a particular issuer could be engaged in “pre-screening” and “pre-selling,” which would require broker-dealer registration. [Brumberg, Mackey & Wall PLC no-action letter.]

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