SEC PROPOSES TO CLARIFY THE ROLE OF FINDERS IN PRIVATE SECURITIES OFFERINGS

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On October 7, 2020, the U.S. Securities & Exchange Commission ("SEC" or the "Commission") voted 3-2 to propose a conditional exemption from broker-dealer registration to natural persons who engage in limited securities activities on behalf of private issuers ("Proposal").[1] The Proposal, which is intended to alleviate capital-raising challenges faced by small businesses, would create two tiers of "finders" and provide an exemption from registration requirements under Section 15 of the Securities Exchange Act of 1934 ("Exchange Act), provided that the finder's involvement is restricted to certain defined and limited activities involving accredited investors.

The Proposal is subject to a 30-day comment period following its publication in the Federal Register.

BACKGROUND

Essential to any capital-raising effort for a business is the meeting between the investors and the investment opportunity. Depending on the size and popularity of the business, the opportunity to access capital, whether in the public or private markets, can be an arduous task. Large businesses often use intermediaries such as registered broker-dealers to connect them to potential investors in exchange for a commission based on the size or success of the offering. Small businesses, on the other hand, generally do not have such an

1 Chairman Jay Clayton and Commissioners Hester Pierce and Elad Roisman voted in favor of the Proposal, while Commissioners Allison Herren Lee and Caroline A. Crenshaw voted against the Proposal.

option because their offerings are often too small to be considered economically beneficial to garner a broker-dealer's time, commitment, and assumption of certain possible liabilities that might be associated with the offering. As such, small businesses often face difficulties in finding potential investors.

Intermediaries such as broker-dealers play a significant role in the securities market. Because of their position in the securities industry and their involvement with the public, the activities of broker-dealers are highly regulated by federal and state regulators. Section 3(4) of the Exchange Act defines a broker as, "any person engaged in the business of effecting transactions in securities for the account of others."[2] Unlike a broker, who acts as an agent to others, a dealer acts as principal; it buys and sells securities for its own account.[3] Section 15(a)(1) of the Exchange Act makes it unlawful for any broker to use the mails or any other means of interstate commerce to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless that broker is registered with the SEC in accordance with Section 15(b) of the Exchange Act.

While U.S. federal securities laws specifically define the terms "broker" and "dealer," federal securities laws do not provide a statutory definition for the term "finder," although such intermediaries are essential to the capital-raising process and have been operating in the process pursuant to an elusive "finder's exemption." The classification between broker-dealer activities and finders' activities is very tenuous, and navigating such demarcation is fact-specific and poses potential legal liabilities for the finder and issuer. As such, through case law, enforcement actions, and no-action letters, securities professionals have come to define finders' activities as those that are not of broker-dealers. Therefore, in order to comply with broker-dealer regulations, finders must avoid being deemed broker-dealers under the federal securities laws, unless they register as such with the SEC and the Financial Industry Regulatory Authority (FINRA). Whether a finder would be considered a broker-dealer depends on several factors. SEC no-action letters, enforcement actions, interpretive guidance, and case law analyses have focused on (1) the finder's involvement in the capital-raising transaction and (2) the type of compensation the finder receives in connection with the transaction.

Under current precedent (based on SEC no-action letters and enforcement actions), the sole involvement of the finder must be limited to the initial referral of potential investors to the issuer. Activities that go beyond the initial referral are generally considered bordering those of broker-dealers. For example, activities such as (1) actively soliciting or recruiting investors; (2) participating in negotiations between the issuer and the investor; (3) advising investors as to the merits of an investment or opining on its merits; (4) handling customer funds and securities; (5) having a history of selling securities of other issuers; and (6) receiving commissions, transaction-based compensation or payment other than a salary for selling the

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2 15 U.S.C. § 78c(a)(4).
3 Section 3(a)(5)(A) of the Exchange Act .

investments are generally considered acting in the capacity of a broker-dealer.[4]

Moreover, the type of compensation that the finder receives for the referral may trigger registration requirements under Section 15 of the Exchange Act. The Commission takes the view that the receipt of compensation that is directly tied to successful investments by investors introduced by the finder gives the finder a "salesman's stake" in the proposed transactions and creates a heightened incentive for the finder to engage in sales efforts.[5] Such "salesman's stake" is considered a hallmark of broker-dealer activity.[6]

While the Commission has taken a broad approach in its application of the definition of broker-dealer activities with respect to transaction-based compensation, some courts have been more lenient. For example, within a year after Brumberg Mackey, in SEC v. Kramer, the U.S. District Court for the Middle District of Florida questioned the SEC's application of the definition of finders.[7] In denying the Commission's enforcement of the broker-dealer registration requirements, the court held that the Commission's single-factor 'transaction-based compensation' test is an inaccurate statement of Section 3(4) of the Exchange Act and that something more than just a transaction-

4 For example, in a 1991 no-action to Paul Anka (the famous 1960s singer), the Commission did not require Anka to register as a broker-dealer because, despite the clear use of transaction-based compensation, the singer merely intended to provide the names of potential investors with whom he had a preexisting business or personal relationship. Although the compensation was directly based on the sales of interests in a limited partnership, the SEC determined that Anka was not required to register as a broker-dealer because he (1) did not participate in any negotiations; (2) did not provide services to facilitate the transactions, such as underwriting or preparing sales literature; (3) did not make recommendations to enter into the transactions; (4) had not previously engaged in public or private offering of securities. See Paul Anka, SEC No-Action Letter, 1991 WL 176891 (July 24, 1991).

5 SEC No-Action Letter to Brumberg, Mackey & Wall, P.L.C. (May 17, 2010).

6 In *Brumberg Mackey*, the finder, Brumberg, Mackey & Wall, P.L.C ("BMW"), intended to enter into an agreement with the issuer, EMPS, whereas the BMW, a law firm, would introduce the issuer to individuals or entities who "may have interest" in the issuer's securities. BMW did not intend to (1) engage in any negotiations on behalf of EMPS or any potential investors; (2) provide any potential investors with any information about EMPS that may be used as the basis for any negotiations for funding to be provided to EMPS; (3) have any responsibility for making any recommendations concerning the terms, conditions, or provisions of any agreement between EMPS and potential investors; or (4) provide any assistance to any investors or EMPS with respect to any transactions involving the financing of funds for EMPS. In denying a no-action letter to BMW, the SEC Staff indicated that "a person's receipt of transaction-based compensation in connection with the sale of securities is a hallmark of broker-dealer activity. Note that where a fee for services rendered is determined by a fixed amount, whether on a retainer/lump sum, per referral, or hourly basis, the SEC would probably not require the finder to register as a broker-dealer. In *Charles Schwab & Co.*, for example, the use of a nominal flat fee for each order transmitted to broker-dealers through online services acting as finders did not require broker-dealer registration by the online services. *See* SEC No-Action Letter, *Charles Schwab & Co., Inc.* (Nov. 27, 1996). Similarly, in *Colonial Equities Corp.*, the Staff agreed to take no action after the compensation payable by a registered broker-dealer to multiple finders was changed from a percentage of the net brokerage commissions generated from sales to a fee that was payable regardless of whether the investor actually made the investment. See *Colonial Equities Corp.*, SEC No-Action Letter, LEXIS 862 (June 28, 1988). In these instances, the presumption was the finder did not have a "salesman stake" in the transactions.

7 *SEC v Kramer*, 778 F.Supp.2d 1320, 1334 (M.D. Fla., 2011). In this case, Kramer entered into an agreement which provided that he would receive a transaction-based compensation. There was no evidence Kramer was involved in key points in the transaction, such as negotiation, analyzing the issuer's financial needs, and discussing details of the transaction.

based compensation is necessary to require broker registration.[8] Nonetheless, since *Kramer*, the Commission continued to bring enforcement actions against finders who were engaged in broker-dealer activities as unregistered brokers[9] with little regulatory clarity to investors, issuers, and the finders who assist them in capital-raising transactions.

THE PROPOSAL

As mentioned above, the Commission is proposing to grant exemptive relief pursuant to Sections 15 of the Exchange Act to permit natural persons who assist issuers with raising capital in private markets from accredited investors. As such, legal persons such as corporations, LLCs, or other legal entities are not eligible for the exemption. Furthermore, the exemption is available to finders that interact with accredited investors. Lastly, the proposed exemption is limited to activities solely in connection with primary offerings. As with any securities transaction, the anti-fraud rules are applicable.

The proposed exemption would create two classes of finders: Tier I Finders and Tier II Finders.

To be eligible for a registration exemption for Tier I and Tier II Finders, the following conditions must be met:

- The issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;[10]
- The issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act; [11]
- The Finder does not engage in the general solicitation;[12]
- 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;

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8 *Id.*

9 *See* Release No. 3563 / March 8, 2013. ADMINISTRATIVE PROCEEDING. File No. 3-15234, In the Matter of Ranieri Partners LLC and Donald W. Phillips; Respondent Phillips received transaction-based compensation and engaged in broker-dealer activities. *See also*, Release No. 82805 / March 5, 2018. ADMINISTRATIVE PROCEEDING. File No. 3-18384, In the Matter of Edwin Shaw, LLC; where Respondent received "administrative fees" for introducing investors to an EB-5 investment and engaged in broker dealer activities. See also Release No. 85905 / May 21, 2019. ADMINISTRATIVE PROCEEDING. File No. 3-19173 In the Matter of Marcus Bradford Bray, Respondent sold securities through a controlled-owned entity and received transaction-based compensation masked as "marketing bonus."

10 The exemption would not be available to issuers that are reporting companies or publicly-traded companies.

11 The exemption would be available to offerings conducted under Regulation D or 4(2) exemption.

12 The exemption would not be available to offerings conducted under 506(c) of Regulation D and Regulation CF or Regulation A. Although these offerings are conducted pursuant to an exemption from the registration requirements under Section 5 of the Securities Act, these offerings involve some level of general solicitation.

- The Finder is not an associated person of a broker-dealer; and
- The Finder is not subject to a statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act.

TIER I

A "Tier I Finder" is defined as a finder who meets the above conditions and whose activity is limited to providing contact information of potential investors in connection with only one capital raising transaction by a single issuer within a 12-month period. As such, a Tier I Finder is precluded from engaging in continuous or multiple sales of securities. In essence, a Tier I Finder is not in the business of effecting securities transactions. A Tier I Finder that complies with all of the conditions of the exemption may receive transaction-based compensation for the limited services described above without being required to register as a broker under Section 15(a) of the Exchange Act. As Commissioner Lee noted in her dissenting statement, the Tier I Finders exemption is the codification of the Paul Anka no-action letter and its progeny.[13]

TIER II

Permitted activities under Tier II are broader than those under Tier I. A Tier II Finder may engage in activities beyond the initial referral, including (i) identifying, screening, and contacting potential investors; (ii) distributing issuer offering materials to investors; (iii) discussing with issuer the 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 (iv) arranging or participating in meetings with the issuer and investor.

Furthermore, because a Tier II Finder is intended to have more interaction with investors than Tier I Finders and engage in limited solicitation-related activities, the former must comply with certain disclosure requirements and other conditions.

First, the Tier II Finder would need to provide a potential investor, before or at the time of the solicitation, disclosures that include:

1. the name of the Tier;
2. the name of the issuer;
3. the description of the relationship between the Tier II Finder and the issuer, including any affiliation;
4. a statement that the Tier II Finder will be compensated for his or her solicitation activities by the issuer and a description of the terms of such compensation arrangement;

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13 Public Statement, US Securities & Exchange Commission, Commissioner Allison Herren Lee, Regulating in the Dark: What We Don't Know About Finders Can Hurt Us, October, 7. 2020, available at https://bit.ly/37rWbhD

5. any material conflicts of interest resulting from the arrangement or relationship between the Tier II Finder and the issuer; and
6. an affirmative statement that the Tier II Finder is acting as an agent of the issuer, is not acting as an associated person of a broker-dealer and is not undertaking a role to act in the investor's best interest.

A Tier II Finder is precluded from engaging in structuring the transaction or negotiating the terms of the offering; handling customer funds or securities or binding the issuer or investor; participating in the preparation of any sales materials; performing any independent analysis of the sale; engaging in any "due diligence" activities; assisting or providing financing for such purchases; or provide advice as to the valuation or financial advisability of the investment. In essence, the Tier II Finder should not act as an agent of or an advisor to the issuer or the investor. Such activities are considered broker-dealer activities or those of associates persons. (To the extent that the finder provides advice concerning the value of the security, such activities may be considered acting in the capacity of an investment adviser, which involves different registration requirements.)

CONCLUSION

We anticipate that market participants will receive the Proposal with mixed reviews. Proponents of the Proposal such as Chairman Clayton and Commissioners Pierce and Roisman will tout the benefits the exemption will provide to small businesses that often face challenges when trying to connect with potential investors in the private market. They will argue the rule provides protections, in part, because it is restricted to accredited investors, does not allow general solicitation, and is available only natural persons (as opposed to business entities and their employees).

Opponents to the Proposed Exemption, such as Commissioner Lee and Crenshaw, will argue that rule, particularly with respect to Tier II Finders, lacks investor protections and opens the door for unregistered persons to engage in broker-dealer activities and take advantage of investors without the important investor protections that come with registration as a broker-dealer. For instance, the Proposed Exemption does not set a limit on the amount that can be raised.[14] The rule does not require the finders (or issuers) to maintain records of their activities or subject Tier II Finders to periodic inspections or examinations. For example, there is no provision to assess whether Finders are providing adequate descriptions of the terms of their compensation arrangements or whether they are adequately disclosing material conflicts of interest resulting from the arrangement or

14 For example, Rule 504 of Regulation D exempts from registration the offer and sale of up to $5 million of securities in a 12-month period. Rule 506 does not have a cap on the amount that can be raised.

relationship between the Tier II Finder and the issuer. As such the Commission will not know whether such finders are complying with any of the conditions in the Proposed Exemption.[15]

As noted above, the Proposed Exemption is open for public comment until November 12, 2020. We trust that the Commission will ultimately find the right balance between promoting capital-raising activities for small businesses and preserving investor protection mechanisms. We will continue to monitor the developments of the proposed rule.

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15 The Proposal also seems inconsistent with SEC's recently adopted Regulation Best Interest, which is intended to provide greater protections to retail investors, including accredited investors. Regulation Best Interest imposes on registered brokers and associated persons strict requirements related to disclosure, supervision, and compensation. The Proposal would allow persons to engage in certain broker-dealer activities without being subject to similar strict requirements.

For a comparative summary of the Proposal and existing rules concerning permissible activites, requirements, and limitations outlined in the exemptive order, please see a chart prepared by the Office of the Advocate for Small Business Capital Formation, ***available here****.*

For further analysis concerning broker-dealer regulation, please see our recent article on Regulation Best Interest, ***available here****.*

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