CLIENT ALERT

SEC Proposes a Finder's Exemption from Broker-Dealer Registration Requirements

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On October 7, 2020, a divided Securities and Exchange Commission ("SEC") voted, 3 to 2, to propose a new limited, conditional exemption[1] from broker-dealer registration requirements for "Finders" who assist private issuers in raising capital from accredited investors. If adopted, the exemption would permit natural persons to engage in specified solicitation activities for private issuers, including funds, without being required to register as a broker-dealer with the SEC. The proposed exemption would provide clarity to private offering participants as to the regulatory requirements applicable to persons acting as "Finders." There is very little discussion of a "finder's exemption" from broker-dealer registration in case law, and the exemption has been the subject of varied interpretations by the SEC and in SEC staff no-action letters and enforcement actions.[2]

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" Exchange Act Release No. 90112 (Oct. 7, 2020) (the "proposed exemption"), here.

2 In *Paul Anka*, SEC No-Action Letter (July 24, 1991), the staff provided no-action relief to an individual who, without registering with the SEC as a broker-dealer: (1) entered into an agreement with an issuer to provide to the issuer a list of names and telephone numbers of potential investors he reasonably believed to be accredited investors and with whom he had a pre-existing business or personal relationship, (2) had no further contact with potential investors concerning the issuer, and (3) received a finder's fee. In the enforcement litigation context and in other SEC staff no-action letters, however, the SEC has argued that "there is no 'finder' exception." Brief for Appellee SEC at 28, *SEC v. Collyard et al.* (8th Cir. June 3, 2016) (No. 16-1405); *see also Brumberg, Mackey & Wall, P.L.C.*, SEC Denial of No-Action Request (May 17, 2010); *John W. Loofbourrow Associates, Inc.*, SEC Denial of No-Action Request (June 29, 2006).

The proposed exemption would provide a non-exclusive safe harbor from broker-dealer registration with the SEC for two classes of Finders: Tier I Finders and Tier II Finders. Tier I Finders would only be permitted to provide issuers with contact information for prospective investors. Tier II Finders would be permitted to engage in solicitation activities that currently require broker-dealer registration and would also be subject to additional disclosure requirements. Tier I and Tier II Finders would both be permitted to accept a commission or other compensation based on the success of the offering ("transaction-based compensation") under the terms of the proposed exemption.

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." Because the Exchange Act does not define what it means to be "engaged in the business of effecting transactions," the question of whether a person is a broker turns on the facts and circumstances of the situation, and often a key consideration is whether the person participates on a regular basis in securities transactions at key points in the chain of distribution.[3] The SEC indicated that one element of participation in the chain of distribution is solicitation of prospective investors. The proposed exemption states that solicitation includes "efforts to induce a single securities transaction as well as efforts to develop an ongoing securities-business relationship," and although not determinative or required to establish broker status, the receipt of transaction-based compensation in connection with securities activities has been considered a critical factor in determining that registration as a broker may be required.

Those engaging in activities outside the requirements of the proposed Finders Tiers would need to otherwise demonstrate that their activities do not require broker-dealer registration. Absent an exemption, effecting securities transactions without proper registration may subject a broker-dealer to enforcement actions by the SEC or relevant state regulators and to private investor actions for rescission. Adverse consequences include cease-and-desist orders, civil penalties (such as fines and disgorgement) and criminal liability. In the case of the SEC, this also includes the ability to impose a bar on future broker-dealer registration.

Tier I Finders

A Tier I Finder would be limited to providing contact information of potential investors in connection with a single capital raising transaction by a single issuer in a 12-month period. The information could be provided either directly to the issuer

[3] The proposed exemption cites *SEC v. Bravata*, 2009 WL 2245649 (E.D. Mich. 2009); *see also Mass. Fin. Servs., Inc. v. SIPC*, 411 F. Supp. 411, 415 (D. Mass. 1976), ***aff'd***, 545 F.2d 754 (1st Cir. 1976) and explains that the courts and the SEC have identified certain activities as indicators of broker status, including: (i) actively soliciting or recruiting investors; (ii) participating in negotiations between the issuer and the investor; (iii) advising investors as to the merits of an investment or opining on its merits; (iv) handling customer funds and securities; (v) having a history of selling securities of other issuers; and (vi) receiving commissions, transaction-based compensation or payment other than a salary for selling the investments. *See SEC v. Hansen*, 1984 U.S. Dist. LEXIS 17835, at *26 (S.D.N.Y. April 6, 1984); *see SEC v. M&A West, Inc.*, 2005 WL 1514101, at *9 (N.D. Cal. June 20, 2005); *see SEC v. Margolin*, 1992 WL 279735, at *5 (S.D.N.Y. 1992); *see SEC v. Benger*, 697 F. Supp. 2d 932, 944 (N.D. Ill. 2010).

or to a placement agent or Tier II Finder assisting the issuer. A Tier I Finder would not be permitted to have any contact with a potential investor about the issuer but would be permitted to receive compensation for his or her assistance, including compensation based on the actual investments made by the named prospects.

Tier II Finders

A Tier II Finder would be permitted to solicit investors on behalf of an issuer provided that the solicitation-related activities were limited to:

i. identifying, screening, and contacting potential investors;

ii. distributing issuer offering materials to investors;

iii. discussing issuer information included in any offering (but not providing advice as to the valuation or advisability of the investment); and

iv. arranging or participating in meetings with the issuer and investor.

Tier II Finders would be subject to disclosure requirements that are based on those required by Rule 206(4)-3 under the Investment Advisers Act of 1940. In particular, a Tier II Finder would be required to disclose to prospective investors the Finder's role and compensation terms, any material conflicts of interest, and disclosure that the Finder is acting as an agent of the issuer and is not undertaking to act in the investor's best interest. The required disclosures would be required to be made prior to or at the time of solicitation. Similar to Rule 206(4)-3, the Finder would also be required to obtain a written acknowledgement regarding the disclosure from the prospective investor (which would be permitted to be obtained through electronic means). Further, a Tier II Finder would be permitted to provide the required disclosures verbally so long as a written set of disclosures were provided prior to the prospective investor making the investment.

Restrictions Applicable to Tier I and Tier II Finders

The proposed exemption would be available only where:

i. the issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;

ii. the issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act of 1933, as amended (the "Securities Act");

iii. the Finder does not engage in general solicitation;

iv. the potential investor is an "accredited investor" as defined in Rule 501 of Regulation D under the Securities Act or the Finder has a reasonable belief that the potential investor is an "accredited investor";

v. the Finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;

vi. the Finder is not an associated person of a broker-dealer;

vii. 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;

viii. the Finder is not involved in structuring the transaction or negotiating the terms of the offering;

ix. the Finder does not handle customer funds or securities or bind the issuer or investor;

x. the Finder does not participate in the preparation of any sales or marketing materials;

xi. the Finder does not perform any independent analysis of the sale;

xii. the Finder does not engage in any due diligence activities;

xiii. the Finder does not assist or provide financing for such purchases;

xiv. the Finder does not provide advice as to the valuation or financial advisability of the investment;

xv. the Finder does not engage in the resale of existing securities or assist with secondary market transactions; and

xvi. the Finder is not operating through a legal entity.

The proposed exemption and questions raised for comment in the proposed exemption also suggest that a Finder may not be allowed to receive a financial interest in the issuer as compensation for the solicitation activities.

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The proposed exemption makes clear that a person acting as a Finder subject to the exemption would still be deemed to be a broker within the meaning of the Exchange Act. As a result, the person would continue to be subject to all applicable laws affecting brokers, including the antifraud provisions of the Securities Act and the Exchange Act and substantive sales practices rules applicable to brokers, such as the Penny Stock rules in Section 15(h) of the Exchange Act. Additionally,

state securities or "blue sky" laws would continue to be applicable, including state broker-dealer registration requirements.[4]

The proposed exemption is open for public comment until November 12, 2020. In light of the strong dissents of two commissioners to the proposal, our expectation is that the proposed exemption will likely be subject to political push-back in the event that the Democrats are successful in the upcoming Congressional and Presidential elections. As a result, even if the exemption is adopted by the SEC, it is possible that it could be later reviewed and modified or revoked in the months following the election.[5]

[4] However, should the proposed exemption be adopted as proposed, state securities regulators could adopt parallel exemptions from their state broker registration provisions, similar to exemptions that have been adopted in some but not all states to coordinate with the SEC's exemptive relief provided in the M&A Brokers Letter. *See* M&A Brokers, SEC Staff No-Action Letter (Jan. 31, 2014) ("M&A Broker Letter"). Certain states previously had or recently have adopted laws, rules or policies which can provide exemptions for M&A brokers, including Alaska, Arkansas, California, Colorado, Florida, Georgia, Illinois, Iowa, Maryland, Michigan, Mississippi, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah and Vermont. *See also* North American Securities Administrators Association Model Rule Exempting Certain Merger & Acquisition Brokers ("M&A Brokers") From Registration, adopted September 29, 2015. https://www.nasaa.org/wp-content/uploads/2011/07/MA-Broker-Model-Rule-adopted-Sept-29-2015-corrected.pdf.

[5] For example, the Congressional Review Act of 1996 authorizes Congress to issue a joint resolution of disapproval within 60 legislative days or 60 session days of its receipt of a rule. Only a simple majority vote is required in both the House of Representatives and the Senate to pass a resolution of disapproval.

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