SEC Proposes to Exempt Certain "Finders" from Broker-Dealer Registration Requirements

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A divided SEC voted last week to issue a **Proposed Exemptive Order** (the **Proposal**) that would, if adopted, permit natural person "finders" to engage in certain private capital raising activities, including in connection with private funds, without registering as a broker-dealer. The extent to which finders are subject to broker-dealer registration has long been uncertain. The question of whether a finders exemption already exists has long been debated, recognized in a very limited form by historical SEC staff no-action letters and more recent case law, but never explicitly adopted by the Commission. The Proposal, if adopted, would provide legal certainty to issuers and finders that previously operated under a legal shadow. The timing and politically divided views on the Proposal, however, raise the question of whether it ultimately will be adopted, should the administration, and thus the political makeup of the SEC, change in January.

Background on Broker-Dealer Registration Requirements and Finders

Broker Registration

The Exchange Act requires all "brokers" that induce or attempt to induce the purchase or sale of a security to register with the SEC, unless they can rely on an exception or exemption. A broker is "any person engaged in the business of effecting transactions in securities for the account of others." Neither "engaging in the business" nor "effecting transactions" is defined in the Exchange Act, so in the years since the Exchange Act's passage, a large body of case law, SEC staff no-action letters, and regulatory guidance have turned the question of who is a broker into an intensely fact-specific inquiry that involves weighing various non-exhaustive factors. These factors include, among others, whether the person is involved in:

- receiving compensation that is tied to the success or size of the transaction (so called "transaction-based compensation"); or
- assisting an issuer to structure a securities transaction;
- identifying or soliciting potential investors;
- negotiating a transaction between the issuer and investors;
- advising as to the valuation or merits of an investment; or
- handling investors' funds and securities.

Historically, the SEC and courts have typically found the receipt of transaction-based compensation as the most critical factor, and the "hallmark" of being a broker, yet judicial decisions and the SEC staff have not always been entirely consistent, even under similar facts, regarding how strongly to weigh the factors.

Finders

Finders, or persons that introduce investors and issuers to one another for a fee, appear to meet many of the factors indicating status as a broker. The SEC staff has recognized through no-action letters, however, a limited category of finders whose activities are sufficiently occasional and insignificant, and that present a sufficiently low risk to investors, as to not be sufficiently "in the business" of "effecting

transactions" to warrant broker-dealer registration. The so-called finder exception has been plagued with uncertainty, however, as the SEC staff in recent years has distanced itself from some of its no-action letter precedents, declined to issue relief in similar situations, and, most recently, taken the position in litigation that "there is no finder exception."[1] And courts have reached inconsistent decisions with some being more willing to recognize a finder exception than others. Industry and legal task forces have for years called on the SEC to provide further clarity or an explicit limited exemption. Most recently, recommendations by the **SEC's Advisory Committee on Small and Emerging Companies** suggested that such an exemption would support small business capital formation by permitting small businesses to raise amounts of capital which are traditionally too small to enlist a registered broker-dealer.

Overview of the Proposed Exemptive Order

Framed as a non-exclusive safe harbor, the Proposal would create two "tiers" of finder exemptions that would allow a finder to assist an issuer to identify potential investors for certain primary offerings. Tier I Finders would be limited to a very narrow and occasional set of activities, while Tier II Finders would have broader latitude, but be subject to greater conditions.

Conditions for Either Tier of Finder

To qualify for either tier, the following conditions would apply:

- the finder must be a natural person who is not subject to "statutory disqualification" and is not at the time an associated person of a broker-dealer;
- the issuer must not be a SEC reporting company and must be conducting a securities offering in reliance on an exemption from registration under the Securities Act;
- the finder may not engage in general solicitation and may only contact (or provide the contact information for) accredited investors or persons the finder reasonably believes are accredited investors; and
- the finder must perform its services pursuant to a written agreement with the issuer that describes the services and compensation.

As a result, the proposed exemption would not be available, for either tier of finder, for:

- finders operating through legal entities;
- registered securities offerings or offerings by a reporting issuer;
- resale of existing securities; or
- transactions involving non-accredited investors.

Tier 1 Finders

The scope of activities in which a Tier I Finder could engage would be exceedingly limited. A Tier I Finder would only be able to facilitate one transaction per 12-month period and may only do so by providing the contact information of accredited investors to the issuer. A Tier I Finder would not be allowed to have any

[1] Brief for Appellee Securities and Exchange Commission at 28, *SEC v. Collyard et al.* (8th Cir. June 3, 2016)(No. 16-1405).

contact with the potential investors about the potential investment.[2] However, a Tier I Finder would not be subject to any conditions beyond what is described above.

Tier II Finders

By contrast, a Tier II Finder would be permitted to participate in an unlimited number of capital raises and engage in a wider range of activities, including identifying, screening, and contacting potential investors. A Tier II Finder would also be permitted to provide an issuer's offering materials to accredited investors, discuss those materials with the prospective investor, and even arrange or participate in meetings between the issuer and investor. However, a Tier II Finder would not be permitted to:

- structure or negotiate the terms of the offering;
- handle customer funds or securities;
- bind an issuer or investor to a transaction;
- participate in the preparation of sales material;
- perform an independent analysis of the sale;
- engage in any "due diligence" activities;
- assist or provide financing for securities purchases; or
- provide advice as to the valuation or financial advisability of the investment.

A Tier II Finder would also be subject to disclosure and procedural compliance obligations. Specifically, a Tier II Finder would be required to disclose to each potential investor, prior to or at the time of a solicitation:

- the name of the Tier II Finder;
- the name of the issuer;
- a description of the relationship (including any affiliation) between the Tier II Finder and the issuer;
- 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;
- any material conflicts of interest resulting from the arrangement; and
- 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.

These disclosures could initially be made orally, so long as they are provided in writing no later than the time that the investment is made, at which point the Tier II Finder would also be required to obtain a written and dated acknowledgement of receipt of these disclosures.

Next Steps

The Proposal is open for public comment until November 12, 2020, following which the SEC could vote to issue a final exemptive order. However, the Proposal's future is far from clear. The proposed exemption

[2] The Tier I Finder category appears to mirror the conditions of the most well-known finder no-action letter, wherein the SEC staff granted relief that permitted the finder to essentially "sell his rolodex," limiting his involvement to providing potential investor contact information in exchange for transaction-based compensation. *See* Paul Anka, SEC No-Action Letter (July 24, 1991).

would represent a significant departure from the SEC's historical policy position and more recent efforts to rein in the activities of unregistered finders, including through enforcement actions. The Proposal also drew strong dissents from the two Democratic commissioners, **Allison Lee** and **Caroline Crenshaw**, who criticized the Proposal for "eroding investor protections" and for being "flawed in both substance and procedure"—including the choice to adopt a broadly applicable substantive exemption through an order, rather than adopting an exemptive rule through the full rulemaking process. As such, the Proposal may be subject to the risks of the political calendar and the results of the November election.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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