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SEC Proposes Conditional Exemption for "Finders"

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On October 7, 2020, the U.S. Securities and Exchange Commission (the "***SEC***") published a proposed conditional exemption for certain natural person "Finders" (the "***Finders Exemption Proposal***").[1] The Finders Exemption Proposal is intended to provide a non-exclusive safe-harbor from broker-dealer registration under Section 15(a) of the Securities Exchange Act of 1934, as amended (the "***Exchange Act***"), to natural persons engaging in certain limited activities on behalf of issuers ("***Finders***") (the "***Finders Exemption***"), as well as clarify the ability of Finders to engage in certain non-registrable activities with respect to private, primary offerings.

Background of Finders

A long-standing issue in broker-dealer regulation is the regulatory status of so called "finders." Section 3(a)(4) of the Exchange Act generally defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[2] Section 15(a)(1) of the Exchange Act, in turn, generally 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.[3] Because the Exchange Act does not define what it means to be "engaged in the business" or "effecting transactions," through No-Action Letters the SEC has adopted a facts and circumstances based approach, applying a number of identifying activities as being indicative of broker-dealer activity. Historically, the most important indicator has been receiving commissions or other transaction-based compensation in connection with the purchase or sale of securities (collectively, "***Transaction-Based Compensation***"). While the SEC has at times in the past through No-Action Letter relief narrowly recognized that a Finder may receive Transaction-Based Compensation,[4] the SEC has never defined or exempted Finders by rule or interpretive release. Given the regulatory ambiguity, a person who identifies and solicits potential investors for Transaction-Based Compensation could be viewed as engaging in an activity that requires registration as a broker.

The Finders Exemption Proposal

General Conditions

Under the Finders Exemption Proposal, the SEC is proposing to exempt two (2) classes of Finders, Tier I Finders and Tier II Finders. Both Tier I Finders and Tier II Finders would be subject to varying conditions tailored to the scope of their respective activities. For example, Tier II Finders may engage in more activities than Tier I Finders and are therefore subject to additional regulatory requirements.

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[1] Notice of Proposed Exemption Order Granting Conditional Exemption from Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders, Proposing Release, Rel. No. 34-90112, File No. S7-13-20, (October 7, 2020), https://www.sec.gov/rules/exorders/2020/34-90112.pdf. The Finders Exemption Proposal will be open to a thirty (30) day comment period following publication in the Federal Register.

[2] Section 3(a)(4)(A) of the Exchange Act, 15 U.S.C. 78c(a)(4)(A).

[3] Section 15(a) of the Exchange Act, 15 U.S.C. 78o(a).

[4] *See*, *e.g.*, *Paul Anka*, SEC Staff No-Action Letter (July 24, 1991).

The proposed Finders Exemption for Tier I Finders and Tier II Finders would be available only where:

- The Finder is a natural person;
- The issuer is not required to file reports under Section 13[5] or Section 15(d)[6] 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, as amended (the "***Securities Act***"), such as Rule 506(b) of Regulation D;
- 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 their participation.

Tier I Finders

A "Tier I Finder" is defined as a Finder who meets the general conditions referenced above and whose activity is ***limited*** to providing contact information of potential investors in connection with only one (1) capital raising transaction or offering by a single issuer within a twelve (12) month period. A Tier I Finder cannot not have any direct contact with the potential investors about the issuer. The Finders Exemption Proposal notes that Tier I Finders can provide issuers with investor contact information which may include, among other things, names, telephone numbers, email addresses and social media information.

A Tier I Finder that complies with all of the conditions of the Finders 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.

Tier II Finders

A "Tier II" finder is defined as a Finder who meets the general conditions referenced above, and who engages in solicitation-related activities on behalf of an issuer, that are ***limited*** to: (i) identifying, screening and contacting potential investors; (ii) distributing issuer offering materials to investors; (iii) 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 (iv) arranging or participating in meetings with the issuer and investor. A Tier II Finder may participate in more than one (1) capital raising transaction or offering within a twelve (12) month period.

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[5] Under Section 13 of the Exchange Act, reports made to the SEC are filed on Schedule 13D, Schedule 13G, Form 13F, and Form 13H.

[6] Under Section 15(d) of the Exchange Act, periodic and current reporting requirements include the requirement to file: (i) annual reports on Form 10-K; (ii) quarterly reports on Form 10-Q; and (iii) current reports on Form 8-K.

A Tier II Finder that desires to rely on the proposed Finders Exemption would need to provide a potential investor, prior to or at the time of the solicitation, disclosures that include: (i) the name of the Tier II Finder; (ii) the name of the issuer; (iii) the description of the relationship between the Tier II Finder and the issuer, including any affiliation; (iv) a statement that the Tier II Finder will be compensated for their solicitation activities by the issuer and a description of the terms of such compensation arrangement; (v) any material conflicts of interest resulting from the arrangement or relationship between the Tier II Finder and the issuer; and (vi) 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. It should be noted that this disclosure obligation is substantially similar to the disclosure obligation of solicitors under the “Cash Solicitation Rule” of the Advisers Act of 1940, as amended (the “***Advisers Act***”).[7]

The Finders Exemption Proposal notes that a Tier II Finder may deliver such disclosure orally, provided that the oral disclosure is supplemented by written (either paper or electronic) disclosure that satisfies all of the disclosure requirements listed above no later than the time of any related investment in the issuer’s securities. In addition, the Tier II Finder must obtain from the investor, prior to or at the time of any investment in the issuer’s securities, a dated written acknowledge that the investor has received such disclosures.

A Tier II Finder that complies with all of the conditions of the Finders 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.

Prohibited Activities

In an effort to narrow the scope of the Finders Exemption, the Finders Exemption Proposal prohibits any Finder (including both Tier I Finders and Tier II Finders) from: (i) being involved in structuring a transaction or negotiating the terms of the offering; (ii) handling customer funds or securities; (iii) binding the issuer or investor; (iv) participating in the preparation of any sales materials; (v) performing any independent analysis of a sale; (vi) engaging in any “due diligence” activities; (vii) assisting or providing financing for purchases; and (viii) providing advice as to the valuation or financial advisability of an investment.

Conclusion

The Finders Exemption Proposal, if adopted, would both codify and, in some instances, expand existing “Finder” SEC No-Action Letter relief. Issuers should take note that while the SEC states that the Finders Exemption is intended to help small businesses raise capital, the Finders Exemption Proposal does not materially limit the issuers or size of offerings that may use Finders operating under the Finders Exemption. For example, limiting the Finders Exemption to issuers not required to file reports under Section 13 or Section 15(d) of the Exchange Act leaves open that non-filing, private companies or private investment vehicles may use Finders, regardless of the amount of capital the issuer intends to raise.

Finders should take note that the Finders Exemption would not affect a Finder’s obligation to continue to comply with all other applicable laws, including the antifraud provisions of the Securities Act and the Exchange Act, such as the obligations under Section 10(b) and Rule 10b-5 under the Exchange Act, and state law. Additionally, the proposed Finders Exemption does not insulate a Finder from the registration requirements of the Advisers Act if such Finder is deemed to be acting as an investment adviser.

[7] Rule 206(4)-(3) of the Advisers Act, 17 CFR 275.206(4)-3.

The foregoing is based upon the Finders Exemption as currently proposed. The SEC is seeking comment on the Finders Exemption Proposal, including forty-five (45) specific questions. Accordingly, there may be additional changes to the Finders Exemption Proposal, if and when formally adopted.

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