

SEC Proposed Exemption Offers Regulatory Clarity For Unregistered Finders

On October 7, 2020, the Securities and Exchange Commission (SEC) voted to provide much needed clarity to the regulatory status of so-called “finder” who assist small businesses in raising capital. In a 3-to-2 vote, the SEC proposed a Finder exemption to the broker-dealer registration requirements of Section 15(a) of the Securities Exchange Act of 1934 (as amended, the Exchange Act) to allow unregistered natural persons, referred to as finders, to engage in certain limited activities to assist issuers in raising capital from accredited investors. The proposed exemption would provide a non-exclusive safe harbor from the broker registration requirements where a finder’s involvement in the capital raising activities are limited to specific circumstances described in the conditional exemption.

Proposed Conditional Exemption Intended to Address the Issue of Capital Access for Small Companies

For many years the SEC has examined the challenges small companies encounter under the existing regulations with respect to connecting with investors in exempt markets. For example, smaller companies do not garner interest from venture capital or registered brokers, but have capital needs that are too large to obtain from friends and family, leaving a funding gap. Finders have the potential to fill this gap, but the regulatory uncertainty leads finders to refrain from engaging in the market because it is unclear whether these activities would require a finder to register as a broker under the Exchange Act.

A “broker” is defined under Section 3(a)(4) of the Exchange Act as “any person engaged in the business of effecting transaction in securities for the account of others” and the question of whether a person is a broker under this definition depends on the facts and circumstances. Historically, whether a finder was required to register as a broker was a fact-specific question dependent upon an array of factors discussed in a collection of SEC no-action letters and various court decisions. The SEC no-action letters and court decisions generally identified certain activities as indicative of broker status, which include, among other things:

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 investments.

The application of these factors by the SEC and the courts has not yielded consistent outcomes due to the factual differences in each instances. As a result of this regulatory uncertainty, potential unregistered finders have been reluctant to help small businesses connect with investors to raise additional capital.

Conditions for Exemption

The specifics of the proposed exemption include the establishment of two tiers of finders, labeled “Tier I” and “Tier II” finders. Each tier would be subject to conditions specific to the scope of the finders’ activities, while there would also be general conditions applicable to both tiers.

General Conditions

Both Tier I and Tier II finders may only employ the proposed exemption in limited circumstances.



Joseph Dever

**Chair,
Securities
Litigation & SEC
Enforcement**

jdever@cozen.com
Phone: (212) 453-3916
Fax: (917) 521-5875



Seth Popick

Member

spopick@cozen.com
Phone: (412) 620-6527
Fax: (412) 275-2390

Related Practice Areas

- Corporate
- Corporate Governance
- Emerging Business & Venture Capital
- Securities Litigation & SEC Enforcement

The exemption would be available only where:

1. the issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;
2. the issuer is seeking to conduct an offering in reliance upon an exemption from registration under the Securities Act;
3. the finder does not engage in general solicitation;
4. the potential investor is, or the finder reasonably believes that the potential investor is, an “accredited investor,” as such term is defined in Rule 501 of Regulation D;
5. the finder enters into a written agreement with the issuer that includes a description of the services provided and associated compensation;
6. the finder is not an associated person of a broker-dealer; and
7. at the time of the finder’s participation, the finder is not subject to “statutory disqualification,” as that term is defined in Section 3(a)(39) of the Exchange Act.

The proposed exemption makes clear that a finder may not rely on the proposed exemption in order to facilitate a registered offering, resale of securities, or sale of securities to unaccredited investors.

Tier I Finders

The proposed exemption further provides that a Tier I finder is one who meets the above conditions and whose activity is limited to providing the contact information of potential investors in connection with “a single capital raising transaction by a single issuer in a 12 month period” and such Tier I finder does not contact a potential investor about the issuer.

Tier II Finders

Alternatively, Tier II finders would be allowed to solicit investors on behalf of an issuer in the following limited instances:

1. identifying, screening, and contacting potential investors;
2. distributing offering materials to potential investors;
3. discussing issuer information included in offering materials, which discussion shall not include advice as to the valuation or advisability of the investment; and
4. the arranging or participation in meetings with the issuer and investor.

In addition, Tier II finders must satisfy the general condition discussed above.

Since, under the proposed exemption, Tier II finders could engage in a larger number of activities than Tier I finders, including more offerings with issuers and investors, a Tier II finder would be required to sufficiently disclose to potential investors the Tier II finders’ role and compensation at or prior to solicitation. Further, under the proposed exemption, the Tier II finder must obtain from potential investors a written acknowledgement at or prior to the investment if the initial disclosure was provided orally. Certain activities, including assisting or providing financing for investment purchases, providing advice as to the valuation or financial advisability of investment, among others activities, would remain strictly within the purview of brokers.

Expected Impact of Proposed Exemption Is Adopted

Chairman Jay Clayton, in his [public statement on the topic](#), indicated that the proposed exemption would address challenges faced by small businesses as they attempt to raise capital, specifically with respect to businesses that lack access to abundant capital sources. Chairman Clayton further indicated that the proposed exemption is aimed at addressing requests for regulatory clarity in the private placement market. Specifically, should the conditional exemptions be adopted, such exemptions have the potential to increase access to capital and increase the number of participants in the market.

As part of the final regulations (if adopted), attention should be paid to whether the SEC clarifies the issuer’s obligations to ensure that any finder involved in assisting with capital raising is compliant with the registration exemption. Failure to do so could potentially result in an issuer having to rescind an investment transaction that involved the use of an unregistered broker and

might also invite unwanted regulatory scrutiny. In addition, even if the proposed exemption is adopted, issuers and finders should be aware that they are still subject to the general antifraud provisions of the Exchange Act and the registration requirements of the Investment Advisors Act of 1940, where applicable.

Next Steps

Following publication in the Federal Register, there will be a 30-day comment period for the proposed exemption. Small businesses, accredited investors, and other market participants are encouraged to participate in the comment process by submitting comment letters addressing any of the 45 specific questions the SEC lists in the Notice of Proposed Exemptive Order.
