

# FINDERS KEEPERS? SEC PROPOSES EXEMPTION FROM BROKER-DEALER REGISTRATION FOR FINDERS IN PRIVATE PLACEMENTS, BUT QUESTIONS REMAIN

Date: 13 October 2020

## Asset Management and Investment Funds Alert

By: Eden L. Rohrer, Richard F. Kerr, Pablo J. Man

### OVERVIEW

On October 7, 2020, the U.S. Securities and Exchange Commission (SEC) proposed a conditional exemption, operating as a nonexclusive safe harbor from the broker registration requirements of Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act) to permit natural persons to engage in certain limited activities on behalf of issuers (Finders).<sup>1</sup> The SEC cited longstanding confusion regarding broker status issues among Finders and others receiving compensation for securities sales and continuous calls from industry participants for clarity as the impetus for this proposed relief.

The proposed exemption would create two classes of Finders: Tier I Finders and Tier II Finders, differentiated by the level, extent, and frequency of their activities on behalf of issuers. Tier I Finders and Tier II Finders would both be permitted to accept transaction-based compensation. However, in order to rely on the proposed exemption, each type of Finder would be required to comply with certain conditions, with heightened conditions applicable to Tier II Finders.

If adopted, the proposed exemption would be a welcome development for some but raises important questions for industry participants. Two SEC Commissioners issued strong dissents and, given the many questions raised by the SEC in the proposing release and a 30-day comment period,<sup>2</sup> the future of the proposal remains uncertain. K&L Gates expects to host an upcoming webinar to discuss the proposed exemption and will provide additional details in the coming days.

### THE PROPOSED EXEMPTION

As proposed by the SEC, the exemption would be limited to certain private offerings of securities (Permitted Offerings). Specifically, both Tier 1 and Tier 2 Finder activity would only be exempted in connection with offerings that meet the following conditions:

- The issuer is not required to file reports under Section 13 or Section 15 of the Exchange Act;
- The offering of securities is conducted in reliance on an applicable exemption from registration under the Securities Act of 1933 (1933 Act), such as Section 4(a)(2) or the Regulation D safe harbor;

- The Finder does not engage in general solicitation;
- The potential investor is an “accredited investor” or the Finder has a reasonable belief that the potential investor is an “accredited investor” (as defined in Regulation D);
- 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 at the time of his or her participation.

In connection with Permitted Offerings, the proposed exemption would create two types of Finders that may qualify for the nonexclusive safe harbor:

- **Tier I Finders:** A Tier I Finder would be limited to providing contact information of potential investors in connection with only a single capital raising transaction by a single issuer in a 12-month period. A Tier I Finder is not permitted to have any contact with a potential investor about the issuer. This category would, essentially, codify existing no-action guidance from the SEC staff.<sup>3</sup>
- **Tier II Finders:** A Tier II Finder would be permitted to participate in a wider range of activities than Tier I Finders, with more frequency and thus subject to additional conditions. A Tier II Finder could not only have contact with potential investors in connection with a Permitted Offering but will be permitted to solicit investors on behalf of an issuer. However, those solicitation activities would be limited to:
  - Identifying, screening, and contacting potential investors;
  - Distributing issuer offering materials to investors;
  - 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
  - Arranging or participating in meetings with the issuer and investor.

In order to comply with the proposed exemption, neither a Tier I Finder nor a Tier II Finder would be permitted to:

- Participate in structuring the transaction or negotiating the terms of the offering;
- Handle customer funds or securities or bind the issuer or investor;
- Participate in the preparation of any sales materials;
- Perform any independent analysis of the sale;
- Engage in any due-diligence activities;
- Assist or provide financing for such purchases; or
- Provide advice as to the valuation or financial advisability of the investment.

In addition, given the heightened level of activities permitted for a Tier II Finder, in order to rely on the proposed exemption, a Tier II Finder will also be required to provide a potential investor, prior to or at the time of the solicitation, disclosures that include:

- The name of the Tier II Finder;
- The name of the issuer;
- The description of the relationship between the Tier II Finder and the issuer, including any affiliation;
- 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;
- Any material conflicts of interest resulting from the arrangement or relationship between the Tier II Finder and the issuer; and
- 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.

The disclosure can be provided orally at the time of the solicitation provided that it is supplemented in writing. The Tier II Finder must then obtain from the investor a dated written acknowledgment of receipt of the required disclosures prior to or at the time of any investment in the issuer's securities. The written disclosure and acknowledgement can be provided in paper form or by electronic means.

## **OPEN QUESTIONS REMAIN**

In recognition that the proposed exemption raises many important issues, the SEC has solicited comment and raised 45 specific questions for industry participants. Some of those questions are highlighted below.

As noted above, Tier II Finders are required to disclose a description of the relationship between the Tier II Finder and the issuer, including any affiliation. The reference to affiliation in the disclosure for Tier II Finders suggests that the proposed exemption would be available to persons related to an issuer (and, in the case of a private fund, personnel of the investment adviser that sponsors the fund). Although Exchange Act Rule 3a4-1 (commonly referred to as the "issuers exemption") currently provides a conditional exemption from broker status, it includes a prohibition of the receipt of compensation based either directly or indirectly on transactions in securities. Consequently, many professional sales and investor relations personnel have found it impractical. While offering additional flexibility, the proposed exemption still includes several conditions that may limit its utility. For example, personnel would still be precluded from having any involvement in the preparation of marketing materials and from advising the prospective investor with respect to the advisability of the investment.

Investment advisers will note the Tier II Finder disclosure regime is very similar, but not identical, to the requirements placed on registered investment advisers that make cash payments to third-party solicitors for advisory client solicitations by Rule 206(4)-3 under the Investment Advisers Act of 1940 (Advisers Act). In November 2019, the SEC proposed amendments to the rule that would extend these requirements to solicitations of investors in private funds.<sup>4</sup> Accordingly, Tier II Finders for private funds would be subject to heightened disclosure and statutory disqualification requirements that would not be applicable in other offerings. Accordingly, the SEC expressly asked for comment on whether it should adopt comparable disclosure requirements with

disclosures required under the proposed changes to Rule 206(4)-3 under the Advisers Act for solicitations of investors in private funds, if adopted (or, alternatively, whether the disclosures required by Tier II Finders should be deemed to satisfy those disclosure requirements).

In addition, notwithstanding the proposed exemption, Finders will still be subject to state regulation. Because the proposed exemption would not preempt state broker registration requirements, it may be inconsistent with Finder registration requirements in some states with respect to issuer or transaction size and the scope of permitted activities. For example, the California Finder law<sup>5</sup> limits the size of a transaction or series of transactions in which a “Finder” (as defined therein) may participate to the offer or sale of securities exceeding \$15,000,000. Both California and Texas<sup>6</sup> require Finder registration with their state regulators.

While the focus of the SEC’s discussion referred to the capital needs of small businesses, the proposed exemption raises the question as to whether the conditions would extend to microcap issuers, which may issue securities in private placement transactions and whose securities trade on the over-the-counter markets but are not technically required to file reports under the Exchange Act. If the SEC is willing to extend the exemption to those issuers, then perhaps other publicly-traded issuers such as small or upstart exchange traded funds that would benefit from additional sources of capital. The SEC sought comment on whether the permitted activities should extend to a narrower or wider range of companies.

Other significant questions include:

- Should the definition of “Finder” be limited to natural persons? To U.S. natural persons?
- Should investors solicited by Finders be subject to investment limitations such as the dollar amount of the investment?
- Should the size of the offering be limited?
- Should a Tier I Finder be permitted to have any contact with potential investors?
- Should the scope be extended to secondary offerings such as transactions facilitating the sale of equity by employees holding options or warrants?
- Should the exemption require a notice filing with the SEC?
- Should a Finder be able to receive equity as compensation?
- Should the SEC consider codifying the M&A Brokers Letter?<sup>7</sup>
- If the proposed exemption is adopted, which SEC staff no-action letters, if any, should be withdrawn?

## **TWO STRONG DISSENTS**

Commissioners Allison Herren Lee<sup>8</sup> and Caroline A. Crenshaw<sup>9</sup> offered strong dissents to the proposal, which underscores the uncertainty of whether an exemption will ultimately be adopted. Commissioners Lee and Crenshaw both criticized the proposed exemption in that it lacks requirements for recordkeeping or periodic inspection by the SEC. Commissioner Lee called for a scaled registration model. Commissioner Crenshaw criticized the proposal in that it seems to encourage the growth of opaque private markets already prone to fraud

at the expense of more transparent public markets and eroding existing investor protections. Both expressed procedural concerns regarding the lack of economic analysis and formal rulemaking process.

## WHO SHOULD COMMENT?

The SEC has not previously recognized a “Finders” exemption or exception. Thus, the proposal represents a seismic shift in broker registration requirements. Registered broker-dealers; issuers, both small and large; public and private; private funds; angel investors; M&A brokers; capital acquisition brokers; funding portals; investment advisers; investment companies; and state-registered financial professionals all have a potential stake in the outcome. Notwithstanding the short comment period, we would encourage industry participants to make their views known to the SEC.

## FOOTNOTES

<sup>1</sup> Proposing release: U.S. SEC. & EXCH. COMM’N, 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, RELEASE NO. 34-90112; FILE NO. S7-13-20 (Oct. 7, 2020), <https://www.sec.gov/rules/exorders/2020/34-90112.pdf>; Clayton statement: <https://www.sec.gov/news/public-statement/clayton-proposed-finders-exemption-2020-10-07>; Peirce statement: Public Statement, Hester M. Peirce, Statement at Open Meeting on Proposed Exemptive Order for Certain Activities of Finders (Oct. 7, 2020), <https://www.sec.gov/news/public-statement/peirce-finders-2020-10-07>; Roisman statement: Public Statement, Elad L. Roisman, Statement at Open Meeting Considering a Proposed Exemptive Order for Finders (Oct. 7, 2020), <https://www.sec.gov/news/public-statement/roisman-finders-2020-10-07>. The Office of the Advocate for Small Business Capital Formation also prepared a video ([https://www.youtube.com/watch?v=1abFkl9LzNY&feature=emb\\_title](https://www.youtube.com/watch?v=1abFkl9LzNY&feature=emb_title)) and a chart (<https://www.sec.gov/files/overview-chart-of-finders.pdf>) showing a comparison of some of the permissible activities, requirements and limitations for Tier I Finders, Tier II Finders, and registered brokers.

<sup>2</sup> The proposing release was published in the Federal Register and the comment period commenced on October 13, 2020.

<sup>3</sup> See Paul Anka, SEC Staff No-Action Letter (July 24, 1991).

<sup>4</sup> Press Release, U.S. Sec. & Exch. Comm’n, SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers (Nov. 4, 2019), <https://www.sec.gov/news/press-release/2019-230>.

<sup>5</sup> Cal. Corp. Sec. L. of 1968 § 25210.

<sup>6</sup> Tex. Admin. Code § 115.1(a)(9).

<sup>7</sup> M&A Brokers No-Action Letter (Jan. 31, 2014, as revised Feb. 4, 2014).

<sup>8</sup> Public Statement, Allison Herren Lee, Regulating in the Dark: What We Don’t Know About Finders Can Hurt Us (Oct. 7, 2020), <https://www.sec.gov/news/public-statement/lee-proposed-finders-exemption-2020-10-07>.

<sup>9</sup> Public Statement, Caroline A. Crenshaw, Statement on Proposed Exemptive Relief for Finders (Oct. 7, 2020), <https://www.sec.gov/news/public-statement/crenshaw-finders-2020-10-07>.

## KEY CONTACTS



**EDEN L. ROHRER**  
PARTNER

NEW YORK  
+1.212.536.4022  
EDEN.ROHRER@KLGATES.COM



**RICHARD F. KERR**  
PARTNER

BOSTON  
+1.617.261.3166  
RICHARD.F.KERR@KLGATES.COM



**PABLO J. MAN**  
PARTNER

BOSTON  
+1.617.951.9209  
PABLO.MAN@KLGATES.COM

---

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.