

Insights: Alerts

Under Proposed Exemptive Order, Finders Need Not Register with a Broker-Dealer to Receive Transaction-Based Compensation

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On October 7, 2020, the Securities and Exchange Commission (the “*Commission*”) released a Notice of Proposed Exemptive Order (“*Notice*”) that would create a conditional exemption from the broker registration requirements for certain activities of Finders (the “*Proposal*”). Key take-aways are outlined below in a Question & Answer format.

Q. Under the Proposal, who can do what?

A. Please see the helpful [Overview Chart](#) provided by the Commission along with the Notice, as well as its [Fact Sheet](#), which is excerpted below:

The [Proposal] would create two classes of exempt Finders, Tier I Finders and Tier II Finders, that would be subject to conditions tailored to the scope of their respective activities. Tier I and Tier II Finders would both be permitted to accept transaction-based compensation under the [Proposal].

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 could not have any contact with a potential investor about the issuer.

Tier II Finders

A Tier II Finder could solicit investors on behalf of an issuer, but the solicitation-related activities would be limited to:

- identifying, screening, and contacting potential investors;
- distributing issuer offering materials to investors;
- arranging or participating in meetings with the issuer and investor, and
- 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.

Q. The safe harbor is conditional; what are the conditions?

A. There are conditions that apply to both tiers, and then additional conditions that only apply to those seeking an exemption for the broader range of activities captured under Tier II:

Conditions for Both Tier I and Tier II Finders

- the issuer is not a public, reporting company (the safe harbor does not apply to registered offerings);
- the offering is a primary offering (the safe harbor does not apply for the resale of securities);
- the issuer's offering is conducted in reliance on an applicable exemption from registration under the Securities Act (e.g., a private offering that meets the requirements of the safe harbor from registration provided by Regulation D);
- the Finder does not engage in general solicitation (e.g., the prospective investors are already known to the Finder);
- the prospective investor is an accredited investor or the Finder has a reasonable belief that the potential investor is an accredited investor (See our [recent blog post regarding the Commission's expansion of the accredited investor definition](#), which is effective December 8, 2020);
- there is a written agreement between the Finder and the issuer that includes a description of the services provided by the Finder 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 (*i.e.*, the Finder is not a so-called bad actor or bad boy; he or she is not subject to a suspension or industry bar by securities regulators, has not been found to have committed in the last 10 years a crime involving fraud, etc.)

Additional Conditions for Tier II Finders

Tier II Finders must meet all of the conditions set forth above, and must also:

- provide prior to or at the time of the solicitation, a fulsome disclosure that includes:
 - the name of the Finder;
 - the name of the issuer;
 - a description of the relationship between the Finder and the issuer;
 - a statement that the Finder will be compensated and a description of the terms of that compensation arrangement;
 - an explanation of any material conflicts of interest resulting from the arrangement or relationship between the Finder and the issuer;
 - an affirmative statement that the Finder is acting as an agent of the issuer, is not acting as an associated person of a broker-dealer, and is not under any obligation to act in the investor's best interest; and
- obtain from the investor, prior to or at the time of any investment in the issuer's securities, a dated written acknowledgment of receipt of the required disclosures (as set forth above).

The requisite disclosures may be made by the Finder orally prior to or at solicitation, but if made orally, then the disclosures must be made again in writing no later than the time of any related investment in the issuer's security.

Q. What activities are prohibited for an exempt Finder under the Proposal?

A. An unregistered, exempt Finder is not permitted to:

- assist in structuring the transaction or negotiating the terms of the offering;
- handle customer funds or securities;
- 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 (this includes an absolute prohibition on recommending the transaction to a prospective investor).

Q. Why are associated persons of a broker-dealer precluded from relying on the Proposal's safe harbor for Finders?

A. The Commission is concerned about investor confusion. The Notice's specific requests for comment indicate that the Commission has similar concerns regarding investment advisers. This is particularly interesting because the Notice cautions that a Finder relying on the safe harbor to avoid registering with the Commission as a broker may nonetheless still be required to register with the Commission (or a state) as an investment adviser, depending on their conduct.

Q. What was the impetus for the Proposal?

A. In the Notice, the Commission acknowledges that there have been many calls for action in this area, with increasing insistence since at least 2005. In particular, the Commission noted that there is (1) "a broad market perception that additional clarity and possibly relief may be needed in this area"¹ and (2) concerns regarding "the perceived inability of smaller companies to engage the services of a broker-dealer to assist with opportunities to raise capital in exempt [private] offerings."² In this regard, the Commission hopes that Finders will both identify interested investors in areas that "lack robust venture capital and angel investor networks" and also bridge the gap between issuers and venture/start-up capital.³

Q. How likely is it that this will come to fruition?

A. The Proposal is not a formal rulemaking and as such may follow a decidedly less onerous process to move from initial proposal to final order. Notwithstanding the foregoing, the Commissioners are split on the proposal (with Commissioners [Crenshaw](#) and [Lee](#) opposed) and based upon the enumerated requests for comment, it appears that there are still a broad range of particulars under consideration by the Commission. The Notice provides 30 days (from publication in the Federal Register) for receipt of public comment.

In reading the statements of the Commissioners, and consistent with existing No Action relief, there seems to be little disagreement about providing the exemption for Tier 1 Finders; the debate seems primarily focused on the breadth of proposed permitted activities for exempt Tier II Finders.

Q. What does it mean that the Proposal is a "safe harbor"?

A. If approved by the Commission, the Proposal would create a presumption that natural persons who comply with the conditions of the exemption are permitted to engage in the prescribed, limited activities on behalf of issuers, and will not be held in violation of law for failing to register as brokers with the Commission. As with all safe harbors, failure to meet the requisite conditions is not tantamount to a violation of law; instead, the Commission's staff would evaluate the facts and circumstances of the situation to determine if a violation of the Exchange Act (Section 15(a)) had occurred.

Because those who are relying on the safe harbor, by definition, are not required to register as brokers, the recordkeeping obligations of 17a-3 and 17a-4 do not apply, nor does the Commission have examination authority over Finders. Notwithstanding the foregoing, those relying on the safe harbor will need to have created and retained the requisite documentation to evidence compliance with the safe harbor's conditions.

Q. What areas are likely to change from the Proposal to a final order?

A. The 45 questions presented at the end of the Notice provide insight into areas of the Proposal that may change. They also make clear that a lot remains up in the air. For example, the Commission queries whether to:

- include limitations such as a dollar limit on the size of the investment, or limit the safe harbor to offerings under a specific size threshold;
 - Elsewhere in the Notice, the amount of “less than \$5 million” is cited as an amount “below a level that would attract venture capital or a registered broker-dealer, but beyond the levels that can be provided by friends and family and personal financing.”⁴;
- limit the amount of a fee that a Finder can receive, or the form of compensation (*e.g.*, a fixed fee versus transaction-based, an interest in the issuer);
- expand the types of offerings beyond exempt offerings only;
- allow general solicitation;
- adopt disclosures like those required under Rule 206(4)-3 under the Advisers Act for solicitations of investors in private funds;
- require that issuers agree to assume liability to investors with respect to misstatements made by Finders (thereby making it easier for harmed investors to sue issuers directly);
- require that Finders file a notice of reliance on the safe harbor with the Commission;
- preclude anyone who has been associated with a broker-dealer in the prior 12 months, is a representative of an investment adviser, or is an associated person of a municipal advisor from relying on the safe harbor;
- provide guidance specific to the activities involving private fund advisers, real estate brokers and M&A brokers; and
- coordinate with other regulators to provide clarity and consistency on what types of activities Finders and other limited purpose brokers may engage in.

As to the last question, this is presumably a reference to FINRA. But, it is important to note that a number of states (*e.g.*, California, Michigan, South Dakota, and Texas) already have laws exempting finders, subject to various conditions. Similarly, New York has proposed registration requirements specific to finders that are not associated with FINRA member firms. The Notice includes a footnote explaining that nothing in the Proposal

excuses compliance from other applicable laws, including the anti-fraud provisions of federal securities laws and all applicable state laws.

We will continue to track the Proposal as it moves through the public comment period, and possibly, beyond. In the meantime, if you have any questions regarding the Proposal, or the rules and regulations relating to broker-dealers or investment advisers, please feel free to contact us.

By the **Investment Management and Broker-Dealer Team** at **Kilpatrick Townsend & Stockton**

Footnotes

¹SEC, *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. 34-60112, page 9, available at <https://www.sec.gov/news/press-release/2020-248>.

²Id. at p. 19.

³Id. at p. 5.

⁴Id. at p. 4.

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