

SEC Proposal to Exempt Certain “Finders” from Broker-Dealer Registration May Allow Significant Capital Raising Activities by Non-Registered Persons

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KEY POINTS

- The Securities and Exchange Commission issued a proposed order that, if adopted, would provide an exemption to certain “finders,” persons who connect potential buyers and sellers of securities for a fee, from broker-dealer registration requirements. This advisory outlines the effect and conditions of this proposed order on two classes of “finders,” its impact on the “issuer’s exemption” from broker-dealer registration and how it is effected by individual state registration requirements.

Introduction

In an attempt to facilitate capital raising efforts by small issuers and to provide clarity to an ambiguous area of law, the Securities and Exchange Commission (the Commission) has issued a proposed order (the Proposed Exemptive Order) that would, if adopted, provide an exemption from broker-dealer registration requirements for certain “finders” (including individuals employed by hedge funds and other issuers) under certain specified conditions.¹

For years, there has been significant debate and confusion regarding the regulatory status of so-called finders.

The term “finder” is not defined under the Securities Exchange Act of 1934 (the Exchange Act) or any rule of the Commission, but the term typically is used to refer to someone who puts potential buyers and sellers of securities in contact with one another for a fee. However, under what circumstances such persons are obligated to register as broker-dealers, under Section 15(a) of the Exchange Act, is far from clear. Court decisions addressing the issue have been inconsistent and guidance (primarily in the form of no-action letters) from the Commission has failed to settle the matter.

Whether or not the Proposed Exemptive Order is appropriately tailored to provide sufficient clarity to finders and issuers, to promote capital raising on behalf of small issuers and to provide adequate protections to investors is likely to be the subject of significant controversy. But there is little question that the Proposed Exemptive Order would allow significant capital raising efforts by persons not registered as, or otherwise associated with, broker-dealers.

¹ 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, Exchange Act Release No. 34-90112 (Oct. 7, 2020) (available [here](#)).

Broker-Dealer Registration Requirements

Section 15(a) of the Exchange Act requires “brokers” and “dealers” using interstate commerce or the facilities of a national securities exchange to effect transactions in securities (other than exempted securities and specified short-term debt instruments), to register with the Commission. Most registered broker-dealers also are required to become members of the Financial Industry Regulatory Authority (FINRA) and are subject to a wide range of regulatory obligations and oversight by both the Commission and FINRA, and any other self-regulatory organization (including national securities exchanges) of which they are a member.

Under the Exchange Act, a “broker” is “any person engaged in the business of effecting transactions in securities for the account of others.”² Under Section 15(a)(1) of the Exchange Act, any broker that uses 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, is required to register with the Commission pursuant to Section 15(b) of the Exchange Act.³

Although neither the Exchange Act nor any of the Commission’s rules promulgated thereunder define what it means to “effect transactions” in securities, the courts and the Commission have regularly determined that one who participates in securities transactions “at key points in the chain of distribution” has effected transactions in securities. The courts and the Commission have found that such participation may include, among other things:

- Identifying and soliciting potential investors;
- Assisting an issuer in structuring securities transactions;
- Advising potential investors as to the merits of an investment;
- Negotiating between the issuer and investor;
- Making valuations as to the merits of an investment;
- Determining the creditworthiness of potential investors; and
- Handling of investor funds or securities.

Perhaps the most important factor in determining whether a person participated at a key point in the chain of distribution is whether that person received transaction-based compensation (i.e., compensation based, directly or indirectly, on the size, value or completion of any securities transaction(s)).

Because finders bring buyers and sellers of securities together, typically for a transaction-based fee, they would generally be viewed as participating in securities transactions at key points in the chain of distribution under the foregoing analysis and, therefore, subject to registration. However, notwithstanding the fact that there is no Exchange Act provision or Commission rule formally exempting finders from broker-dealer registration, the courts and the Commission staff have, at various times, determined that finders, including those who receive transaction-based compensation, may not be required to register. But no consistent definition of a “finder” emerged, and the facts and circumstances in which a determination that registration was not required varied from case to case. As a result, issuers and finders have struggled to determine under what circumstances registration is, or is not, required.⁴

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

³ 15 U.S.C. 78o(a). Section 15(a) of the Exchange Act also requires “dealers” (persons engaged in the business of buying and selling securities or such person’s own account through a broker or otherwise) using interstate commerce to register with the Commission. However, the Proposed Exemptive Order would only apply to activities typically associated with brokers – i.e., effecting securities transactions for the account of others.

⁴ The consequences of an incorrect determination that registration is not required can be severe. Consequences for acting as an unregistered broker-dealer may include cease and desist orders, criminal penalties, fines, disgorgement and, most importantly, rescission of the investments of affected investors.

Impact on Small Issuers

According to the Proposed Exemptive Order, identifying and locating prospective investors can be difficult for small businesses generally, and particularly for smaller offerings (e.g., less than \$5 million) which are unlikely to attract the interest of venture capital or a registered broker-dealer. Registered broker-dealers, according to the Commission, are less and less willing to participate in such small offerings.⁵ Finders often operate in this void, providing capital raising assistance to small businesses. According to the Commission, due to the lack of certainty around the regulatory status of such finders:

Observers have described a “gray market,” reflecting a “major disconnect” between the various laws and regulations applicable to securities brokerage activities, and the methods and practices by which capital is raised to fund early stage businesses in the United States. As a result of this uncertainty, individuals potentially could be engaging in unregistered brokerage activity, or alternatively, not serving the market because of the regulatory uncertainty associated with playing even a limited role in a capital raise.⁶

To address this “major disconnect” and to provide clarity to issuers, finders and investors, the Commission issued the Proposed Exemptive Order, which, if adopted, would create a safe harbor from the Exchange Act’s broker registration requirement for two classes of finders.

The Proposed Exemption for Finders

The Proposed Exemptive Order “is intended to provide clarity with respect to the ability of a [f]inder to engage in certain activities without being required to register as a broker under Section 15(a),”⁷ by exempting two classes of finders (Tier I Finders and Tier II Finders, collectively “Finders”), based upon the types of activities in which they engage, subject to certain limitations set forth in the Proposed Exemptive Order. Tier I Finders would be able to engage in only very limited capital raising activities, whereas Tier II Finders would be able to engage in a broader spectrum of such activities but would be subject to additional conditions and obligations to fit within the proposed exemption. Finders that limit their activities in accordance with the limitations and conditions set forth in the Proposed Exemptive Order (as described below), would be able to receive transaction-based compensation in connection with their activities without having to register as a broker.

Permissible Activities of Tier I Finders. Under the Proposed Exemptive Order, Tier I Finders would be limited to providing the issuer with contact information (e.g., names, e-mail addresses, phone numbers, etc.) regarding potential investors, *and would not be permitted to have any contact with such potential investors* about the issuer. Tier I Finders could only provide such information in connection with one capital raising transaction by a single issuer within any 12-month period.

Permissible Activities of Tier II Finders. Tier II Finders, on the other hand, would be able to engage in a broader range of capital raising activities on behalf of the issuer and still be eligible for the Proposed Exemptive Order’s safe-harbor from broker registration. In particular, a Tier II Finder would be able to: (1) identify, screen and contact potential investors; (2) distribute issuer offering materials to investors; (3) discuss 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 (4) arrange and participate in meetings with the issuer and investor. Notably, Tier II Finders, unlike Tier I Finders, would not be limited to participation in only one capital raising transaction by a single issuer in a 12-month period. However, Tier II Finders would be subject to additional conditions and requirements, as discussed below.

⁵ See Proposed Exemptive Order at p. 4.

⁶ Proposed Exemptive Order at p. 6 (footnote references omitted).

⁷ Proposed Exemptive Order at p. 17.

Conditions Applicable to both Tier I and Tier II Finders. Under the Proposed Exemptive Order, exemption from broker registration would be available to Tier I and Tier II Finders only under the following conditions:

- **The Finder must be a natural person.** The exemptive relief is not available to entities.
- **The issuer must be a non-reporting issuer.** If the issuer for whom the Finder is acting is required to file reports with the Commission under Section 13 or Section 15(d) of the Exchange Act, the Proposed Exemptive Order's safe-harbor from registration is not available.
- **The offering must be pursuant to an exemption from registration under the Securities Act of 1933.** The issuer of the securities in question must be seeking to conduct the offering under an exemption from registration.
- **Primary offerings only.** The proposed exemption would apply solely in connection with primary offerings and would not, therefore, apply to secondary offerings or activities to facilitate the resale of securities.
- **The Finder may not engage in general solicitation.** The Commission staff has provided guidance, primarily through no-action letters, regarding what types of communications would constitute general solicitation. Advertisements or other communications in public media, because they are targeted to a broad base of potential investors, would not be allowed. Instead, to rely on the safe-harbor, Finders would largely be limited to contacting prospective investors with whom either the issuer or the Finder has a pre-existing, substantive relationship.
- **Accredited investors only.** The Finder's capital raising activities must be limited to accredited investors (as defined in Regulation D) or to potential investors that the Finder reasonably believes to be accredited.⁸
- **Finder services must be provided pursuant to a written agreement.** The Finder must enter into a written agreement with the issuer describing the services to be provided by the Finder and the compensation to be paid to it in return for such services.
- **The Finder may not be an associated person of a broker-dealer.** The Commission believes that if the safe-harbor contemplated by the Proposed Exemptive Order were available to associated persons of broker-dealers, investor confusion and abusive sales practices could result (because such persons could attempt to circumvent requirements applicable to regulated persons).
- **The Finder may not be subject to statutory disqualification.** Persons who have engaged in certain types of misconduct (e.g., persons enjoined from violating securities laws by a court, convicted of a felony in the past 10 years, or barred or suspended from association with a broker-dealer by the Commission) are subject to statutory disqualification under Section 3(a)(39) of the Exchange Act. Such persons are not eligible to act as Finders under the Proposed Exemptive Order during the time he or she is subject to the statutory disqualification.

Additional Conditions Applicable to Tier II Finders Only. To be eligible for the registration exemption, Tier II Finders would be required to provide each potential investor, prior to or at the time of solicitation, with disclosures that include the Finder's name, the issuer's name, a description of the relationship between the Tier II Finder and the issuer, a description of the terms of the compensation arrangement between the Finder and the issuer, any material conflicts of interest arising from the relationship between the Finder and the issuer and a statement that the Tier II Finder is an agent of the issuer, not acting as an associated person of a broker-dealer, and is not undertaking to act in the investor's best interest.

⁸ An accredited investor is a natural person or entity that come within, or that the issuer reasonably believes comes within, certain categories (e.g., a natural person whose net worth exceeds \$1,000,000, a corporation or partnership with total assets in excess of \$5,000,000, etc.) at the time of the sale of securities. See 17 CFR 230.501(a).

The foregoing disclosures may be made orally, but only if supplemented by written disclosure no later than the time of any investment in the issuer's securities by the investor in question. Additionally, the Tier II Finder would be required to obtain from the investor, prior to or at the time of investment, a dated written acknowledgment that the investor received the required disclosures.

Activities Outside the Scope of the Proposed Exemptive Order. For clarity, in the Proposed Exemptive Order, the Commission identified various activities that fall beyond the scope of the contemplated exemptive relief. In particular, the safe-harbor would not be available to Tier I or Tier II Finders that:

- handle customer funds or securities;
- have the power to bind the issuer or an investor;
- are involved in the structuring of the transaction/offering;
- take part in negotiating the terms of the offering;
- participate in the preparation of any sales materials;
- perform an independent analysis of the sale;
- engage in due diligence activities;
- assist in providing financing for purchases; or
- provide advice as to the valuation or financial advisability of the investment.

The feasibility of these prohibitions — and particularly the prohibition against providing advice as to the financial advisability of the investment (i.e., against recommending that the prospective investor make an investment) when applied to Tier II Finders — remains to be seen.

The Commission's Office of the Advocate for Small Business Capital Formation created a chart that provides a useful overview of permissible activities, requirements and limitations applicable to Tier I and Tier II Finders under the Proposed Exemptive Order, as well as those applicable to registered brokers. That chart is set forth as Exhibit A to this advisory.

The Safe-Harbor Contemplated by the Proposed Exemptive Order is Non-Exclusive. The Commission went to great pains in the Proposed Exemptive Order to make clear that the safe-harbor from registration contemplated therein is non-exclusive. In other words, if a person fails to satisfy all of the requirements contemplated by the Proposed Exemptive Order, that failure does not necessarily mean that the person is required to register as a broker:

[T]he proposed exemption would provide a non-exclusive safe harbor from broker registration, and no presumption shall arise that a person has violated Section 15(a) of the Exchange Act if such person is not within the terms of the proposed exemption but rather the need for registration would depend on the facts and circumstances of the situation.⁹

Impact of the Proposed Exemptive Order on the "Issuer's Exemption" from Broker-Dealer Registration

Issuers themselves are not required to register as brokers because they sell securities for their own account and do not effect securities transactions for the account of others. However, employees, directors and other persons associated with an issuer who are involved in the issuer's offers of securities — and in finding and soliciting

⁹ Proposed Exemptive Order at p. 29, fn 93.

investors in particular — may be required to register as brokers under Section 15(a) of the Exchange Act. However, Exchange Act Rule 3a4-1 sets forth a non-exclusive safe harbor from broker-dealer registration for associated persons of an issuer that satisfy certain conditions. In particular, an associated person of an issuer¹⁰ is exempt from registration if the associated person: (1) is not subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act; (2) is not compensated, directly or indirectly, by transaction-based compensation; (3) is not an associated person of a broker-dealer; and (4) meets any one of the following conditions:

1. restricts his or her participation to offers/sales of securities to certain specified financial institutions (such as banks and registered broker-dealers);
2. performs, after the offering, substantial duties for the issuer other than marketing securities, was not an associated person of a broker-dealer within the prior 12 months and does not participate in the sale of securities for the issuer more than once every 12 months; or
3. restricts his or her activities preparing written materials approved by an officer or director of the issuer, responding to investor-initiated inquiries by providing information contained in a registration statement or other offering document, and/or ministerial or clerical work.

In practice, this “issuer’s exemption” (as it is sometimes called) often proves to be overly restrictive for the associated persons of issuers, such as hedge funds, that offer securities on a continuous or frequent basis. Such issuers therefore may be unable to rely on the issuer’s exemption, and the Commission has brought many actions against personnel of issuers for broker registration violations.

The Proposed Exemptive Order, if adopted, could help address this issue. In particular, the exemptive relief would be available to personnel of an issuer who satisfy the Tier II Finder conditions.¹¹ Notably, however, one such condition is that an issuer’s personnel not “provide advice as to the valuation or financial advisability of the investment.” This restriction could limit the proposed exemption’s utility to issuer’s seeking to market their securities with internal staff. Nonetheless, if adopted, the Proposed Exemptive Order could allow such issuers to utilize their own personnel, instead of engaging a registered broker-dealer, to market their securities.

State Registration Requirements Would Not be Impacted by the Proposed Exemptive Order

State laws typically require registration at the state level for firms and their associated persons that solicit securities transactions in the state. While the Proposed Exemptive Order would provide a safe harbor from registration for Finders, only a handful of states (including California, Michigan and New York) have registration exemptions for finders — but even in those states, the scope of the exemption varies. Accordingly, even if the Commission does adopt the Proposed Exemptive Order, Finders relying on the order’s safe harbor would need to continue to assess compliance with state law registration requirements on a state-by-state basis.

Commission Request for Comments

The Commission is seeking comments on all aspects of the Proposed Exemptive Order and included a list of 44 specific questions for which it is seeking public feedback. These questions include whether the exemption should be limited to natural persons, whether investors identified by Finders should be subject to investment limitations (e.g., a dollar amount limit) and whether the exemption should be applicable to secondary offerings. The comment period is open through November 12.

¹⁰ Under Rule 3a4-1, an “associated person of an issuer” includes any natural person who is a partner, officer, director, or employee or an issuer or of companies in a control relationship with the issuer.

¹¹ It should be noted, however, that the Commission expressly requested feedback on the issue of whether the proposed exemption should be limited to individuals who are not associated persons of an issuer. Proposed Exemptive Order at p. 35.

It also bears noting that the Proposed Exemptive Order was passed by a 3-2 vote of the Commission, with the vote split along party lines. The dissenting Commissioners objected primarily on investor protection grounds but also asserted that the Commission did not have sufficient data to support the need for the contemplated exemption, and that the exemption should go through the rulemaking process instead of adoption via Commission order. Therefore, to the extent that the composition of the Commission changes after the upcoming presidential election, it is possible that the Proposed Exemptive Order could be withdrawn or that any exemption that ultimately is adopted could vary significantly from the proposal.

Conclusion

The regulatory status of finders has been a gray area for some time and has created unnecessary uncertainty for issuers, finders, investors and practitioners alike. While the Proposed Exemptive Order would create some much-needed clarity on this front, it is sure to generate a large volume of comments, both by those who believe it is overly restrictive and will not sufficiently facilitate capital raising activities, and by those who believe it is overly permissive and will put prospective investors at risk. Accordingly, it is too early to tell whether the contemplated exemption ultimately will be adopted and, if it is, what form it will take once adopted.

CONTACTS

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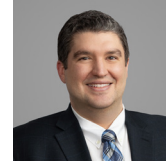
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EXHIBIT A

Finders Proposed Exemptive Order: Overview Chart of Tier I Finders, Tier II Finders and Registered Brokers

The below chart¹ provides a summary overview of some of the permissible activities, requirements and limitations outlined in the [proposed exemptive order](#) granting a conditional exemption from broker registration for finders.² The proposed exemptive order has not been finalized and remains subject to change. Finders may not rely on the proposed exempt activities, requirements and limitations outlined below until such time they are made part of a final operative exemptive order, if any, issued by the Commission.

		Proposed Finder Safe Harbors		Registered ³ Brokers
		Tier 1 Finders	Tier 2 Finders	
WHO	Natural person	✓	✓	✓
	Entities (including crowdfunding platforms)			✓
	Associated person of a broker-dealer			✓
\$	Transaction-based compensation	✓	✓	✓
INVESTORS	Accredited investors	✓	✓	✓
	Non-accredited investors			✓
ISSUER	Non-reporting (private) company	✓	✓	✓
	Reporting (public) company			✓
OFFERING	Primary exempt offerings	✓	✓	✓
	Secondary sales			✓
	Registered offerings (e.g., IPOs, follow-on offerings)			✓
PERMITTED ACTIVITIES	Provide investor contact information to issuer	✓	✓	✓
	Identify, screen and contact potential investors		✓	✓
	Distribute issuer offering materials to investors		✓	✓
	Discuss issuer information included in offering materials		✓	✓
	Arrange or participate in meetings with the issuer and investor		✓	✓
	Structure the transaction or negotiate the terms of the offering			✓
	Engage in general solicitation			✓
	Handle customer funds or securities			✓
	Power to bind the issuer or the investor			✓
	Participate in the preparation of sales materials			✓
	Perform independent analysis of the sale			✓
	Engage in due diligence activities			✓
	Assist or provide financing for investment purchases			✓
	Provide advice as to the valuation or financial advisability of the investment			✓
May participate in more than one capital raising transaction within a 12 month period		✓	✓	
OTHER TERMS OF EXEMPTION	Anti-fraud protections apply	✓	✓	✓
	Written agreement with issuer required	✓	✓	*
	Written disclosure to investors required		✓	✓**
	No statutory disqualification	✓	✓	✓

* Depending on the activities a registered broker engages in, it may be required to enter into a written agreement with an issuer.

** While the proposed exemptive order prescribes clear disclosure criteria required of Tier II Finders, whether and the extent to which a broker-dealer is required to provide disclosures is generally based on the nature of the transaction and the rules and provisions of the Exchange Act that apply to the specific transaction.

1 This chart was created by the Office of the Advocate for Small Business Capital Formation and highlights several of the proposed terms of the conditional exemption from broker registration. It is not a rule, regulation, or statement of the Securities and Exchange Commission (the Commission). The Commission has neither approved nor disapproved its content. This chart, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. We encourage you to look at the proposed exemptive order for more details and to share your feedback!

2 As described in the proposed exemptive order, the Commission has not broadly addressed the other types of specific activities that might implicate the Commission's regulatory regime for brokers. Activities that go beyond the scope of the proposed safe harbors outlined herein (and any that may be adopted) and ultimately whether a person is a broker within the meaning of Section 3(a)(4) turns on the facts and circumstances of the matter.

3 See 15 U.S. Code § 78o and applicable provisions of the federal securities laws and related rules and regulations. Different types of broker-dealers may engage in different types of activities. For purposes of this chart, we are assuming that a registered broker-dealer satisfies all applicable requirements and has received all necessary approvals to engage in the identified activities. There are a variety of legal requirements, including Commission and FINRA rules, that apply to transactions involving registered broker-dealers, not all of which are highlighted in this comparative finders chart. For additional information on registration as a broker-dealer, see the Division of Trading and Markets' [Guide to Broker-Dealer Registration](#).