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SEC proposes exemptive order for conditional exemption from broker registration requirements

By Lloyd Spencer

On October 7, 2020, the Securities and Exchange Commission (SEC) approved a Notice of Proposed Exemptive Order (Notice) that would grant exemptive relief to permit natural persons to engage in limited activities (Finders) on behalf of issuers, without registering as brokers under Section 15 of the Securities Exchange Act of 1934 (Exchange Act).

The SEC acknowledged that it has not previously recognized a “finders” exemption or exception, nor has it broadly addressed whether and under what circumstances a person may “find” or solicit potential investors on behalf of an issuer without being required to register as a broker. Over the past decades, market participants have had to look at staff no action letters discussing circumstances under which persons act as “finders” without registering as a broker-dealer, as well as denials of no action requests. There has been little clarity in this area despite many requests having been made to the SEC. Currently, the determination of whether the actions of a Finder constitute acting as a broker under the Exchange Act hinges on an analysis of several factors, and the SEC staff interpretations have only provided an exception from registration under limited circumstances. The lack of clarity and limited conditions has adversely impacted the ability of small businesses to reach investors and raise capital. A new exemption from broker status for Finders that provides more clarity in this area is greatly needed and long overdue.

The SEC is proposing an exemption that would provide a non-exclusive safe harbor from broker registration. The intent is to provide clarity with respect to the ability of a Finder to engage in certain activities without being required to register as a broker under Section 15(a) of the Exchange Act. The proposed exemption provides for two classes of Finders with corresponding conditions, referred to as Tier I Finders and Tier II Finders. The proposed exemption is limited to primary unregistered offerings by issuers.

The proposal is subject to a 30-day comment period following publication in the *Federal Register*.

Conditions for availability of the proposed exemption

The proposed exemption would be available only where:

The issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act. The SEC is proposing to limit the exemptive relief to non-Exchange Act reporting companies because it believes these non-reporting issuers are the types of companies most likely to experience difficulty obtaining the assistance of a broker-dealer and most likely to need the assistance of a Finder.

The issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act of 1933 (Securities Act). The SEC noted that the failure of the issuer to comply with the conditions of an exemption may not necessarily affect the ability of a Finder to rely on the proposed exemption provided the Finder can establish that he or she did not know and, in the exercise of reasonable care, could not have known, that the issuer had failed to comply with the conditions of an exemption. However, a Finder that, through his or her activities on behalf of the issuer, causes the issuer's offering to be ineligible for an exemption from registration, would not be able to rely on the proposed exemption.

The Finder does not engage in general solicitation. The SEC is proposing to restrict the use of general solicitation to provide investor protection by limiting the scope of potential investors with whom Finders are permitted to engage on behalf of the issuer.

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." Again, the SEC believes that limiting the scope of investors will enhance investor protection. Also, the accredited investor requirement is intended to ensure that Finders solicit only potential investors who have a sufficient level of financial sophistication. With regard to the "reasonable belief" requirement, the SEC stated that Finders can look to the methods that other market participants currently use to establish a reasonable belief regarding an accredited investor's status in other contexts.

The Finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation. The SEC included this requirement to document the explicit role of the Finder and establish accountability between the parties.

The Finder is not an associated person of a broker-dealer. This condition is intended to ensure that regulated persons do not attempt to circumvent applicable rules and regulations to which they are already subject, including their required standard of conduct when providing recommendations; 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 his or her participation.

Tier I Finders

The proposal defines "Tier I Finder" as a Finder who meets the above conditions and whose activity is limited to providing contact information of potential investors in connection with only one capital raising transaction by a single issuer within a 12-month period and does not have any contact with the potential investors about the issuer. The limited activity permitted under the proposal for Tier I Finders without registration is consistent with prior interpretations of the SEC staff.

Historically, the SEC staff has held the receipt of transaction-based fees as a strong indicator that the Finder should be registered as a broker. Significantly, the proposal provides that a Tier I Finder that complies with all of these conditions may receive transaction-based compensation for the limited services without being required to register as a broker under Section 15(a) of the Exchange Act.

Tier II Finders

The proposal defines “Tier II Finder” as a Finder who meets the above conditions and who engages in solicitation-related activities on behalf of an issuer, which are limited to (1) identifying, screening, and contacting potential investors; (2) distributing issuer offering materials to investors; (3) discussing issuer information included in any offering materials, provided the Finder does not provide advice as to the valuation or advisability of the investment; and (4) arranging or participating in meetings with the issuer and investor. The SEC believes that limiting the proposed exemption to these activities associated with solicitation, along with certain additional conditions, will appropriately narrow the role of the Tier II Finder. The permitted activities of a Tier II Finder would be an expansion of prior interpretations by the SEC staff.

The SEC noted in the Notice, that Tier II Finders would not be permitted to be involved in structuring the transaction or negotiating the terms of the offering. A Finder also could not 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 purchases, or provide advice as to the valuation or financial advisability of the investment.

Additional Conditions for Tier II Finders

The proposal provides that a Tier II Finder would need to provide a potential investor, prior to or at the time of the solicitation, disclosures that include (1) the name of the Tier II Finder; (2) the name of the issuer; (3) the description of the relationship between the Tier II Finder and the issuer, including any affiliation; (4) 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; (5) any material conflicts of interest resulting from the arrangement or relationship between the Tier II Finder and the issuer; and (6) 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 proposal would permit this disclosure to be made orally provided the oral disclosure is supplemented by written disclosure, including electronic communications, no later than the time of any related investment in the issuer’s securities. 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 acknowledgement of receipt of the Tier II Finder’s required disclosures.

Similar to Tier I Finders, a Tier II Finder that complies with all of the conditions of the proposed exemption may receive transaction-based compensation for services provided in connection with the activities described above without being required to register as a broker under Section 15(a) of the Exchange Act.

Other regulatory requirements

The SEC noted that the proposed 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 Exchange Act. In addition, the proposed exemption is not intended to affect the rights of the SEC or any other party to enforce compliance with other applicable law. Regardless of whether or not a Finder complies with the proposed exemption, he or she may need to consider whether they are acting as another regulated person, such as an investment adviser or a municipal advisor. Finally, the proposed exemption would not impact any state law broker registration requirements.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

— Lloyd Spencer, 202-585-8303, lspencer@nixonpeabody.com
