

SEC Proposes Conditional Broker Exemption for Finders

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What You Need To Know:

- The SEC proposes to exempt two types of Finders from broker-dealer registration pursuant if they satisfy certain conditions.
- Tier I Finders may provide potential investors' contact information to issuers but may not engage in solicitation-related activities with the potential investors.
- Tier II Finders may engage in solicitation-related activities with potential investors provided such potential investors are given disclosures prior to or at the time of solicitation.
- Tier I and Tier II Finders may receive transaction-based compensation and still remain exempt from broker-dealer registration.
- The proposed registration exemption does not apply to, among other things, a resale of securities.
- The proposal is currently in its comment period.

On Oct. 9, 2020, the U.S. Securities and Exchange Commission (SEC) released a proposed Exemptive Order (the Proposal) to exempt "Finders," who traditionally connect potential investors to issuers seeking to raise capital, from broker-dealer registration under the Securities Exchange Act of 1934, as amended (the Exchange Act). Under the Exchange Act, a "broker" is any person engaged in the business of effecting transactions in securities for the account of others. Brokers are prohibited under the Exchange Act from effecting any transactions or inducing or attempting to induce the purchase or sale of any security unless such brokers are registered. The Proposal creates two exempt classes subject to the conditions below.

Requirements for All Exempt Finders

An individual must satisfy all the requirements listed below to qualify as either a Tier I Finder or a Tier II Finder.

- The issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act.

- The issuer is seeking to conduct the securities offering in question in reliance on an applicable exemption from registration under the Securities Act of 1933, as amended.
- The Finder does not engage in general solicitation.
- 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."
- 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.
- 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

A Tier I Finder is one who meets the conditions

above and whose activity is limited to providing the contact information of potential investors in connection with **only one** capital-raising transaction by a single issuer within a 12-month period, provided that the Finder does not have any contact with the potential investors about the issuer (i.e., soliciting securities sales or purchases). The contact information may include, among other things, names, telephone numbers, email addresses, and social media information. This classification is essentially the codification of the SEC's rarely used Paul Anka no-action letter from 1991, but with an expansion of the number of times it can be relied upon from once ever to once every 12 months.

Tier II Finders

A Tier II Finder is a Finder who may solicit potential investors only if the Finder provides to the potential investors, prior to or at the time of the solicitation, disclosures that include the following:

- The name of the Tier II Finder
- The name of the issuer for the transaction
- A 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 their 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
- 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 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 acknowledgment of receipt of the required disclosures in either paper or electronic format.

The solicitation-related activities would be limited to (i) identifying, screening, and contacting potential investors; (ii) distributing issuer offering materials to investors; (iii) 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 (iv) arranging or participating in meetings with the issuer and investor.

A Tier II Finder could not (i) be involved in structuring the transaction or negotiating the terms of the offering; (ii) handle customer funds or securities or bind the issuer or investor; (iii) participate in the preparation of any sales materials; (iv) perform any independent analysis of the sale; (v) engage in any "due diligence"

activities; (vi) assist or provide financing for such purchases; or (vii) provide advice as to the valuation or financial advisability of the investment.

Takeaways

The lack of clarity in applying the definition of broker to full-time marketing personnel of private issuers and to third parties that provide services to private issuers related to the sale of securities has led to, among other things, ambiguous service agreements and undesired compensation arrangements. For example, under current regulations and regulatory guidance, private issuers have largely avoided paying transaction-based compensation to their unlicensed marketing and investor relations personnel as well as to certain unlicensed third-party agents involved in capital-raising activities.

The Proposal appears to recognize the reality of many desired Finder relationships and creates practical guidelines. In so doing, it allows private issuers and Finders to better define the scope of services provided by a Finder, and to create a framework for clear disclosure to solicited investors, and allows Finders (whether full-time employees of the issuer or third parties) to receive transaction-based compensation without onerous registration and examination requirements. The Proposal also complements the M&A broker no-action letter from 2014 in the common goal of making capital raising for small businesses more accessible. Similar to the M&A broker no-action letter, however, the Proposal does not dictate state law treatment of the covered activities.

If enacted, the Proposal would benefit, for example, private funds (e.g., hedge funds, private equity funds, and venture capital funds) and other private issuers in capital-raising activities and provide much-needed certainty regarding Finder arrangements. However, given the limited permissible activities by Tier II Finders, the Proposal may have limited application to full-time employees of a private issuer. Lastly, given the timing of the Proposal relative to the upcoming election, it is difficult to say with any certainty whether the Proposal will ever become law.

Next Steps

Please contact one of the listed authors of this Client Alert or another Lowenstein Sandler contact if you have any questions with respect to the Proposal.

For additional information regarding the Proposal, please see the following links:

- [SEC Press Release](#)
- [SEC Proposed Exemptive Order](#)

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

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