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Client Alert Commentary

Latham & Watkins Financial Regulatory Practice

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Finders, Keepers: SEC Proposes Safe Harbor Framework for Unregistered Finders

The proposal would significantly impact finders by granting tailored exemptive relief to individuals engaging in limited capital raising activity.

Key Points:

- The Proposal would provide a conditional exemption that would allow natural persons to engage in certain limited capital raising activities without needing to register as a broker (sometimes referred to as a broker-dealer) under the registration requirements of the Securities Exchange Act of 1934 (Exchange Act).
- The Proposal would create two tiers of "finders" subject to certain conditions that are tailored to the scope of their respective activities.
- The Proposal would allow unregistered finders that comply with the conditions of the exemption to receive transaction-based compensation without being subject to sales practice and other requirements applicable to registered broker-dealers.

On October 7, 2020, the US Securities and Exchange Commission (SEC) issued a 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 (the Proposal). The Proposal was issued in response to a recommendation by the SEC's Division of Trading and Markets. It aims to establish, for the first time, a framework for permissible non-registered finder activity, which until this point has been addressed by a "patchwork of staff guidance and no-action letters."[1] If adopted, the Proposal would establish a non-exclusive safe harbor from the requirement to register as a broker-dealer with the SEC applicable to finders engaged in certain specified capital-raising activities for companies that are not required to file reports under Section 13 or Section 15(d) of the Exchange Act (non-reporting companies).

Background

In setting forth the rationale behind the Proposal, the SEC drew attention to small businesses' critical need to raise capital through private placements and the difficulties such businesses often face in finding investors. The SEC highlighted that individual finders can play an important role in connecting such businesses with investors but, under the current regulatory framework, such finders inhabit a "gray market" in which they are technically restricted from even playing a limited role in a capital raise without registering as a broker-dealer. Accordingly, the SEC stated that it believed the exemption "would provide

clarity to investors and issuers, and establish clear lanes for both registered broker activity and limited activity by finders that would be exempt from registration."[2]

Finders

The Proposal seeks to clarify finders' regulatory status by establishing two classes or tiers of finders, each subject to conditions specific to the activities in which they are permitted to engage.

Tier I Finders

- Tier I finders would be limited to providing contact information for potential investors in connection with only one capital raising transaction by a single issuer in a 12 month period
- Tier I finders would not be permitted to have any contact with a potential investor about the issuer

This tier effectively codifies the infamous Paul Anka no-action letter[3] which marked the only time the SEC has officially blessed a finder's compensation arrangement for fundraising purposes. Although this tier would be of limited utility, it is notable because the SEC staff has — on numerous occasions since its initial release — disavowed the reasoning in, and continued applicability of, the Paul Anka letter. Nevertheless, the letter was never officially withdrawn.

Tier II Finders

- Tier II finders would be permitted to engage in additional solicitation-related activities on behalf of an issuer beyond those allowed for Tier I finders, but the solicitation[4] 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
    - Arranging or participating in meetings with the issuer and investor

Conditions Applicable to Both Tiers of Finders

The Proposal would allow both tiers of finders to benefit from the broker-dealer registration exemption only if all the following conditions are met:

- 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 a primary securities offering in reliance on an applicable exemption from registration under the Securities Act of 1933 (Securities Act).
- The finder does not engage in general solicitation of potential investors.
- The potential investor is an accredited investor as defined in Rule 501 of Securities Act 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 (as defined in Section 3(a)(18) of the Exchange Act).
- The finder is not subject to statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act).

The safe harbor would not apply to finder activity with respect to registered offerings (including, e.g., initial public offerings and follow-on offerings), secondary market sales of securities, or the sale of securities to investors that are not accredited investors (or that are not reasonably believed by the finder to be accredited investors).

In addition, under the Proposal, unregistered finders in either tier may not:

- Be involved in structuring the transaction or negotiating the terms of the offering[5]
- 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 of securities in the offering
- Provide advice as to the valuation or financial advisability of the investment

Additional Disclosure Requirement for Tier II Finders

Under the Proposal, Tier II finders would be permitted to participate in a wider range of activities than Tier I finders, including certain limited solicitation activities, and would not be restricted with respect to the number of offerings that they can participate in annually. In light of this, the Proposal includes the additional requirement that Tier II finders make the following disclosures prior to or at the time of solicitation:

- Basic information such as the finder's and issuer's name
- A description of the relationship between the finder and the issuer
- The terms of the compensation arrangement between the finder and the issuer
- Any material conflicts of interest resulting from the compensation 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 undertaking a role to act in the investor's best interest

Such disclosure could initially be made orally but would need to be supplemented by written disclosure no later than the time of any related investment in the issuer's securities by the investors. The Finder would also be required to procure from potential investors a written and dated acknowledgment of receipt of the required disclosures prior to or at the time of such investment.

Takeaways From the Proposal

- Although in setting forth its rationale for the Proposal, the SEC focused on small businesses and their capital needs, the Proposal does not impose a cap on the size of the issuer, the size of the offering or the aggregate amount of investor capital unregistered finders may raise within the safe harbor. Further, the Proposal does not limit the amount of compensation an unregistered finder may be paid, and does not require that compensation to such finders be structured in a particular form (e.g., payment in cash or on a flat, hourly, or other fixed fee basis). Accordingly, while the proposed safe harbor is restricted to private offerings by non-reporting companies, the Proposal still leaves a broad swath of transactions that would not be subject to broker-dealer regulation and oversight.

- Tier II finders are not permitted to "provide advice as to the valuation or financial advisability of an investment". Given the SEC's broad view of what may constitute a "recommendation" by a broker-dealer in the context of a securities offering, it is unclear how this restriction would impact or otherwise limit a Tier II finder's ability under the exemption to identify and screen investors and discuss with them issuer information in the issuer's offering materials. Is the ability to identify and screen investors limited to determining accredited investor status? Would the finder be able to discuss the strengths and weaknesses of the issuer and the merits of the investment? Thus, while Tier II finders would be required to disclose that they are acting as an agent of the issuer and not undertaking to act in the investor's best interest, it remains unclear as to what the actual parameters would be for a discussion between a Tier II finder and a potential investor regarding a prospective investment.

- The Proposal would offer an exemption solely to natural persons acting in an individual capacity; it would not apply to entities.

- As currently constructed, the safe harbor may reduce the need of some private fund groups to maintain "captive" private placement broker-dealer subsidiaries, as non-registered fund employees could possibly facilitate private placements of fund interests within the parameters of the safe harbor.

- Yet another potential consequence — the safe harbor would grant greater flexibility to broker-dealers in working with unregistered, non-associated, third-party finders to source investors. Rule 2040 of the Financial Industry Regulatory Authority, Inc. (FINRA) prohibits the payment or sharing of fees by a FINRA member to a person that is not registered as a broker-dealer under the Exchange Act, if the receipt of the payment and related activities would require such person to become so registered. If both the transaction and the activities of the finder stay within the confines of the safe harbor, apparently broker-dealers could pay transaction-based compensation to the finder without contravening FINRA Rule 2040 in accordance with FINRA's supplemental guidance .01.

- The Proposal states that, in addition to not being required to register with the SEC as a broker-dealer, finders that comply with the requirements of the Proposal "would not be subject to broker-dealer sales practice rules, including Regulation Best Interest".[6] The Proposal also states that

finders would continue to be obligated to comply with all other applicable laws, including the antifraud provisions of the Securities Act and the Exchange Act. The Proposal does not expressly state, however, that finders also would be exempt from other broker-dealer requirements under the Exchange Act, such as net capital or recordkeeping requirements, that do not specify whether the broker-dealer is required to be SEC-registered.

- While the Proposal would provide a safe harbor from broker-dealer registration requirements at the federal level, finders must continue to consider the securities laws of the various US states and territories which, in most cases, require state registration or licensing of finders. Such requirements varying widely by jurisdiction: [7] for example, while Michigan excludes finders from the definition of broker-dealer for state licensing purposes,[8] California provides a narrowly tailored exemption from registration for finders meeting a specific set of criteria,[9] and Texas allows those that meet the state definition of finder to avail themselves of a limited licensing regime.[10] On the other end of the scale, in April 2020, New York announced a suite of proposed rule changes that would define and classify finders and explicitly require registration of finders as broker-dealers in New York.[11] This patchwork of state level requirements is likely to persist for some time as the North American Securities Administrators' Association has made a point of including the protection of the states' regulatory oversight of finders and private placement brokers as one of its legislative priorities for the current congressional session.[12]

Next Steps

The Proposal is for exemptive relief rather than rulemaking, and therefore may benefit from reduced friction on the road to finalization. The Proposal will be open to public feedback, with the comment period closing 30 days following its publication in the Federal Register on October 13, 2020.[13] Those interested in submitting comments may find useful the list of 45 questions posed by the SEC at the conclusion of the release, inviting feedback on all aspects of the Proposal.

The SEC has also provided market participants with a handy overview chart clarifying how the Proposal would impact both tiers of finders, in comparison to currently permissible activities of registered brokers.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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1 *See* Statement of SEC Chairman Jay Clayton on Proposed Finders Exemption, available at https://www.sec.gov/news/public-statement/clayton-proposed-finders-exemption-2020-10-07.

2 Proposal, at 10.

3 *See* Paul Anka, SEC No-Action Letter (available July 24, 1991), available at https://securities.utah.gov/docs/Anka_Letter.pdf.

4 The SEC notes in the Proposal that it "generally views solicitation as any affirmative effort to induce or attempt to induce a securities transaction." Proposal at 23.

5 The SEC notes that "terms of the offering" would be interpreted for purposes of the Proposal as "the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period." Proposal, note 92 at 28.

6 Proposal, note 87 at 26.

7 In this regard, note that FINRA Rule 2040 addresses only the question of whether the unregistered person is required to register with the SEC under the Exchange Act and does not, by its terms, prohibit payments to persons that would be required to register as a broker-dealer under state law.

8 *See* Michigan Uniform Securities Act (2002), Act 511 of 2008, Section 451.2102 (available at http://www.legislature.mi.gov/(S(vkgsronh1zc2lebymty3sw0z))/mileg.aspx?page=getObject&objectName=mcl-451-2102) and Rule 451.1.2 Broker-Dealer definition exclusion (available at https://dtmb.state.mi.us/ORRDocs/AdminCode/1957_11010_AdminCode.pdf).

9 *See* Rule 25206.1 of the California Corporations Code available at http://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=25206.1.

10 *See* FAQs for Dealers and their Agents available at https://www.ssb.texas.gov/faqs-dealers-and-their-agents#2-C for additional information.

11 *See* New York State Register, April 15, 2020 Vol. XLII, Issue 15 available at https://www.dos.ny.gov/info/register/2020/041520.pdf.

12 Available at https://www.nasaa.org/policy/legislative-policy/legislative-priorities/.

13 Available at https://www.govinfo.gov/content/pkg/FR-2020-10-13/pdf/2020-22565.pdf.