

## SEC Proposes Conditional Exemption for Small Business “Finders”

OCTOBER 19, 2020

On October 7, 2020, a divided U.S. Securities and Exchange Commission (SEC) voted to propose a new limited, conditional exemption from the broker registration rules to allow natural persons to act as “Finders” to assist small businesses to raise capital in private markets from accredited investors.<sup>[1]</sup> If adopted, the Proposed Exemptive Order would create two classes of Finders, Tier I Finders and Tier II Finders, with different conditions for each class as discussed below.

### Conditions for Finders Generally to Rely on the Proposed Exemption

The Proposed Exemptive Order would permit Finders to engage in certain defined activities on behalf of an issuer without registering as a broker under Section 15 of the Securities Exchange Act of 1934 (Exchange Act). The proposed exemption would only be available to a Finder when 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 the securities offering in reliance on an applicable exemption from registration under the Securities Act;
- 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; 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.<sup>[2]</sup>

If these conditions are met, the Proposed Exemptive Order would allow a natural person to act as a Finder and accept transaction-based compensation without being required to register as a broker dealer under Section 15(a) of the Exchange Act, provided that such Finder complies with the additional limitations discussed below to qualify as either a Tier I Finder or a Tier II Finder.

#### *Tier I Finders*

In addition to meeting the above conditions, a Tier I Finder would be required to meet the following conditions:

- Limit activity to providing contact information of potential investors in connection with only one capital-raising transaction by a single issuer within a 12-month period.
- Have no contact with the potential investors about the issuer.<sup>[3]</sup>

#### *Tier II Finders*

If a Finder meets the conditions to be a Tier II Finder, the Finder would be allowed to engage in additional solicitation-related activities beyond those permitted for Tier I Finders. To qualify as a Tier II Finder, a Finder must meet the general conditions discussed above, and must limit his or her solicitation-related activities conducted on behalf of an issuer to the following:

- 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; and
- Arranging or participating in meetings with the issuer and investor.<sup>[4]</sup>

To rely on the proposed exemption, the Tier II Finder would need to satisfy certain disclosure requirements and other conditions. With respect to disclosure requirements, a Tier II Finder would need to provide the potential investor, prior to or at the time of the solicitation, disclosures including the following information:

- The name of the Tier II Finder;
- The name of the issuer;
- The 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 his or her 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; and
- 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.<sup>[5]</sup>

The proposal allows such disclosure to be made orally, provided that the oral disclosure is supplemented by a written disclosure containing this information no later than the time of any related investment in the issuer's securities. The Tier II Finder must also "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 Tier II Finder's required disclosures."<sup>[6]</sup>

#### *Scope of Finder Activity Under the Proposed Exemptive Order*

The Proposed Exemptive Order would not allow a Finder to engage in broker activity beyond the scope of the specific activities outlined above. For example, a Finder could not rely on the proposed exemption to facilitate the sale of securities to investors that are not accredited investors or that the Finder does not have a reasonable belief are accredited investors, or to facilitate a registered offering or a resale of securities. A Finder also could not be involved in structuring the transaction or negotiating the terms of the offering. In addition, a Finder "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 such purchases; or provide advice as to the valuation or financial advisability of the investment.”<sup>[7]</sup>

## SEC Approval of the Proposed Exemptive Order and Path Forward

As noted above, the Commission vote to approve the Proposed Exemptive Order was split, and drew sharp dissents from two commissioners who were concerned that the exemption would fuel activity in opaque private markets.

The Proposed Exemptive Order is intended to “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.”<sup>[8]</sup> SEC Chairman Jay Clayton remarked that “[t]he staff’s proposed exemptive order is intended to be narrowly tailored to address the capital formation needs of entrepreneurs and certain smaller issuers while preserving investor protections.”<sup>[9]</sup> He further stated that “[t]he current patchwork of staff guidance and no-action letters in this area has not provided needed clarity, and the time for Commission action is overdue.”<sup>[10]</sup>

Democratic Commissioners Caroline Crenshaw and Allison Herren Lee dissented, citing concerns about transparency and investor protection. Commissioner Crenshaw called the proposal “a radical departure from established registration requirements” that “continues two disturbing Commission trends . . . encouraging the growth of opaque private markets at the expense of better-lit public markets . . . [and] eroding the investor protections provided by our tried and true regulatory framework.”<sup>[11]</sup> She noted that the Proposed Exemptive Order “seeks to facilitate capital raising in the private markets” and expressed concerns with the proposal specifically and recent SEC activity in this area generally: “as with other recent actions in this space, I question why the Commission is encouraging activity in these markets absent sufficient visibility into how they operate.”<sup>[12]</sup>

Commissioner Lee was similarly skeptical about the Proposed Exemptive Order, arguing that “today we simply propose to permit unregistered activity that meets the traditional definition of brokerage without adding basic protections such as recordkeeping requirements or the ability to inspect for compliance.”<sup>[13]</sup> She was concerned that this proposal is “effectively creating a new category of unregistered financial professionals”<sup>[14]</sup> without any of the investor protections provided by SEC regulation.

The federal regulation of Finders is further complicated by the interactions with state law. For example, California has enacted a Finders exemption that exempts Finders from the California broker-dealer registration requirements if certain requirements are met.<sup>[15]</sup> However, this state exemption is of limited use unless and until a comparable federal exemption, such as the Proposed Exemptive Order, is enacted.

The SEC is accepting public comments on the Proposed Exemptive Order until November 12, 2020.

## For More Information

The SEC Office of the Advocate for Small Business Capital Formation has prepared a video<sup>[16]</sup> and a chart<sup>[17]</sup> comparing some of the permissible activities, requirements, and limitations for Tier I Finders, Tier II Finders, and registered brokers.

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<sup>[1]</sup> SEC Proposes Conditional Exemption for Finders Assisting Small Businesses with Capital Raising (Oct. 7, 2020), *available here*.

<sup>[2]</sup> These bullet points are found in the text of the SEC proposal. 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, 85 Fed. Reg. 64542, 64546–64547 (Oct. 13, 2020) (“Proposed Exemptive Order”).

<sup>[3]</sup> *Id.* at 64548.

<sup>[4]</sup> *Id.* The text in these bullet points is found in the text of the SEC proposal.

<sup>[5]</sup> *Id.* at 64548–64549. The text in these bullet points is found in the text of the SEC proposal.

<sup>[6]</sup> *Id.* at 64549.

<sup>[7]</sup> *Id.*

<sup>[8]</sup> *Id.* at 64544.

<sup>[9]</sup> Jay Clayton, Chairman, SEC, Open Meeting on Proposed Finders Exemption – Providing Regulatory Clarity to Benefit Small Businesses (Oct. 7, 2020), available [here](#).

<sup>[10]</sup> *Id.*

<sup>[11]</sup> Caroline A. Crenshaw, Commissioner, SEC, Statement on Proposed Exemptive Relief for Finders (Oct. 7, 2020), available [here](#).

<sup>[12]</sup> *Id.*

<sup>[13]</sup> Allison Herren Lee, Commissioner, SEC, Regulating in the Dark: What We Don't Know About Finders Can Hurt Us (Oct. 7, 2020), available [here](#).

<sup>[14]</sup> *Id.*

<sup>[15]</sup> Cal. Corp. Code § 252061; Cal. Code Regs. Tit. 10, § 260.211.4 through § 260.211.7.

<sup>[16]</sup> Proposed Exemptive Order, available [here](#).

<sup>[17]</sup> Finders Proposed Exemptive Order: Overview Chart of Tier I Finders, Tier II Finders and Registered Brokers, available [here](#).

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