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Safe Harbor for Permissible Capital-Raising Activities by Unregistered Finders

Posted by Spencer G. Feldman, Olshan Frome Wolosky LLP, on Thursday, November 5, 2020

Editor's note: Spencer G. Feldman is a partner at Olshan Frome Wolosky LLP. This post is based on his Olshan memorandum.

Recognizing the longstanding need for a new approach to the regulation of finders who help smaller businesses raise early stage capital, the SEC has published a notice of a proposed exemptive order and request for comment to formalize the regulatory status of unregistered finders. The proposed finders exemption from broker-dealer registration would facilitate a role for unregistered finders in the capital-raising process and clarify the circumstances under which issuers can legally compensate finders who comply with specified conditions. The author's thoughts on the proposed finders exemption follow a summary of the rule proposal.

On October 7, 2020, the Securities and Exchange Commission published its long-awaited rule proposal to provide a safe harbor exemption permitting an individual acting as an unregistered financial intermediary, or "finder," to engage in capital-raising activities on behalf of smaller private companies without registering as a broker-dealer. [1] The SEC's proposal (Release No. 34-90112, File No. S7-13-20) reflects several decades of thinking by the SEC staff, various government-business and bar association committees, numerous law professors and securities lawyers, who have acknowledged the role of finders in locating and referring capital to small businesses but have disagreed on the appropriate level of regulation to protect investors. In the capital markets today, there is no general guidance on finders from the SEC, other than interpretive positions taken by the SEC staff in no-action letters, prompting some to refer to the use of finders as the "gray market."

It is noteworthy that, in contrast to previous approaches, the rule proposal does not recommend finders be required to register with the SEC under a newly created broker-dealer 'lite' regulatory regime, become associated with a FINRA member, satisfy FINRA series exams or comply with various sales practice rules. Instead, the SEC's current approach is to create a controlled environment for finders where the need to impose registration is mitigated by transactional and individual guideposts.

Basic Conditions of the Proposed Finders Exemption

To avail oneself of the safe harbor finders exemption, a finder—whether a tier 1 finder or tier 2 finder (as described in detail below)—would need to comply with a number of basic conditions. *First*, a finder may only provide capital-raising services to privately held issuers that are not required to file reports under the Securities Exchange Act of 1934 and only in connection with offers and sales of securities in private placements made in reliance on an applicable exemption from registration under the Securities Act of 1933. *Second*, a finder may not engage in

general solicitation of potential investors, and potential investors must be "accredited investors" or investors that the finder has a reasonable belief are "accredited investors," as defined in Rule 501 of Regulation D under the Securities Act. *Third*, a finder must enter into a written agreement with the issuer that includes a description of the services to be provided and the compensation to be paid. And *fourth*, a finder cannot be an associated person of a registered broker-dealer, as defined under Section 3(a)(18) of the Securities Exchange Act, and cannot be subject to a statutory "bad actor" industry bar or disqualification, as that term is defined in Section 3(a)(39) of the Securities Exchange Act.

The SEC's rule proposal divides finders into two tiers—one for the proverbial dentist or mail carrier who identifies a potential investor on a passive, isolated basis (a tier 1 finder), and one for the individual whose business is focused on the active solicitation of potential investors for securities offerings by emerging companies (a tier 2 finder). The SEC's proposed tier system takes into account the different components of capital raising performed by finders.

Permitted Tier 1 Finder Activities

A tier 1 finder's permitted 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, provided the finder does not have any contact with the potential investors about the issuer. The contact information may include, among other things, name, telephone number, e-mail address and social media information. A tier 1 finder that complies with this limitation and the basic conditions of the proposed finders exemption may receive transaction-based compensation without being required to register as a broker-dealer.

The SEC has long viewed commissions and other success-based compensation on sales traceable to a finder's efforts to be a significant factor in requiring broker-dealer registration. However, where a tier 1 finder's activities are limited such that there is no opportunity or incentive to engage in abusive sales practices, the SEC appears to take the position that registration, which is intended to regulate and prevent such conduct, is not necessary. The conditions to qualify as a tier 1 finder are noticeably similar to those described in the SEC's 1991 Paul Anka no-action letter, which the SEC disavowed by 2004.

Permitted Tier 2 Finder Activities and Disclosures

A tier 2 finder's activities would include additional solicitation-related activities beyond those permitted for tier 1 finders. A tier 2 finder may: (i) identify, screen and contact potential investors, (ii) distribute issuer offering materials to investors, (iii) discuss issuer information included in the offering materials, but cannot provide advice as to the valuation or advisability of the investment, and (iv) arrange or participate in meetings with an issuer and prospective investor.

A tier 2 finder wishing to rely on the proposed finders exemption would need to provide, either prior to or at the time of the solicitation, a potential investor with disclosures that include:

- the name of the finder and name of the issuer;
- a description of the relationship between the tier 2 finder and the issuer, including any affiliation;

- a statement that the tier 2 finder will be compensated for his or her solicitation activities by the issuer and a description of the terms of such compensation arrangement;
- a statement of any material conflicts of interest resulting from the arrangement or relationship between the tier 2 finder and the issuer; and
- an affirmative statement that the tier 2 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.

Under the rule proposal, this disclosure may be provided to the investor orally as long as the oral disclosure is supplemented by written disclosure and satisfies all of the disclosure requirements listed above no later than the time of an investment in the issuer's securities. Then, the tier 2 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 finder's required disclosures. The requirement for written disclosures and the acknowledgment can be satisfied either through paper or electronic means.

A tier 2 finder that limits its solicitation-related activities, complies with the investor disclosure obligations and follows the basic conditions of the proposed finders exemption may receive transaction-based compensation without being required to register as a broker-dealer.

Prohibited Activities by Finders

To further delineate the parameters of a finder's permitted activities, the SEC's rule proposal specifically noted a number of ancillary capital-raising services in which a finder may not engage. As proposed, a finder may not:

- structure a transaction or negotiate the terms of an offering;
- handle customer funds or securities or bind an 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 any purchases; or
- provide advice as to the valuation or financial advisability of an investment.

In addition, the proposed exemption is limited to activities solely in connection with primary offerings and is not applicable for resales of securities by existing shareholders of an issuer.

The SEC's rule proposal concluded by noting other legal matters that apply to finders even if the safe harbor finders exemption is being followed. For example, the exemption does not affect a finder's obligation to comply with the antifraud provisions of federal and state securities laws, and a finder may need to consider registration if it is acting as another regulated entity, such as an investment adviser.

Thoughts on the Proposed Finders Exemption

1. While a newly created SEC broker-dealer 'lite' registration structure for finders who engage in capital-raising transactions may not necessarily be a solution, a registration process would make

it possible for small businesses to locate registered finders, review their regulatory and disciplinary histories and ascertain their experience. Under the SEC's current approach, any individual could hold themself out as a finder. There would be no central registry of registered finders similar to FINRA's BrokerCheck program and no verified historical records that might reveal a pattern of questionable dealings by an unscrupulous finder (unless the proposed finders exemption is used as a "back door" for past violators suspended or barred from the brokerage industry, which would be documented). Since disciplinary actions may take place on the state, federal, FINRA or stock exchange level, social media is unlikely to capture a finder's full history. It may be that competent finders would rather be sure of their status by being registered, instead of operating in the present gray market.

2. The SEC's rule proposal is meant to aid smaller companies seeking early stage private capital from angels and venture capitalists. This is reflected by the SEC's decision to exempt its broker-dealer registration requirements based on a transaction's status as a private placement, as opposed to a public offering. Though public offerings are generally conducted by larger, more sophisticated companies with greater access to traditional brokerage firms for underwritings, finders routinely introduce emerging growth IPO candidates to potential underwriters, often creating disclosure and legal issues with respect to sharing or splitting commissions and other transaction-based compensation with unregistered persons.

3. The SEC's rule proposal restricts a finder from negotiating and structuring the terms of an offering or providing advice to an issuer or investor of an investment, but permits a tier 2 finder to participate in meetings with them. Additional guidance from the SEC may be necessary to give a finder comfort that their attendance in a meeting in which negotiations regarding the structure of the offering are held does not exceed the limited role contemplated by the SEC's proposed finders exemption. It is unclear, for example, whether a finder is permitted to articulate, explain or defend negotiating proposals or positions that have been adopted by the issuer with whom he or she is engaged.

4. No general solicitation of investors for securities is one of the basic conditions of the proposed finders exemption. An examination of a finder's solicitation activities would likely involve a determination not only as to the content and extent of the solicitation, but its mode of communication. The SEC has previously established narrow, fact-specific guidelines regarding online investment matchmaking activities. The SEC should address current unregistered Internet funding networks and other electronic marketplaces that give multiple buyers and sellers the ability to exchange information, locate interested parties and enter into transactions between themselves. Arguably, unregistered operators of these websites are engaged in such limited activities that would not create material risks for investors or the public generally. Consideration should be given to identifying technologies that would be permissible for finders and to establishing parameters as to their use without triggering broker-dealer registration requirements.