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Finders Keepers

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SEC PROPOSES TO ALLOW FINDERS TO RECEIVE TRANSACTION-BASED COMPENSATION IN CERTAIN LIMITED CIRCUMSTANCES WITHOUT HAVING TO REGISTER AS A BROKER-DEALER

In an effort to help small and emerging businesses raise capital, the Securities and Exchange Commission ("SEC") has proposed a conditional exemption from broker-dealer registration for finders in private transactions involving "accredited investors."

If enacted, the exemption would permit individuals to engage in certain limited capital-raising activities for privately held companies and receive transaction-based compensation. The exemption is designed to address difficulties small businesses face raising capital, particularly in geographic locations that "lack established, robust capital raising networks."

CURRENT LAW

Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires a "broker" to be registered with the SEC and thereby comply with a labyrinth of regulations. A broker is defined as "any person engaged in the business of effecting transactions in securities for the account of others."

> The finder must not engage in a "general solicitation."

By analyzing the underlying facts and circumstances to determine whether a person is engaged in the business of effecting transactions for others, over the years courts and the SEC have identified certain activities as indicators of broker status:

(1) actively soliciting investors,

(2) participating in negotiations between the issuer and the investor,

(3) advising investors as to the merits of an investment or opining on its merits,

(4) handling customer funds and securities,

(5) having a history of selling securities of others, and

(6) receiving transaction-based compensation.

While no one factor is dispositive, in practice, a person receiving transaction-based compensation (which happens to be the market standard for compensating finders) will almost always be found to have engaged in the business of "effecting transactions for … others" and thereby be unable to receive transaction-based compensation unless registered with the SEC and subject to strict and costly oversight.

PROPOSED SAFE HARBOR

To provide finders with a nonexclusive safe harbor from broker registration, on October 7, 2020, the SEC proposed a new "finders" exemptive order that would enable a finder to receive transaction-based compensation. The order contains general requirements and allows for two types of exempted finders, Tier I and Tier II. The SEC has invited comments on its proposal by November 6, 2020.

GENERAL REQUIREMENTS

A. The issuer

The issuer must be a private company that is not a reporting company under the Exchange Act.

The issuer must be conducting a securities offering that is not required to be registered with the SEC under the Securities Act of 1933.

B. Both Tier I and Tier II finders

The finder must not engage in a "general solicitation." In that regard, having a preexisting relationship with a potential investor can demonstrate the absence of a general solicitation.

The finder cannot (a) be involved in structuring the transaction or negotiating the terms of the offering, (b) handle customer funds or securities or bind the issuer or the investor, (c) participate in the preparation of any sales materials, (d) perform any independent analysis of the sale, (e) engage in any "due diligence" activities, (f) assist or provide financing for such purchases, or (g) provide advice as to the valuation or financial advisability of the investment.

The potential investor must be an "accredited investor" or the finder must have a reasonable belief that the potential investor is an accredited investor.

The finder must provide services pursuant to a written agreement with the issuer that includes a description of the services to be provided and the related compensation.

A Tier II finder would be prohibited from providing advice as to the valuation or financial advisability of the proposed investment.

The finder must not be associated with a broker-dealer or otherwise prohibited from participating in a securities offering.

Tier I

A Tier I finder would be permitted only to provide an issuer with contact information of potential investors in connection with a single capital-raising transaction by a single issuer in a 12-month period. A Tier I finder cannot have any direct contact with potential investors about the issuer or the contemplated capital raise.

Tier II

A Tier II finder would be permitted to engage in additional solicitation-related activities on behalf of any issuer, such as (a) identifying, screening and contacting potential investors, (b) distributing issuer offering materials to potential investors, (c) discussing issuer information including in offering materials, and (d) arranging or participating in meetings with the issuer and potential investors.

A Tier II finder would be prohibited from providing advice as to the valuation or financial advisability of the proposed investment. Significantly, unlike Tier I finders, a Tier II finder would not be subject to any frequency or time limitations.

A Tier II finder must disclose to a potential investor, no later than the time of the solicitation,

(1) the name of the finder and the issuer,

(2) a description of the relationship between the finder and the issuer, including any affiliation,

(3) any material conflicts of interest resulting from the arrangement or relationship between the finder and the issuer,

(4) that the finder will be compensated for his or her solicitation activities by the issuer, and a description of the terms of such compensation arrangement, and

(5) that the finder is acting as an agent of the issuer, is not acting for a broker-dealer, and is not undertaking a role to act in the investor's best interest.

A Tier II finder must also obtain from an investor, no later than the time in which an investment in the issuer's securities is made, a written acknowledgment of receipt of the finder's required disclosures.

OBSERVATIONS

The SEC proposal, if enacted, could provide much-needed clarity and certainty for small and emerging companies, their investors and their advisers — principally, that finders may retain transaction-based compensation and issuers will not risk their privately placed securities being "put" back to it, should the finder not be registered as a broker under the Exchange Act.

The proposal continues the SEC's recent focus on facilitating capital-raising activities of start-ups and other small businesses, illustrated in the SEC's recent determinations (a) allowing business advisers to receive transaction-based compensation in the purchase or sale of ownership and control of private companies without registering as a broker (see here[1]) and (b) expanding the definition of "accredited investors" (see here[2]).

The Level I finder is patterned directly after a 1991 SEC No-Action letter provided to Paul Anka, the famous singer and songwriter. Despite his receiving transaction-based compensation in connection with a private placement of securities in the United States, the proceeds of which were to be used to admit the Ottawa Senators into the National Hockey League, the SEC did not require Mr. Anka to register as a broker.

In reaching its determination, the SEC noted that Mr. Anka's sole act in connection with the securities transaction was providing the issuer with the names of potential investors with whom he had a preexisting business or personal relationship, and who he reasonably believed were accredited investors.

The Level I finder is patterned directly after a 1991 SEC No-Action letter provided to Paul Anka, the famous singer and songwriter.

Significantly, Mr. Anka did not contact the potential investors directly; contacts were made by an officer, employee, director or majority owner of the issuer, who disclosed to the potential investor that Mr. Anka was the source of the referral.

Further, Mr. Anka's primary occupation was as an entertainer; he had not been previously engaged to act as a finder in any capital-raising transaction, nor did he intend to act as finder in any other transaction. The SEC refused to apply *Paul Anka* in arguably analogous subsequent no-action requests, such that many questioned whether the SEC had disavowed its decision in *Paul Anka*.

We raise *Paul Anka* because we believe that the requirement that a Tier I finder be limited to assisting with one transaction every 12 months should be eliminated because it would significantly limit the benefit of the safe harbor without serving the purpose of protecting potential investors.

So long as a Tier I finder does not have direct contact with the potential investors, it should not matter how many transactions they engage in. It is quite a stretch to conclude that such a limited finder "effects transactions for ... others."

Instead, the issuer should be required to disclose to the potential investor the identity and contact information of the Tier I finder who recommended the investor to the issuer, as was the case in *Paul Anka*, and thereby enable the potential investor to instruct the Tier I finder to remove his name from the finder's "list," should the investor wish to do so.

Finally, as currently proposed, the exemption requires that a finder not be associated with a broker-dealer only during the capital transaction in question. It may be advisable to require a "cooling off" period so that a finder that had recently been associated with a broker-dealer could not claim the exemption.

Notes

[1] https://bit.ly/2Hiddnl

[2] https://bit.ly/34iiOTq

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