Hogan Lovells

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SEC proposes narrow broker-dealer registration exemption for finders

The U.S. Securities and Exchange Commission (SEC) proposed a new exemptive order on Wednesday, October 7, which would exempt certain "finders" from broker-dealer registration under Section 15(a) of the U.S. Securities Exchange Act of 1934 (the Exchange Act) that, if adopted, would provide a degree of clarity for intermediaries seeking to assist certain small and emerging private companies with capital formation.

The proposed order is available in full here and will be subject to a comment period that will end 30 days after publication in the Federal Register.

The SEC voted 3-2 to propose the exemption, arguing that it would facilitate capital formation for small and emerging private companies seeking investors, especially for small businesses seeking to locate relatively low amounts (*e.g.* less than US$5 million) that are beyond the scope of personal financing. Admitting the existence of a "gray market" where issuers have struggled to understand the broker-dealer rules for finders, the proposed exemption is designed to help issuers avoid, on the one hand, encouraging unregulated broker activity and, on the other hand, forgoing the use of finders altogether.

Section 3(a)(4) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Absent the proposed exemption, the question of whether a person is a broker has turned on a facts-and-circumstances analysis. The SEC and courts, over the years, have identified some of the following indicators of broker status:

- actively recruiting or soliciting investors;
- participating in negotiations between the issuer and investor(s);
- advising investors or otherwise opining as to the merits of an investment;
- handling customer funds and securities;
- having a history of selling securities of other issuers; and
- receiving success-based compensation for their assistance in raising investment capital.

In recent years, particularly following a January 2014 no-action letter providing relief for unregistered intermediaries in private merger and acquisition (M&A) transactions, the ability of an unregistered intermediary to assist with capital formation and receive success-based compensation has been uncertain. Rule 3a4-1, which provides relief for executives of an issuer who participate in securities offerings and do not receive specific compensation for those efforts, is of little or no utility for independent agents or internal personnel without substantial other responsibilities. Thus, the newly proposed exemption expands the permitted activities of unregistered intermediaries that seek to operate within the parameters of the proposed exemption.

Two new tiers of finders

The exemption creates two new tiers of finders: "Tier I finders" and "Tier II finders."

Tier I finders are defined as those whose 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. Such information may include, among other things, the name, telephone

number, email address, and social media information of potential investors.[1]

Tier II finders are defined to encompass far wider activity and are not limited to a single capital raise by a single issuer in each 12-month period. As proposed, Tier II finders would be able to engage in solicitation-related activities on behalf of an issuer, so long as the activities of the finder are limited 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 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.

Conditions for both tiers of finders

In order to take advantage of the proposed exemption, both Tier I and Tier II finders would have to meet certain baseline conditions:

- The issuer cannot be required to file reports under Section 13 or Section 15(d) of the Exchange Act; *i.e.*, the issuer cannot be a reporting public company.
- The issuer must be seeking to conduct the securities offering in reliance on an applicable exemption from registration under the U.S. Securities Act of 1933 (the Securities Act). The proposed order would provide that an issuer's failure to comply with the conditions of an exemption from registration under the Securities Act would not, in itself, affect the ability of a finder to rely on the proposed exemption, provided that the finder can establish that he or she did not know and could not have known (in the exercise of reasonable care) that the issuer had failed to comply with the conditions of the exemption. A finder would not be able to rely on the proposed exemption if he or she actually caused the issuer's offering to be ineligible.
- The finder may not engage in general solicitation (*i.e.*, public marketing and advertising). For example, the finder would not be eligible for the proposed exemption in relation to capital raises conducted pursuant to Rule 506(c) of Regulation D under the Securities Act.
- The potential investor must be 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." This requirement is intended to ensure that finders solicit potential investors who have a sufficient level of financial sophistication to participate in investment opportunities.
- The finder must provide services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation, though such written agreement may be satisfied by means of electronic media and communications.
- The finder may not be an associated person of a broker-dealer (as defined in Section 3(a)(18) of the Exchange Act). The SEC included this requirement because it believes there exists the potential for investor confusion and abusive sales tactics when the finder is associated with a broker-dealer, given the existing protections and standard of conduct applicable to registered broker-dealers.
- Finally, the finder may not be subject to statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act), at the time of his or her participation, given that the SEC believes there is potential for abusive practices where persons subject to statutory disqualification are also not subject to adequate supervision or regulatory oversight.

1 This is not dissimilar to several SEC no-action letters dating back to the 1991 *Paul Anka* no-action letter in which the SEC stated that it would not recommend enforcement against an individual who (i) entered into an agreement to provide to the issuer a list of names and telephone numbers of potential investors who he believed to be accredited investors with whom he had a pre-existing relationship; (ii) had no further contact with potential investors concerning the issuer; and (iii) received a finder's fee for doing so.

Additional disclosures for Tier II finders

In addition to the conditions set forth above, Tier II finders must take additional steps to qualify for the proposed exemption by providing certain disclosures to each potential investor, prior to or at the time of the solicitation:

- 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.

The proposed order would permit the Tier II finder to provide such disclosures orally, so long as the oral disclosure is supplemented by written disclosure that satisfies its full disclosure requirement no later than the time of any related investment in the issuer's securities.

Furthermore, 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 acknowledgement (including by electronic means) of the receipt of the Tier II finder's disclosures.

Prohibitions on certain activities

Finally, given that the proposed exemption is designed to permit unregistered finders to engage in a limited scope of solicitation and other activities, the SEC lists certain activities in which traditional broker-dealers engage that would be inappropriate for exempted finders. Accordingly, the proposed order would prohibit such finders from engaging in the following activities:

- structuring the transaction or negotiating the terms of the offering;
- handling customer funds or securities or bind the issuer or the investor;
- participating in the preparation of any sales materials;
- performing any independent analysis of the sale;
- engaging in any "due diligence" activities;
- assisting or providing financing for any such purchases; or
- providing advice as to the valuation or financial advisability of the investment.

Notably, the SEC's proposed order expressly states that the exemption would not affect a finder's obligation to comply with all other applicable laws, including Rule 10b-5 and any other antifraud provisions of either the Securities Act or the Exchange Act. In addition, the SEC states that the proposed exemption does not otherwise insulate a finder from the registration requirements of the U.S. Investment Advisers Act of 1940 if the finder is also acting as an investment adviser.

Conclusion

As the SEC notes in its proposed order, issuers and finders have for years sought clarity as to when a finder's activities are sufficient to cause the finder to become a broker, as defined in the Exchange Act. The SEC's proposed exemption would provide issuers and finders alike a path to compliance with the Exchange Act that to date had not existed. We expect that issuers and finders, particularly in the small and emerging companies space, may find the proposed order's goals helpful in enabling qualifying finders to assist in certain aspects of capital formation by small and emerging companies when it is not practical for the intermediary to comply with broker-dealer registration requirements.

We will continue to monitor developments as the proposed order moves into the comment period.

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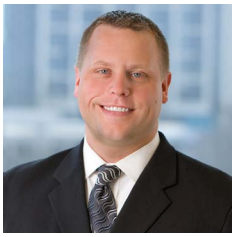

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