

SEC Proposes Conditional Exemption for Finders:

Assisting Small Businesses with Capital Raising

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Introduction:

If you are a General Partner of a private equity or venture capital fund that considers using Finders for sourcing deals or fundraising, the latest SEC proposal impacting Finders will be of interest to you. This proposal provides more leeway in how Finders can assist you despite the lack of broker-dealer registration.

On October 7, 2020, the SEC voted to propose an [exemptive relief](#) from the broker registration requirements for “Finders” who help issuers raise private capital from accredited investors.

Background:

Under current SEC rules, it is illegal for any person to assist in effecting any capital transaction for compensation without registering with the SEC as a broker or associating with a registered broker-dealer. An unregistered broker-dealer could face SEC sanctions and be unable to collect payment for their services. One such SEC enforcement action occurred in the case of Ranieri Partners. In that case, a private equity firm, its managing director and consultant were all subject to enforcement action because of the consultant’s failure to register as a broker-dealer. The SEC order found that the private equity firm paid transaction-based fees to a consultant for soliciting investors for private fund investments even though the consultant was not registered as a broker-dealer.

Current case law provides very few exemptions from the requirement that Finders register as a broker-dealer. Failure to meet these exemptions or register could cause the agreement with the Finder to be unenforceable. In addition, investors who invested in the issuer through an unregistered broker-dealer or Finder could claim that they were misled by the Finder and issuer. This means the investors could rescind their investment, and the issuer would need to repay the original investment amount.

Registering as a broker-dealer means increased regulatory requirements. Some believe additional regulations and registration requirements ultimately led to certain smaller markets being underserved from a fundraising and investment perspective as connecting with potential investors can be difficult in these markets. Further, while there are currently exemptions available from the registration requirements, albeit narrow in scope, the proposal aims to reduce ambiguity about what is permitted and what is not when it comes to the registration of Finders.

Proposed Rule:

To assist smaller issuers with raising capital, the proposed exemption aims to clarify the registration requirements by creating two “Tiers” of Finders. The proposal outlines the limited activities that would allow Finders to effect capital transactions without being required to register with the SEC as a broker.

Proponents of this proposal believe that this would open up additional fundraising opportunities to smaller issuers as Finders would fill a gap in the current system by facilitating introductions between the issuers and potential investors.

The Tiers are structured as follows:

Tier I Finders:

A Tier I Finder can only provide contact information about potential investors and can only assist with a single fundraising transaction for a single issuer within a 12-month period. A Tier 1 Finder is restricted from contacting or soliciting potential investors about the issuer.

Tier II Finders:

A Tier II Finder is permitted to solicit investors on behalf of an issuer; however, as stated in the [SEC Fact Sheet](#), the solicitation would be limited to:

- i. Identifying, screening, and contacting potential investors
- ii. Distributing issuer offering materials to investors
- iii. Discussing issuer information included in any offering materials, provided the Finder does not provide advice as to the valuation or advisability of the investment
- iv. Arranging or participating in meetings with the issuer and investor

Conditions for both Tier I and Tier II Finders:

To qualify for exemption, both Tier I and Tier II Finders would be required to adhere to certain conditions. Exemption would only be available to Tier I and Tier II Finders when:

- 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.

Additionally, this proposed exemption does not allow the Finder to engage in broker activity beyond the scope of the proposed exemption. Also, investors must still be accredited investors, so a Finder cannot rely on this proposed exemption to facilitate a registered offering, a resale of securities, or the sale of securities to an investor that is not accredited or believed to be an accredited investor.

Further, as stated in the [SEC Fact Sheet](#), a Finder cannot:

- i. be involved in structuring the transaction or negotiating the terms of the offering;
- ii. handle customer funds or securities or bind the issuer or investor;
- iii. participate in the preparation of any sales materials;
- iv. perform any independent analysis of the sale;
- v. engage in any “due diligence” activities;
- vi. assist or provide financing for such purchases; or
- vii. provide advice as to the valuation or financial advisability of the investment.

Additional Conditions for Tier II Finders

Because Tier II Finders could participate in a wider range of activity and have the potential to engage in more offerings with issuers and investors, the Commission has proposed additional, heightened requirements. A Tier II Finder wishing to rely on the proposed exemption would need to satisfy certain disclosure requirements and other conditions. These disclosure requirements, which include a requirement that the Tier II Finder provide appropriate disclosures of the Tier II Finder's role and compensation, must be made prior to or at the time of the solicitation. Further, 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 acknowledgment of receipt of the required disclosures.

Conflicting Views:

The proposal was approved by a 3:2 vote. Those voting against the proposal expressed their main concern as the lack of customer protection for investors, especially under the Tier II structure. Tier II allows Finders to engage in a broad range of activity that is currently subject to broker-dealer registration. Under the Tier II structure, the Finders would have a salesman's stake in the potential transaction, and they are permitted to be a part of the sales process except that they cannot conclude their presentation with the recommendation to invest. However, they are not required to operate in a manner consistent with the rules that govern broker-dealers.

Those in favor of the proposal argued that investor protections still exist because Finders can only solicit accredited investors. However, Reg BI (Regulation Best Interest) which went into effect in June 2020 was implemented specifically to provide investor protections to all investors, and accredited investors were not excluded from that category. Just three months after the implementation of Reg BI, the Commission proposed to carve out accredited investors from the investor protection rules implemented in June 2020. Another disconnect is that less than two months ago, the Commission expanded the [definition of Accredited Investor](#) to include new categories of individuals. The expansion was justified at the time by arguing that it did not raise any investor protection concerns. Now, one month later, these accredited investors could potentially be stripped of the protections when dealing with Tier II Finders.

With exemption also comes the lack of requirement to maintain records of capital raising activities. In addition, the Finders would not be subject to periodic inspections or examinations. This means there is no way for the SEC to know if the Finders are complying with the conditions laid out in the proposal.

This exemptive order also bypasses the normal rulemaking process which requires that the Commission support its policy choices with empirical evidence about the impact of the policy on efficiency, competition and capital formation.

Final Thoughts:

This exemptive relief appears to be a step back from the investor protection that the Commission has previously pushed for. There is a 30-day comment period for the proposed exemption which ends right around election time. Whether this exemption will see the light of day may well depend on the results of the election.

Will this exemption really improve the ability of small issuers to raise more capital? Or will it create a greater opportunity for bad actors to deceive investors? We would love to hear your thoughts on this.