

SEC Proposes Broker-Dealer Exemption for “Finders,” Though Much Remains Uncertain

By Alex Seldin and Chris Yaracs

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A recently proposed Securities and Exchange Commission (“SEC”) exemption from broker-dealer registration may make it easier for small and medium-sized businesses to raise capital from accredited investors, but questions remain.

On October 7, 2020, the SEC voted to propose a new exemption (the “Proposed Exemption”) to the broker-dealer registration requirements for “Finders,” a designation that would become available to qualifying individuals who connect private companies seeking capital with accredited investors.¹ The Proposed Exemption would provide relief from current securities laws that make it illegal or impractical for individuals to introduce companies seeking capital to potential investors, and could open new sources of financing to entrepreneurs.

Under current law, Section 15(a) of the Securities Exchange Act of 1934 (the “Exchange Act”) makes it illegal to “effect a transaction in securities” or “attempt to induce the purchase or sale of any security.” In practice, this has generally been interpreted to mean that a person seeking to receive a commission for introducing investors to a company must register with the SEC and affiliate with a firm regulated by the Financial Industry Regulatory Authority. Such registration and affiliation requirements often prove too costly or burdensome for individuals, and stifle their ability to make potentially beneficial introductions. Further, the risks of violating the current broker-dealer registration requirements are exacerbated by Section 29(b) of the Exchange Act, which provides that every contract made in violation of the broker-dealer registration requirements “shall be void,” and gives disgruntled investors a *de facto* right of rescission or ability to “put” such investors’ securities back to the company. This significant risk customarily leads to companies using only registered broker-dealers as intermediaries when raising capital.

¹ The full text of the Proposed Exemption is available at: <https://www.sec.gov/rules/exorders/2020/34-90112.pdf>. Additional information is available at: <https://www.sec.gov/news/press-release/2020-248>.

The Proposed Exemption creates a safe-harbor from Section 15(a) of the Exchange Act for a Finder that satisfies the following conditions:

- The company is not registered under the Exchange Act (i.e., the company is a “private company”).
- The company is seeking to issue securities in reliance on an exemption from registration under the Securities Act of 1933 (i.e., a private placement).
- The Finder does not engage in general solicitation.
- The potential investor is an “accredited investor” (or the Finder reasonably believes they are an accredited investor).
- There is a written agreement between the Finder and the company.
- The Finder is not associated with a registered broker-dealer.
- The Finder is not subject to SEC disqualification.

Importantly, the Proposed Exemption also limits the Finder’s activities. Under the Proposed Exemption, the Finder may not:

- Assist in structuring the investment or negotiating the terms of the investment.
- Handle funds or securities, or bind the company or investor.
- Participate in the preparation of any sales materials.
- Perform any independent analysis of the sale.
- Engage in any “due diligence” activities.
- Assist with or provide financing for any purchases.
- Provide advice as to the valuation or financial advisability of the investment.

The Proposed Exemption creates two tiers of Finder:

- A Tier 1 Finder may only participate in a single capital-raising transaction for a single company in any 12 month period, and may not contact potential investors regarding the proposed investment.
- A Tier 2 Finder may contact potential investors regarding the proposed investment, but is subject to additional regulatory requirements, including the requirement that the Finder make written disclosures to potential investors regarding the Finder’s role in the proposed investment and the Finder’s compensation, which must be acknowledged in writing by the potential investors.



While the Proposed Exemption may prove beneficial to companies raising capital and the people who want to help them, it is not a panacea. For instance, the Proposed Exemption does not apply to individuals involved in structuring or negotiating a proposed investment, making it unavailable to professionals like accountants and lawyers, who may arguably be most able to help connect companies with suitable investors. Further, some argue that having an unregulated intermediary involved in the solicitation process could harm investors who may, implicitly or otherwise, rely on the Finder's involvement in evaluating the proposed investment. Concerns of this nature were raised by some SEC Commissioners who objected to the Proposed Exemption and will likely emerge from the public comment period on the Proposed Exemption, which closed on November 12, 2020.²

Now that the public comment period has closed, the SEC will review the comments and may make revisions to the Proposed Exemption. The SEC Commissioners will then vote upon the final Proposed Exemption and, if it receives majority support, the Proposed Exemption will take effect. While uncertainty regarding enactment of the Proposed Exemption remains, the SEC's attention to the unique issues faced by individuals who would like to introduce companies to new sources of capital is undoubtedly a positive development for entrepreneurs and investors alike. We expect to know more about whether the Proposed Exemption will be enacted in the coming months and will provide updates as more information becomes available.

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² Additional information regarding these concerns is available at: <https://www.sec.gov/news/public-statement/lee-proposed-finders-exemption-2020-10-07>. Comments regarding the Proposed Exemption are available at: <https://www.sec.gov/comments/s7-13-20/s71320.htm>.