

New Proposed SEC Rule Would Allow Finders to Receive Commissions Without Registering as a Broker Dealer

Hinshaw Alert | 5 min read

Nov 3, 2020

In order to clarify various no action letters and court decisions, the Securities and Exchange Commission (SEC) has proposed an rule that would allow two classes of “finders” to avoid having to register as a broker-dealer or as an associated person in circumstances where they play a role in raising money by private companies issuing securities. This client update will briefly touch on existing law and more deeply delve into the SEC’s proposed finder exemption.

The proposed rule reminds us that capital formation does not just happen in the public securities markets but also occurs as part of private or exempt offerings of securities. The proposed rule also reminds us that many regions in the U.S. are not awash with angel investors nor venture capital. Another aim of the proposed exemption is to clear up a gray area where the law and industry practice are not always well aligned. In proposing this exemption, the SEC is seeking to provide greater clarity so everyone understands the “rules of the road.”

Overview of Current Law

Existing law defines a broker as “a person engaged in the business of effecting transactions in securities for the accounts of others.” Absent an exception or exemption, a person meeting the definition of broker would need to register as a broker under Section 15(a) of the Securities and Exchange Act of 1934, as amended (“Exchange Act”). Over the years, the SEC has stated that the following non-exhaustive list are indications of acting as a broker:

- (a) receiving transaction based compensation for selling securities, i.e., a commission but not a salary;
- (b) handling customer funds or securities;
- (c) selling securities of other issuers;
- (d) recruiting investors or actively soliciting the same;

(e) opining as to the merits of an investment or advising investors about the merits of purchasing an investment; and

(f) participating in negotiations between investors and issuers.

Furthermore, the SEC and courts have found the following activities to be solicitation if connected with an investment: (1) telephone calls; (2) mailings; (3) advertising (print or online); (4) conducting seminars; or (5) any affirmative effort intended to induce a securities transaction.

Prerequisites to Acting as any Sort of Finder under the Proposal

Under the proposed rule, here are the prerequisites for acting as a finder:

- 1) The finder cannot be an associated person of a broker-dealer. Obviously, the SEC does not want those that are already registered to utilize the less restrictive exemption;
- 2) The issuer does not engage in a public offering but only in a private or exempt securities offering. Given the motivations listed by the SEC, this exemption is not intended for companies that are large enough or already access the public markets. Examples of private or exempt offerings include those utilizing Regulation D and Regulation S;
- 3) The finder does not engage in a “general solicitation”. Another way of stating this is that the finder has a pre-existing, substantial relationship with the prospective investor. General solicitation would include placing an ad for all to see;
- 4) The potential investor is an accredited investor [as defined under Rule 501 to Regulation D](#). In fact, the finder can get by with merely having a “reasonable belief” that the proposed investor is an accredited investor;
- 5) The issuer need not report under Section 13 or 15 (d) of the Exchange Act. Section 13 generally deals with reporting of publicly traded securities over certain thresholds and Section 15(d) deals with publicly traded companies that file periodic reports like Forms 10K or 10Q;
- 6) The issuer and the finder have a written contract that discusses compensation and a description of services to be provided; and
- 7) The finder is not subject to a list of statutory disqualifications as listed in Section 3(a)(39) of the Exchange Act. An example of the foregoing is a bar by a state securities regulator. These are prior bad activities that demonstrate the privilege of registration should not be granted to these persons. Consequently, the SEC does not want to give them back door access to any role in the securities industry.

The Severally Limited Tier I Finder Exception

If the proposed finder meets all of the above qualifications, then they are permitted to provide the issuer of securities with the contact information (telephone #, e-mail address and social media info) of possible investors.

The Tier I Finder is not allowed to have any contact with the potential investor about the issuer or offering of securities. A Tier I Finder may only work with one issuer during a twelve month period. If the Tier I Finder complies with all of the general finder rules discussed above and specific Tier I Finder limitations listed herein, then they may receive transaction related compensation, i.e., commissions, without having to register as a broker under Section 15(a) of the Exchange Act or an associated person thereof.

A More Functional Tier II Finder Provision -

A Tier II Finder would be allowed to solicit for an issuer if those efforts are limited to:

a) “identifying, screening” and contacting potential investors; (b) distributing issuer provided offering materials to investors; (c) discussing issuer information included in the offering material, if and only if, the finder does not give advice as to the advisability of the investment or as to valuation; and (d) arranging or taking part of meetings with issuers and investors.

Any other solicitation activities beyond those listed above would blow the exemption. Again, solicitation has been defined by the SEC And the courts as any affirmative effort to induce a securities transaction. For instance, a Tier II Finder could not be given funds or securities by an issuer or investor.

Required Disclosures to be Given by a Tier II Finder

Prior to or at the time of solicitation, the finder must give the following disclosures:

(i) the name of the Tier II Finder; (ii) the name of the issuer; (iii) a description of the affiliation or relationship between these two parties; (iv) disclosure that the Tier II Finder will be compensated for his or her solicitation activities and a description of such arrangements; (v) a description of material conflicts of interest resulting from the relationship or arrangement between the issuer and the Tier II Finder; and (vi) an affirmative statement that the Tier II Finder is acting as the issuer’s agent, is not acting as an associated person of a broker-dealer and is not required to act in the investor’s best interest.

Notably, these disclosures can be given orally if such disclosure is supplemented by a written disclosure containing items (i)-(vi) above no later than the time of any related investment in the issuer’s securities. Lastly, the Tier II Finder must obtain a dated written acknowledgement of receipt of the Tier II Finder’s required disclosures. If the Tier II Finder complies with all of the general finder rules listed above and specific Tier II Finder limitations contained herein, then the Tier II Finder may receive transaction related compensation, i.e., commissions, without having to register as a broker under Section 15(a) of the Exchange Act or an associated person thereof.

What is not covered by the foregoing proposed exemption?

Just because a finder is exempt from registration does not mean that they are exempt from the anti-fraud rules of the Exchange Act. Moreover, being exempt from registration also does not mean that the finder is exempt from other laws like the Investment Advisers Act of 1940.

Conclusion

As this is a proposed rule, the SEC has asked for and will receive comments. It is likely that the final rule will see some changes. If you have any questions about this proposed rule, please contact Andrew May or your Hinshaw attorney.