

# SEC Proposes “Finders” Exemption from Broker Registration Requirements

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On October 7, 2020, the Securities and Exchange Commission (“SEC”) published a proposed exemption (“Proposed Exemption”) that would exempt natural persons who assist issuers, including private funds, with raising capital in private markets from accredited investors (“Finders”) from the requirement to register as a broker-dealer, subject to certain conditions.

The Proposed Exemption would create two classes of Finders that are exempt from broker-dealer registration requirements, subject to satisfying certain conditions: Tier I Finders and Tier II Finders. A Tier I Finder would be able to provide contact information of potential investors in connection with a single capital raising transaction by a single issuer in a 12 month period. However, Tier I Finders would not be allowed to have any contact with a potential investor about the issuer. A Tier II Finder would be able solicit investors on behalf of an issuer, but the solicitation-related activities 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 that the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and (iv) arranging or participating in meetings with the issuer and investor. A Tier II Finder would be subject to additional disclosure requirements relating to its role and compensation, among other matters, but is not limited to participating in one capital raising transaction by a single issuer in a 12 month period.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

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NEW YORK

**Colin Lloyd**  
+1 212 225 2809  
[clloyd@cgsh.com](mailto:clloyd@cgsh.com)

**Maurice R. Gindi**  
+1 212 225 2826  
[mgindi@cgsh.com](mailto:mgindi@cgsh.com)

**Adrianna ScheerCook**  
+1 212 225 2247  
[ascheercook@cgsh.com](mailto:ascheercook@cgsh.com)

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WASHINGTON D.C.

**Carl Emigholz**  
+1 202 974 1876  
[cemigholz@cgsh.com](mailto:cemigholz@cgsh.com)

**Sarah Stanton**  
+1 202 974 1627  
[sstanton@cgsh.com](mailto:sstanton@cgsh.com)



## Background

Section 3(a)(4) of the Securities Exchange Act of 1934 (“Exchange Act”) generally defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” Accordingly, absent an exception or exemption, any person engaged in the business of effecting transactions in securities for the account of others must register as a broker-dealer with the SEC.

However, the Exchange Act does not define what it means to be “engaged in the business” or “effecting transactions.” While the SEC has generally determined that a person who identifies and solicits potential investors for an issuer or other party, such as a Finder, could be viewed as engaging in “broker” activity, the SEC has not broadly addressed whether, and under what circumstances, a person may solicit potential investors on behalf of an issuer without being required to register as a broker-dealer. Currently, market participants rely on SEC no-action letters discussing circumstances under which Finders do not have to register as broker-dealers.

The Proposed Exemption is intended to provide clarity with respect to the ability of a Finder to engage in certain activities without being required to register with the SEC as a broker-dealer and facilitate capital formation, particularly for small businesses in the private markets.

## Conditions for Finders

In order to qualify for the exemption from broker-dealer registration, both Tier I Finders and Tier II Finders would be subject to the following conditions:

- The issuer must not be required to file reports under Section 13 or Section 15(d) of the Exchange Act;
- The issuer must be seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act of 1933 (“Securities Act”);

- The Finder must not engage in general solicitation;
- The potential investor must be an “accredited investor” as defined in Rule 501 of Regulation D of the Securities Act, or someone whom the Finder reasonably believes is an “accredited investor”;
- The Finder must provide services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
- The Finder must not be an associated person of a broker-dealer; and
- The Finder must not be subject to statutory disqualification, as defined in Section 3(a)(39) of the Exchange Act, at the time of the Finder’s participation.

In addition, a Tier II Finder would be required to satisfy certain disclosure requirements, including that such Tier II Finder disclose its role and compensation prior to or at the time of solicitation and receive a written acknowledgment from the investor of the receipt of such disclosures prior to or at the time of any investment in the issuer’s securities. Additionally, Regulation D requirements would still apply, including identifying people on Form D who are compensated in connection with a sale.

A Finder could not rely on the exemption from broker-dealer registration to engage in broker activity beyond the scope of the activities set forth in the Proposed Exemption (*e.g.*, to facilitate a registered offering, a resale of securities or a sale of securities to non-accredited investors). Additionally, a Finder would not be eligible for an exemption from broker-dealer registration if he or she:

- Is involved in structuring the transaction or negotiating the terms of the offering;
- Handles customer funds or securities or binds the issuer or investor;

- Participates in the preparation of any sales materials;
- Performs any independent analysis of the sale;
- Engages in any “due diligence” activities;
- Assists or provides financing such purchases; or
- Provides advice as to the valuation or financial advisability of the investment.

## Key Takeaways

- *The Proposed Exemption would increase access to potential sources of capital, particularly for smaller private issuers.* By enabling Finders to engage in certain capital raising activities without registering as a broker-dealer, the Proposed Exemption would facilitate access to more capital outside of traditional broker-dealer fundraising sources. This may be particularly significant for smaller private issuers that are the most likely to experience difficulty obtaining the assistance of a broker-dealer when seeking to raise capital. However, because the exemption is limited to non-reporting companies, it could potentially create disparities in the ability of similar-sized companies to raise capital.
- *By providing greater certainty, the Proposed Exemption may increase the number of Finders who are willing to engage in the permitted activities.* An increase in Finders willing to engage in the activities permitted under the Proposed Exemption may enable greater numbers of smaller private issuers to obtain capital in exempt securities placements, as well as facilitate a broader investment base for such issuers.
- *The Proposed Exemption could be useful to private fund advisers seeking investors for their funds.* Private fund sponsors, particularly new sponsors or small managers, could benefit from the Proposed Exemption in connection with fundraising by providing an ability to compensate Finders (including anchor investors) to tap networks of investors the sponsor may not otherwise be able to access.
- *The Proposed Exemption’s conditions may limit its usefulness for private fund advisers raising capital for portfolio companies.* Although the Proposed Exemption would allow private fund advisers to solicit “accredited investors” for portfolio companies’ exempt offerings, such advisers would not be able to help negotiate the terms of the offering, participate in the preparation of sales materials or provide advice with respect to the investments. These restrictions may make the Proposed Exemption less valuable to private fund advisers, and the SEC requested comment on whether it should provide guidance regarding activities of private fund advisers.
- *The SEC has requested comment on whether the Proposed Exemption should be limited to persons that are not associated with an investment adviser.* If the Proposed Exemption is limited only to persons that are not associated with an investment adviser, the exemption’s utility for the private funds industry may be more limited.
- *The Proposed Exemption does not extend to other registration categories, and a Finder may be subject to additional such requirements.* The Proposed Exemption notes that even if a Finder complies with the conditions, he or she may need to consider whether he or she is acting as another regulated entity, such as an investment advisor or a municipal advisor. In addition, the relief would not extend to state-level registration requirements, and Finders will need to consider whether their activities require registration or may qualify for an exemption under relevant state law. Finders and investment advisers may need to consider applicability of the cash solicitation rule, which imposes certain requirements on arrangements between investment advisers’ and their solicitors.
- *The SEC has requested comment on whether the Proposed Exemption should be limited to “finding” or soliciting for primary offerings or expanded to include secondary offerings.* If the

Proposed Exemption was expanded to include secondary offerings, the exemption could be useful to Finders who facilitate the sale of equity by employees and early stage investors.

- *The SEC has requested comment on whether the exemption should be limited to a natural person resident in the United States.* There are other forms of relief for a non-U.S. natural person or entity for certain Finder activities, including generally under Rule 15a-6 of the Exchange Act, and in connection with certain M&A activities under the SEC no-action letters of July 12, 2012 to Ernst & Young (allowing treatment for certain U.S. persons as Major U.S. Institutional Investors under Rule 15(a)(6)) and May 28, 2013 to Roland Berger Strategy Consultants (allowing certain contacts with potential U.S. buyers and sellers that are Major U.S. Institutional Investors and certain additional contacts with such buyers' and sellers' M&A personnel). However, the Proposed Exemption would provide broader relief, in some respects, to non-U.S. Finders by allowing the solicitation of "accredited investors," rather than restricting their activities to U.S. Institutional Investors and Major U.S. Institutional Investors.
- *The Proposed Exemption is distinct from other broker-dealer relief that is frequently relevant to Finders. A Finder may be able to utilize multiple of these exemptions, as the SEC noted that the Proposed Exemption is a non-exclusive safe harbor.*
  - *Rule 3a4-1 of the Exchange Act ("Rule 3a4-1").* The exemption under Rule 3a4-1 allows Finders to assist issuers in raising capital in connection with non-exempt securities offerings if its sales duties are restricted in certain ways. However, the applicability of Rule 3a4-1 is limited to associated persons of the issuer and does not allow Finders to receive transaction-based compensation, neither of which is a condition under the Proposed Exemption. While reliance on both Rule 3a4-1 and the Proposed Exemption may be possible, activities undertaken pursuant to the Proposed

Exemption may also result in the unavailability of Rule 3a4-1 (for example, Rule 3a4-1(a)(4)(ii)(C) requires that an associated person of the issuer not participate in selling an offering of securities for any issuer more than once every 12 months other than in reliance on other exemptions in Rule 3a4-1).

- *SEC No-Action Letter of January 31, 2014 with respect to "M&A Brokers" ("M&A Broker Letter").* The M&A Broker Letter covers different activities than the Proposed Exemption. Under the M&A Broker Letter, an entity engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately held company ("M&A Broker") may facilitate mergers, acquisitions, business sales and business combinations of privately-held companies if the buyer, or group of buyers, actively operates the company or the business conducted with the assets of the business upon the completion of the transaction. As the M&A Broker Letter and the Proposed Exemption provide relief with respect to different types of transactions, a Finder could utilize both to assist issuers.
- *Financial Industry Regulatory Authority ("FINRA") rules for "Capital Acquisition Brokers" ("CAB Rules").* The CAB Rules allow entities to engage in activities that are specifically prohibited under the Proposed Exemption, including assisting in the preparation of offering materials and providing fairness opinions, valuation services, expert testimony, litigation support and negotiation and structuring services. However, the CAB Rules is more restrictive with respect to solicitation, which is restricted to "institutional investors," rather than "accredited investors," as under the Proposed Exemption. Additionally, Capital Acquisition Brokers are registered as broker-dealers and subject to certain FINRA rules.

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