Finders play a vital role in introducing startups to potential investors.  Yet the general requirement that persons soliciting investors must register with the Securities and Exchange Commission as broker-dealers and be subject to the SEC’s broker-dealer regulatory regime has been a source of much uncertainty for finders and companies alike and has posed a serious impediment to raising capital.  On October 7, a divided SEC voted to [propose](https://www.sec.gov/rules/exorders/2020/34-90112.pdf) a limited, conditional exemption from broker-dealer registration for individual finders who engage in limited activities on behalf of issuers.  The proposal will undergo a 30-day comment period.  Its ultimate fate is uncertain, at least in the announced form, given the split vote and election uncertainties that could impact the SEC’s composition after November.

**Background**

Section 3(a)(4) of the Securities Exchange Act generally defines a “broker” as “*any person engaged in the business of effecting transactions in securities for the account of others*.”  Section 15(a)(1) of the Exchange Act generally makes it unlawful for any broker to “*effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security*” unless that broker is registered with the SEC. Consequently, absent an available exemption, a person engaged in the business of effecting transactions in securities for the account of others is a broker and required to register as such under the Exchange Act.

The question of whether a “finder” – a capital raising matchmaker with no involvement in negotiating price or other terms – is a “broker” within the meaning of the Exchange Act turns on the relevant facts and circumstances of each case.  Over the years, courts and the SEC have focused on whether a person participates on a regular basis in securities transactions at key points in the chain of distribution, including actively soliciting or recruiting investors, participating in negotiations, providing investment advice, handling funds or securities and, perhaps most notably, receiving transaction-based compensation.

The SEC has not previously recognized a “finders” exemption.  Instead, deal makers have sought guidance from SEC staff no-action letters addressing circumstances under which persons may act as “finders” without registering as broker-dealers.

Folks my age and older may remember pop singer Paul Anka for hits like [“*Put Your Head on My Shoulder*”](https://genius.com/Paul-anka-put-your-head-on-my-shoulder-lyrics) and [“(You’re) *Having My Baby*“](https://www.last.fm/music/Paul+Anka/_/(You%27re)+Having+My+Baby),  but securities lawyers associate the name with an [SEC no-action letter](https://securities.utah.gov/docs/Anka_Letter.pdf) relating to acting as a finder without registration.  In 1991, Mr. Anka entered into an agreement with The Ottawa Senators Hockey Club Limited Partnership (the “Senators L.P.”) to provide it names of potential investors in exchange for a transaction-based success fee.  In its related no-action letter, the SEC staff stated it would not recommend enforcement against Mr. Anka if, without registering as a broker-dealer (and presumably without giving the staff a private performance of “*Having My Baby*”), he provided the Senators L.P. a list of potential investors he had a pre-existing relationship with and reasonably believed to be accredited, but with whom he would have no further contact concerning the Senators L.P.  The staff noted its no-action decision was also conditioned on Mr. Anka not engaging in the following activities: soliciting the prospective investors, participating in any general solicitation, assisting in the preparation of sales materials, performing independent analysis, engaging in “due diligence”, assisting or providing financing, providing valuation or investment advice and handling any funds or securities.

The Paul Anka no-action letter only has relevance, however, to one-off arrangements and does not give much comfort to finders seeking to introduce investors to issuers for a living.  The staff’s response noted that Mr. Anka had not previously engaged in any offering of securities (other than buying and selling securities for his own account), had not acted as a broker or finder for other private placements of securities and did not intend to participate in any distribution of  securities after the completion of the proposed private placement.  Accordingly, finders in the business of intermediating private capital-raising transactions have not been able to rely on the Paul Anka letter, and consequently have had to choose between registering with the SEC as broker-dealers and assuming the risk of not doing so including the possibility of an SEC enforcement action.  This has dissuaded otherwise well-connected individuals from acting as finders, thus denying many early stage companies and other issuers an important capital raising tool.

**The Finder Exemption Proposal**

The proposed finder exemption would provide a non-exclusive safe harbor from broker registration for two types of finders based on the activities in which they are permitted to engage and with conditions tailored to the scope of their activities. Tier I Finders would be limited to just providing names and contact information of prospective investors to issuers. Tier II Finders would be permitted to engage in limited solicitation efforts.

***General Conditions***

Both Tiers would be subject to the following general conditions:

* Only for deals with issuers not required to be SEC reporting companies.
* Only exempt offerings (i.e., no registered offerings).
* Finder may not engage in general solicitation.
* Potential investor must be an accredited investor, or finder has reasonable belief potential investor is an accredited investor.
* Written agreement between finder and issuer describes services and fees.
* Finder not an associated person of a broker-dealer.
* Finder not subject to statutory disqualification.

Finders seeking to rely on the exemption would not be permitted to participate in transaction structuring, negotiating offering terms, handling funds, preparing of sales materials, providing independent analysis or due diligence, investment financing, providing valuation or investment advice and secondary offerings.

A few observations about the general conditions. An issuer’s failure to comply with the conditions of an offering exemption would not, in itself, make the broker-dealer exemption unavailable to the finder provided the finder can establish that he did not know and, in the exercise of reasonable care, could not have known, that the issuer had failed to comply.  But a finder who causes the issuer’s blown offering exemption would not be able to rely on the broker-dealer exemption.  Presumably, the condition that the finder not engage in general solicitation does not limit the exemption to only offerings that prohibit general solicitation; for example, the exemption could be available in offerings under 506(c), so long as the finder himself does not engage in any general solicitation act. Although not explicit, the prohibition on general solicitation implies that finders may only approach investors with whom they’ve had a pre-existing relationship.  The requirement that the potential investor be accredited suggests that the exemption would be unavailable if one of the finder’s potential investors was not accredited, even if all purchasers in the offering were.  Finally, if the proposal is approved, the written agreement requirement would make it prudent for finders to engage counsel to assist them with crafting appropriate engagement letters that conform to the ultimate rule, including provisions such as indemnification that are not mandated by the proposal but would provide additional protection.

***Tier I Finders***

Tier I Finders would be allowed to provide names and contact information of potential investors in connection with a single capital raising transaction by a single issuer in a 12-month period, but would not be allowed to have any contact with any potential investors about the issuer.  Basically, the exemption as to Tier I Finders is essentially a codification of the Paul Anka letter with a few additional requirements (non-reporting issuer, associated person and statutory disqualification), inasmuch as it prohibits solicitation activities and severely limits the frequency of transactions.

***Tier II Finders***

Tier II Finders would be allowed to solicit investors on behalf of an issuer and would not be subject to any transaction frequency limitation, provided the solicitation-related activities are limited to:

* Identifying, screening, and contacting potential investors;
* Distributing issuer offering materials to investors;
* Discussing issuer information included in any offering materials, provided no valuation or investment advice is provided; and
* Arranging or participating in meetings with the issuer and investor.

In exchange for being allowed to solicit investors and have the potential to engage in more offerings with issuers and investors, Tier II Finders would need to provide potential investors, prior to or at the time of the solicitation, certain disclosures that include:

* Tier II Finder’s name;
* Issuer’s name;
* Description of relationship between Tier II Finder and issuer, including any affiliation;
* Statement that Tier II Finder will be compensated by the issuer for their solicitation activities and description of terms of such compensation arrangement;
* Any material conflicts of interest resulting from the arrangement or relationship between Tier II Finder and issuer; and
* Affirmative statement that Tier II Finder is:
  + acting as an agent of the issuer;
  + not acting as an associated person of a broker-dealer; and
  + not undertaking a role to act in the investor’s best interest.

The foregoing disclosures may be made orally, provided they are subsequently made in writing (including electronically) prior to or at the closing.  To help ensure the investor receives the required disclosures, a Tier II Finder would also need to 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 Tier II Finder’s required disclosures, which can also be satisfied electronically.

***Seeking Comments***

The SEC is seeking comments with respect to 45 questions relating to the proposed finders exemption.

As to whether the exemption should be limited to natural persons, I think the answer is no.  Most finders operate through an entity for limited liability purposes.  Restricting the exemption to natural persons would deny those individuals the protection of limited liability otherwise afforded them by doing business through an entity.

As to the question of whether the finder should be prohibited from engaging in general solicitation, it strikes me that the accredited investor requirement mitigates the investor protection concern.  I would analogize the circumstances here to Rule 506(c) offerings, where the allowance for general solicitation is mitigated by the requirement that all purchasers be accredited investors.  Shouldn’t the same principle apply here?

On the question of whether the agreement between Tier II Finders and the issuer should subject the issuer, without affecting the finder’s obligations, to liability to investors for the finder’s misstatements, I would say maybe. Although the issuer cannot always control the finder, the issuer can protect itself by negotiating in engagement letters for reciprocal indemnification by the finder of the issuer for losses suffered as a result of third party claims over finder misstatements.

On the question of whether finders should be prohibited in certain circumstances from receiving transaction-based compensation, and instead be required to receive compensation that is not tied to the success of the transaction (i.e., a fixed fee or other arrangement), I would say no.  In the real world, finders and issuers will not work together if the finder may not be paid a transaction based fee.