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Broker Registration Requirements: The SEC Proposes a Limited Conditional Exemption for Finders

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On October 7, 2020, the Securities and Exchange Commission (the "SEC") voted to propose¹ a new limited, conditional exemption from the broker registration requirements for individuals acting as "finders." The proposed exemption is limited to individuals acting as finders in assisting private issuers raise capital from accredited investors. SEC Chairman Jay Clayton explained that "small businesses face difficulties raising the capital that they need to grow and thrive, particularly when they are located in places that lack established, robust capital raising networks" and that uncertainty with respect to finders' regulatory status impedes the capital raising process for small businesses. Clayton continued, "If adopted, the proposed relief will bring clarity to finders' regulatory status in a tailored manner that addresses the capital formation needs of certain smaller issuers while preserving investor protections."

This client alert summarizes the current and new proposed rules applicable to finders, and discusses the potential positive impact of the SEC's proposed exemption and certain regulatory limitations. Overall, the proposal, if adopted, should prove helpful to small businesses, private investors, and people acting as finders.

The Current Registration Requirements for Brokers

The current regulatory framework for finders is complex and burdensome. In general, Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act") requires that brokers (as defined) register with the SEC unless an applicable exemption is available. The Exchange Act defines a "broker" as any person "engaged in the business" of "effecting transactions in securities." The Exchange Act does not define the terms "engaged in the business" or "effecting transactions in securities," and the SEC's published guidance to date has been limited to various SEC no-action letters and enforcement proceedings that identify certain activities as being indicative of broker activity requiring registration, but do not establish clear standards for what is and is not permitted. Activities indicative of broker activity include receiving compensation linked to a securities transaction and participating in negotiations for the sale of securities. Although the SEC guidance has been inconsistent and is very fact-specific, it generally suggests that to the extent a finder receives transaction-based compensation or the activities of a finder go beyond a merely introductory role, a finder may be required to register as a broker with the SEC. As a result, the ability of a finder to operate without a broker license is extremely limited. The broker registration process is costly and burdensome, which makes registering as a broker impractical for many finders who might otherwise facilitate capital raising transactions.

The SEC's Proposed Exemption for Finders – Tier I and Tier II Finders

In an effort to alleviate the registration burden on finders and boost private investment in small businesses that may not have ready access to traditional brokers or private markets, the SEC's proposed exemption would create two "tiers" of finders who would be exempt from the normal registration requirements. The proposed exemption would provide a non-exclusive safe harbor from broker registration requirements. The SEC produced an easy-to-use chart (linked [here](#)) that identifies specific activities which would be permitted by Tier I and Tier II Finders without registration with the SEC, as summarized below.

Tier I Finders

Under the SEC's proposal, "Tier I Finders" would be limited to providing issuers with the contact information of potential investors. Tier I Finders could only do this with one single capital raising transaction, by a single issuer, in a twelve-month period. Furthermore, Tier I Finders would not be allowed any contact with a potential investor about the issuer. Essentially, Tier I Finders would be able to avoid registration if their activities were limited to providing referrals to a single issuer, in a single capital raising transaction, and only once in a twelve-month period.

Tier II Finders

Under the SEC's proposal, "Tier II Finders" would be allowed more substantial interaction with potential investors, but permitted activities would also be limited. Tier II Finders could solicit investors on behalf of an issuer, but solicitation would be limited to the following activities: (i) identifying, screening, and contacting potential investors; (ii) distributing an issuer's offering materials to investors; (iii) discussing issuer information included in offering materials; and (iv) arranging or participating in meetings with the issuer and investor. However, an important limitation on Tier II Finders would be that they could never provide advice to a potential investor regarding the valuation or advisability of an investment. Since Tier II Finders would be allowed to conduct wider activities, a Tier II Finder would need to satisfy certain disclosure requirements at the time of solicitation, including a description of the relationship between the issuer and the Tier II Finder and any material conflicts of interest. In addition, Tier II Finders would have to obtain a written acknowledgment from an investor confirming receipt of such disclosures.

Conditions to Qualifying as a Tier I or Tier II Finder; Limitations on Activities

The SEC's proposal, if adopted, would impose conditions on qualifying as a Tier I or Tier II Finder. Only individuals, not entities, would qualify as Tier I or Tier II Finders. In addition, both Tier I and Tier II Finders would be able to act on behalf of an issuer only when that issuer is not subject to reporting requirements under Section 13 or 15(d) of the Exchange Act and when the issuer seeks to sell securities under an offering exempt from registration. Tier I or Tier II Finders would not be allowed to generally solicit investments. A potential investor sourced by a Tier I or Tier II Finder would have to be an "accredited investor," or the Tier I or Tier II Finder would have to reasonably believe that the potential investor is "accredited." The Tier I or Tier II Finder would be required to enter into a written agreement with the issuer that includes a description of services and the compensation to be earned. No finder would qualify as a Tier I or Tier II Finder if the finder is an associate of a broker-dealer or is subject to statutory disqualification. Furthermore, a Tier I or Tier II Finder's activities would be limited in that the finder could not help with structuring or negotiating the offering, handle customer funds or securities, bind the issuer or investor, prepare any sales materials, perform any independent analysis, engage in any due diligence, assist or provide financing for the purchase of securities, or provide advice regarding

the valuation or advisability of the investment. The proposal for permitted activities by a Tier I or Tier II Finder could be summarized as “finding accredited investors, and nothing else.”

The Potential Impact of the Proposed Exemption

The proposed exemption, if adopted, could positively impact small businesses, finders, investors, and the economy as a whole. For small businesses, the proposed exemption would facilitate giving more investors more access to private offerings exempt from registration. The goal of the exemption is to assist small businesses in raising capital beyond family and friends. Raising capital from third-party investors is a critical step in scaling a business that needs capital to fund growth, and identifying potential investors is a challenging process, particularly for businesses seeking to raise amounts that are lower than what traditionally attracts venture capital firms and registered brokers. With respect to finders, the proposed exemption offers regulatory clarity and lessens the burdens of registration with the SEC and other regulators. With respect to individual investors, the proposed exemption promises greater access to potential investments in underserved businesses and markets. Finally, according to the U.S. Small Business Administration, in 2018 small businesses comprised over 99% of U.S. businesses and employed approximately 47.5% of all employees in the United States. Greater access to capital for these businesses could have an outsized impact on the economy, including by lowering unemployment and fostering innovation across industries.

A Potential Problem – Compliance with State Registration Requirements

One limitation of the SEC’s proposal is that it does not address or preempt the need for compliance with individual states’ broker-dealer registration laws. A finder doing business in a particular state may or may not be required to register as a broker under state law even if that finder can rely on the proposed exemption from registration under federal law. Specifically, in April 2020, New York State Attorney General Letitia James announced proposed amendments to New York’s state regulations which included a specific requirement that finders register as broker-dealers in New York. The registration requirement would apply to any finder who does business in New York, not only those finders who reside in New York. If the SEC ultimately adopts its proposed rule, finders and companies will need to continue paying attention to applicable state laws and regulations applicable to the finders’ activities.

Conclusion and Next Steps

As of the date of this client alert, no official exemption has been adopted by the SEC. The SEC is seeking public comment on its proposal, which must be received on or before thirty days after the publication of the proposed exemption.

Should the proposed exemption be adopted and approved, individuals will have more flexibility to act as finders in facilitating capital raising for small businesses. It is still too early to determine how public comments may impact the proposal, and conflicting state regulations could limit the usefulness of the exemption. Hopefully, greater clarity in this area will spur economic activity, development, and innovation by small businesses.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ The SEC's press release, with links to the proposed exemptive order and additional information, is available at: <https://www.sec.gov/news/press-release/2020-248>.

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