



At Last! – SEC Proposes Safe Harbors for Compensating Finders in Raising Capital

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On October 7, 2020, the U.S. Securities and Exchange Commission (SEC) approved a proposal that would allow finders to be compensated for assisting small businesses with capital raising without registering as a broker if certain conditions are satisfied.^[1] If adopted, the exemption would create a safe harbor clarifying the activities that do not trigger the registration requirement, thereby giving greater latitude to emerging enterprises who want to connect with investors interested in supporting them.

The proposed exemption would address a long-standing area of uncertainty and concern that has impeded capital raising by small businesses for decades, one that several policy-based advocates have campaigned for SEC attention for nearly 20 years.

“Finders” — intermediaries who identify and sometimes solicit potential investors — can play an important role in helping small businesses that need capital to locate investors who are interested in supporting emerging enterprises. The finder’s compensation is commonly a transaction-based commission equal to a percentage of the total offering proceeds resulting from the finder’s solicitation activity, payable in cash or equity.

However, engaging in the business of buying and selling securities requires registration as a broker under federal and state securities laws.^[2] There is no statutory definition of “finder,” and no clear guidance as to when a finder crosses the line to engage “in the business of” brokering securities transactions.

There has long existed a general understanding that paying a commission to a person who does no more than introduce a prospective investor to an issuer of securities would not necessarily require registration. However, this so-called “finder exemption” has been construed ever narrowly by regulators in recent years. The SEC staff has asserted that transaction-based compensation alone creates the incentive for abusive sales practices (a “salesman’s

stake”) that registration is intended to regulate and prevent.^[3]
Violating the broker registration requirements poses significant risks not only to the finder but also to the company raising capital.

The safe harbor proposal would exempt two classes of finders, Tier I finders and Tier II finders, based on the types of activities in which they are permitted to engage.

General Finder Conditions

Applicable to both Tier I and Tier II finders:

- The issuer must be a private company that does not file Exchange Act^[4] reports with the SEC;
- The issuer is conducting the securities offering in reliance on an applicable exemption from registration under the Securities Act;
- The finder does not engage in “general solicitation” — that is, soliciting prospects with whom the finder does not already have a substantive relationship, generally through advertising or public media;
- The potential investor must be, or the finder must have a reasonable belief that the potential investor is, an “accredited investor” as defined by Rule 501(a) of the Securities Act;
- The finder must enter into a written agreement with the issuer that describes the services provided and the associated compensation;
- The finder cannot be associated with a broker-dealer; and
- The finder cannot be a “bad actor” subject to statutory disqualification at the time of his or her participation.

Tier I Finder Conditions

- The Tier I finder can provide only contact information of potential investors and only in connection with one capital raising transaction by a single issuer within a 12-month period; and

- The Tier I finder can have no contact with the potential investors about the issuer.

Tier II Finder Conditions

Tier II finders would be permitted to conduct solicitation-related activities on behalf of an issuer, which are limited to the following:

- Identifying, screening, and contacting potential investors;
- Distributing issuer offering materials to investors;
- 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
- Arranging or participating in meetings with the issuer and investor.

We are regularly asked whether and in what circumstances a company can compensate individuals who assist in capital-raising efforts, which has been a problem due to the absence of consistent regulatory guidance. For small companies seeking advice on the “dos and don’ts” of a capital raise, having safe harbors will provide much needed clarity.

The proposal was approved by a 3 to 2 vote, with the two Democratic appointees dissenting. Interestingly, one of the dissenters had no objection to the Tier I safe harbor, stating, “Tier I essentially codifies prior no-action relief....”^[5] This acknowledgment that finders can be compensated for providing non-solicitation assistance to an issuer would seem to override the SEC staff’s more recent stance that paying a commission alone is sufficient to require registration. Even if the proposal is ultimately not adopted, issuers can take comfort that some latitude to use finders still exists.

The SEC’s action does not bind state securities regulators, as the states have their own separate broker registration requirements. One can hope that the states will follow the SEC’s lead in clearing up this obstacle to capital formation by small enterprises.

For more information, please contact [Alan MacDonald](#) or any attorney in Frost Brown Todd's [Securities & Corporate Governance](#) practice group.

[1] Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders, SEC Rel. No. 34-90112 (Oct. 7, 2020).

[2] See 15 U.S.C § 78o(a).

[3] Brumberg, Mackey & Wall, SEC No-Action Letter (May 17, 2010).

[4] Filings required by either Section 13 or Section 15(d) of the Securities Exchange Act of 1934, as amended (17 U.S.C. §§ 78a et. seq.). Issuers filing reports with the SEC after issuing securities in reliance on the exemption provided by Regulation A under the Securities Act of 1933, as amended (17 U.S.C. §§ 77a et. seq.) could compensate a finder under the proposal.

[5] Regulating in the Dark: What We Don't Know About Finders Can Hurt Us, Public Statement by Commissioner Allison Herren Lee (Oct. 7, 2020) available at [here](#).

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