SEYFARTH SHAW

Management Alert

SEC Advisory Committee Recommends Additional Clarity Regarding So-Called "Finders"

By Matthew I. Hafter and Whitney K. Schmidt

The Securities and Exchange Commission ("SEC") Advisory Committee on Small and Emerging Companies ("Advisory Committee") announced new recommendations to make it easier for small and emerging companies to raise capital using finders rather than registered broker-dealers.

In its September 23, 2015 letter to the SEC, the Advisory Committee noted that of issuers relying on Regulation D for their private placement exemption, only 13% of the offerings between 2009 and 2012 reported using a financial intermediary, such as a broker-dealer or finder. The Advisory Committee observed that this "void" means that small and emerging companies are most likely using unregistered persons to identify and solicit potential investors. Under the current regulatory scheme, this creates a risk of significant liability to both issuers and unregistered persons, and the Advisory Committee urged the SEC to clarify its position on what activities require registration.

The Advisory Committee presented recommendations to the SEC in its September 23, 2015 letter, the most substantive of which are that:

- The SEC should take steps to clarify that persons receiving transaction-based compensation solely for providing names of or introductions to prospective investors are not subject to broker-dealer registration.
- The SEC should exempt intermediaries involved in discussions, negotiations and structuring, and solicitation of prospective investors, for private financings provided they are registered as a broker under state law.

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." This definition applies to a very broad range of intermediary activities. If the following factors exist, registration as a broker may be required under federal and state securities laws:

- Whether the intermediary participates in important parts of a securities transaction, including, for example, identifying or screening potential investors, structuring the securities transaction, or participating in negotiations between the issuer and investors;
- Whether compensation for participation in the transaction depends upon, or is related to, the outcome or size of the transaction or deal; or
- Whether the intermediary handles the securities or funds of others in connection with securities transactions.

One key factor is whether the intermediary receives transaction-based compensation. With a stake in the deal, transaction-based compensation can lead to the intermediary using high pressure sales tactics that are inconsistent with investor protection. Broker registration and supervision is designed to mitigate these problems.

The SEC has historically recognized an exception from broker regulation for intermediaries that simply act as a "finder" and in essence rent their contact list to put potential investors in contact with the issuer for a fee.[1] Recently, however, the SEC

Staff has abandoned that position in requests for no-action letters, in its enforcement strategy, and in public speeches, in favor of a single factor test based solely on the receipt of transaction-based compensation.[2]

Congress, on the other hand, is moving in a different direction. In the JOBS Act, a new exemption from broker-dealer registration exists for online platforms that market securities in Rule 506 offerings under Regulation D (which is separate from the JOBS Act exemption for crowd funding portals). The new online platform exemption permits a person, in a Rule 506 offering to: (i) maintain a platform that permits the offer, sale, purchase, negotiation, general solicitations, general advertisements, or similar activities by issuers, whether online, in person, or through other means, (ii) co-invest in the offering, or (iii) provide ancillary services such as due diligence, if certain condition are met. Online platforms relying on the exemption (i) may not receive transaction-based compensation but may charge other types of fees, (ii) cannot handle funds or securities, and (iii) may not be compensated for investment advice to issuers or investors. Although the exemption is narrow, it is designed to help issuers locate angel investors by allowing online investment intermediaries to provide services. The SEC has stated that employees or other persons who receive a salary or other compensation to promote the issuer's securities cannot rely on the exemption.

The Advisory Committee's recommendations would help to resolve the ambiguities arising from the broker vs. finder distinction, and would also assist start-up and early stage companies to raise capital. It remains an open question as to whether the SEC will take up this issue and issue rules that reflect the Advisory Committee's recommendations.

In the meantime, issuers and intermediaries should remain cautious. The consequences of raising capital using unregistered brokers include rescission rights of investors under Section 29(b) of the Securities Exchange Act of 1934 (in addition to civil and possible criminal penalties from the SEC and state securities regulators). Under Section 29(b) of the Securities Exchange Act of 1934, an investor who was located through an unregistered broker and acquired securities under a contract is permitted to rescind the contract until the *later* of (i) three years from the date the securities were issued or (ii) one year after discovering the violation. This gives an investor a potentially long period to determine whether the investment is successful before electing "put" the security back to the issuer and to require it to return his or her money. For an early stage company, this presents a potentially crippling risk, and makes future capital raises awkward in view of the company's obligation to disclose potential liquidity problems that exist during the time period for prior investors to exercise rescission rights and other contingencies arising from failing to comply with legal requirements.

In light of the above risks, we suggest that issuers and intermediaries continue to exercise caution until the SEC takes a formal position on the Advisory Committee's recommendations.

In particular, we recommend that any arrangement involving compensation to an intermediary (other than a fixed fee payable without regard to the outcome of the offering) be carefully reviewed. Issuers should also review the experience of persons they engage as finders. Naturally issuers will want to work with intermediaries having a successful track record of raising funds, however such a long track record of capital raising also suggests that the intermediary is "in the business" of effecting transactions in securities and thus most likely to be subject to broker regulation. Finally, an issuer may find value in utilizing the online platform exemption in connection with its offering since such online platform has a specific codified exemption from broker-dealer registration.

If you have any questions, please contact your Seyfarth attorney, Matthew Hafter at *mhafter@seyfarth.com* or Whitney Schmidt at *wschmidt@seyfarth.com*.

---

[1] See Paul Anka, SEC No-Action Letter (July 24, 1991), in which the SEC granted no-action relief where Mr. Anka provided names of investors in exchange for a transaction-based fee, but played no other role in the transaction.

[2] See, e.g., John W. Loofbourrow Associates, Inc., SEC Denial of No-Action Request (June 29, 2006); Brumberg, Mackey & Wall, P.L.C., SEC Denial of No-Action Request (May 17, 2010); Comments by Kristina Fausti, Special Counsel, Office of Chief Counsel, SEC Division of Trading and Markets, at the Private Placement Broker and M&A Broker Panel at SEC Forum on Small Business Capital Formation (Nov. 20, 2008); Comments by David W. Blass, Chief Counsel of the SEC's Division of Trading and Markets, in a speech to an American Bar Association subcommittee (April 15, 2013).