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SEC's Proposed Broker-Dealer Exemption May Apply to "Finders" for Municipal Securities: Mintz Levin

Introduction

Today, the SEC published in the Federal Register[1] a proposed notice of an exemptive order (the "Proposal") that would, subject to limitations and conditions discussed below, exempt certain individuals seeking to find investors for private companies, unregistered funds and other non-reporting issuers ("Finders") from federal broker-dealer regulation requirements. Among other things the Proposal would allow Finders to earn commissions or other transaction-based compensation. Although not targeted at municipal securities, the proposal would cover otherwise-eligible finders for most municipal securities as municipal securities generally meet the requirement that the issuer is not a public company for purposes of the Securities Exchange Act of 1934 (the "Exchange Act') and that the securities are exempt from the Securities Act of 1933's registration requirements.

The Exchange Act generally requires any individual or entity engaged in the business of effecting securities transactions to register as a broker-dealer (or, if the broker is an individual, to register as a broker-dealer representative). The burdens and uncertainties surrounding the registration requirements have discouraged many potential Finders from helping issuers raise capital. The Proposal would attempt to alleviate this by exempting two classes of Finders – Tier I Finders and Tier II Finders – from registering under the Exchange Act, based on the activities permitted. The SEC indicated the Proposal's relief is "intended to be narrowly-tailored and seeks to address the capital formation needs of certain smaller issuers while preserving appropriate investor protections."

Tier I Finders

To qualify as a Tier I Finder, a Finder's activities would be limited to providing contact information of potential investors:

- without having any contact with the potential investors about the issuer; and
- in connection with only one capital raising transaction by a single issuer within a 12-month period.

Tier II Finders

The Proposal would permit Tier II Finders to engage in the following activities related to "solicitation"[2]: identifying, screening, and contacting potential investors; distributing issuer offering materials; and arranging or participating in meetings with the issuer and prospective investors. To qualify for the relief, a Tier II Finder would need to provide each potential investor before or early in the solicitation process the following written disclosures:

- the names of and the relationship between the Tier II Finder and the issuer;
- a description of the Tier II Finder's compensation;
- any material conflicts of interest; and

- a statement that the Tier II Finder is acting as the issuer's agent, not associated with a broker-dealer, and "not undertaking a role to act in the investor's best interest."

As a condition on the relief, the Tier II Finder must obtain before each investment a dated written acknowledgment of the investor's receipt of the required disclosures.

Conditions on Both Tiers

The relief for either kind of Finder would apply only if:

- the Finder is a natural person (i.e., not an entity);
- the issuer is not a reporting company under the Exchange Act;
- the transaction is intended to be exempt from registration under the Securities Act of 1933 ("Securities Act");
- the potential investors are, or the Finder reasonably believes the potential investors are, "accredited investors" under Securities Act Rule 501; and
- the Finder's services are pursuant to a written agreement describing the Finder's services and compensation.

Neither Tier I Finders nor Tier II Finders would qualify for the Proposal's relief if they:

- engage in general solicitation;
- help structure the transaction;
- negotiate offering terms;
- handle customer funds or securities;
- have authority to bind the issuer or any potential investor;
- participate in offering material preparation;
- perform independent transaction analysis;
- engage in due diligence;
- assist or provide financing of any securities purchase;
- advise on valuation or advisability of the potential investment;
- are associated with a broker-dealer; or
- are subject to statutory disqualification under the Exchange Act.

Requests for Comment

The Proposal seeks comments on 45 questions, including whether various aspects of the relief are appropriate for investor protection, whether the relief should be subject to the limitations and conditions summarized above, whether certain existing no-action letters granting and denying broker-dealer registration relief should be codified or withdrawn, whether the SEC should issue guidance on related matters (including applicability of broker-dealer registration to private fund advisers and real estate brokers), and how the Tier II disclosure requirements should relate to proposed amendments to the SEC's cash solicitation rule.[3] Comments are due November 12, 2020.

Relation to Existing No-Action Relief and Issuer Safe Harbor

The relief in the Proposal is non-exclusive. It would be additive to and combinable with existing kinds of relief from broker-dealer registration under the Exchange Act, including the safe harbor for associated persons associated with an issuer[4] and the no-action letter granting relief to mergers and acquisition brokers.[5]

Relation to State Broker-Dealer Requirements

Nothing in the Proposal affects requirements to register as a broker-dealer or broker-dealer agent under state "blue sky" securities laws.

Observations

Uncertainties about broker registration present legal risks and obstacles for private companies and funds seeking to engage and incentivize individuals with the requisite industry experience and connections to raise capital. Such uncertainties also may affect capital-raising outreach by or on behalf of smaller issuers or borrowers in the municipal markets. Among other things, not registering when required can: (i) trigger SEC or state enforcement action against a finder for violating registration requirements or against an issuer or investor for aiding and abetting the finder's violations; (ii) give rise to rescission claims by investors solicited by an unregistered finder; and (iii) prevent finders from prevailing on claims to collect fees. The non-exhaustive safe harbor in the Proposal would allow engagements and success fee arrangements not possible today while providing much-needed clarity on which solicitation-related activities require registration and which do not.

The limitations on the narrowly tailored relief in the Proposal will keep it from being useful in many situations that commonly arise. Conditions that would make it challenging for many consulting arrangements to use the relief as proposed include the inability to pay a Finder's entity, structure transactions, help prepare marketing materials, value deals, or perform due diligence. The ban against negotiation could be difficult in practice because soliciting investors often bleeds into discussing terms.

Relief from registering federally with the SEC and FINRA is of limited use if a Finder must still register in one or more states. State adoption of parallel relief under identical conditions would be ideal. In the absence of such parallel state relief. Finders could explore existing finder exemptions under state law, which have their own conditions and restrictions that differ with the Proposal, or other state broker-dealer exemptions and exclusions.

Finally, in the context of municipal issuers, as noted by the SEC in the notice, whether or not a Finder complies with the proposed broker-dealer exemption, he or she may need to consider whether the contemplated activities require registration as a municipal advisor.

Next Steps

Private companies, managers and advisers of private funds, municipal issuers and borrowers and prospective Finders interested in taking advantage of any relief resulting from the Proposal should contact the authors or their Mintz attorney. We stand ready to assess how to pursue the opportunities presented to further clients' business objectives and to help prepare any comment letters that might make the final relief more valuable than the Proposal.

Endnotes

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, 85 FR 64542 (Oct. 13, 2020).

2 The Proposal defines "solicitation" broadly as "any affirmative effort to induce or attempt to induce a securities transaction."

3 See Investment Adviser Advertisements; Compensation for Solicitations, Release No. IA-5407 (Nov. 4, 2019), 84 FR 67518 (Dec. 20, 2019).

4 See Exchange Act Rule 3a4-1, 17 C.F.R. § 240.3a4-1.

5 See SEC No-Action Letter re M&A Brokers (Jan. 31, 2014).

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