The SEC's Proposed Exemptive Order for Finders in Private Placements: An Uncertain Future for Regulatory Certainty

Perspectives from an ADR Professional

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At age 79, Paul Anka, the crooner and songwriter, is more relevant than ever. In 2020, he appeared on Season 4 of "The Masked Singer," enjoyed a popular resurgence courtesy of TikTok, reworked his anthem "My Way" for the global pandemic and was elevated to the status of a proposed safe harbor by the U.S. Securities and Exchange Commission (SEC).

In 1991, Mr. Anka requested no-action relief from SEC staff relating to his role in a securities offering for the Ottawa Senators Hockey Club. Mr. Anka, who was not a registered securities broker, sought confirmation that he would not be referred for enforcement action if his involvement in the team's private placement was a one-off and limited to providing names and contact details of prospective investors in exchange for a percentage of the raise. A no-action letter was issued. (*See* Paul Anka, SEC No-Action Letter (July 24, 1991) (Anka Letter).)

Section 15 of the Securities Exchange Act of 1934 (Exchange Act) makes it unlawful for a person to use interstate commerce to "effect any transactions in" or "attempt to induce the purchase or sale of" any security unless that person is registered as a broker with the SEC and joins a self-regulatory organization. Section 3(a)(4) of the Exchange Act defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

In the context of capital-raising, so-called "finders" are intermediaries who introduce companies with cash needs to prospective investors—and who sometimes engage in other activity. The term "finder" is not defined by statute, but it is understood to mean someone without securities licenses who is not associated with a registered broker-dealer. Mr. Anka was a finder.

The Exchange Act does not contain a finders exception to the broker registration requirements. The definition of "broker" in Section 3(a)(4) and the language of Section 15 are susceptible of various meanings, and may encompass finder activity. The $64,000 question has long been the following: To what extent and in what manner may an unlicensed intermediary engage in the capital-raising process without triggering the broker registration requirements?

The SEC has not promulgated a rule or otherwise articulated an official position on this issue. Its *Guide to Broker-Dealer Registration* (April 2008) suggests that almost any involvement by an intermediary in a capital raising transaction may create an obligation to register as a broker.

SEC staff has periodically answered questions about finder activity when presented with requests for no-action relief, such as Mr. Anka's. Staff views do not bind the agency and are not administrative interpretations entitled to *Chevron* deference. (*See Chevron, U.S.A., Inc. v. NRDC* (1984) 467 U.S. 837.) Although devoid of legal force and precedential value, no-action letters are closely monitored, considered important and viewed by some as a quasi-secondary source of law.

For years, the Anka Letter was a benchmark and stood for the proposition that an intermediary involved in one private placement who did nothing but deliver a list of prospective investors, and was paid a success fee, need not be registered as a securities broker.

SEC staff then appeared to pivot. In 2010, it denied no-action relief to a finder ostensibly because of a transaction-based fee arrangement, which had become a "hallmark of broker-dealer activity." (*See Brumberg, Mackey & Wall, PLC*, SEC No-Action Letter (May 17, 2010).) SEC staff had previously signaled a more expansive view of the broker registration requirements in 2000, when it withdrew a no-action letter issued in 1985 to Dominion Resources. (*See Dominion Resources, Incorporated*, SEC No-Action Letter (Aug. 24, 1985) and *Dominion Resources, Inc.,* SEC No-Action Letter (Mar. 7, 2000).) SEC staff is permitted to take inconsistent positions, as no-action responses are officially subject to reconsideration, but this created confusion.

Courts addressing the finder-as-broker issue use a facts-and-circumstances analysis and look to a range of factors, including whether the intermediary actively solicited investors, structured the transaction, negotiated deal terms, opined on the merits of the investment, prepared offering materials, handled customer funds or securities, and received transaction-based compensation. This is not an exhaustive list. Some courts include additional factors; others address only a few. No court has articulated a test for weighing the various considerations. Broker activities are often characterized as a "regularity of participation in securities transactions at key points in the chain of distribution."

Because there is no discernible standard, and due to the variances among circuits, SEC staff's changing position and some discord between the agency's analysis and that of the courts, there is a legal muddle. This has been particularly vexing for securities lawyers who provide advice on the finder issue, as regulatory uncertainty means excessive risk. They and various market participants have sought agency clarification for years, to no avail.

There are legal implications and potentially serious consequences for issuers that use finders. Chief among these is the rescission right created by Section 29(b) of the Exchange Act. In addition, payment of a finder's fee may jeopardize the exempt status of a planned private offering under blue sky statutes, and a transaction involving a finder becomes a disclosure item that can affect future rounds of financing.

As for finders, they risk enforcement actions and the possibility of not being paid. Contracts between issuers and finders are styled in various ways, including as consulting agreements, placement agency agreements and referral fee agreements. Many of those contracts include multi-step or tiered ADR clauses. Disputes between issuers and finders will often settle at the mediation stage, particularly if the mediator can guide the parties through a meaningful discussion of the broker-dealer registration issues and related liability. In the arbitration context, it is not unusual to see a claim for failure to perform, a counterclaim for payment of unremitted fees and a defense based on the intermediary's status as an alleged unregistered broker. Adjudication of those issues involves a fact-based analysis in arbitration as it does elsewhere.

Companies routinely engage finders despite the risks. Many early-stage companies that need cash cannot attract an SEC-registered broker to act as placement agent. For businesses that lack contacts with angel investors—the source of most private capital—retaining a finder can mean the difference between executing on a business plan and shutting down for good.

Mindful of these and other considerations, the SEC voted on October 7, 2020 to issue a proposed exemption from the broker registration requirements for finders. The proposal would create two finder categories—Tier I and Tier II—and establish a nonexclusive safe harbor for certain activities. Finders in both tiers must be natural persons, are limited to exempt private placements for nonpublic issuers with accredited investors, may receive transaction-based compensation and are subject to prohibitions that generally track the factors used by many courts to assess broker status under existing law. Tier I essentially codifies the Anka Letter. Tier II finders can engage in a wider range of activity and have disclosure obligations. (*See Notice of Proposed Exemptive Order* (10/7/20), SEC Release No. 34-90112, https://www.sec.gov/rules/exorders/2020/34-90112.pdf.)

The proposed exemption would bring coherence to a confused area of law that has developed through no-action letters, enforcement proceedings and court decisions. During the public comment period, statements in support and opposition were submitted by law firms, bar associations, advocacy groups, regulators, registered broker-dealers, self-identified finders and others. Some suggested changes. Most acknowledged the SEC for taking a step toward clarity.

The fate of the proposal is unclear. It was issued on a 3-to-2 vote, and the SEC will have a different composition and perhaps different priorities under a Biden–Harris administration, as the agency's tripartite mission—protecting investors, facilitating capital formation and maintaining fair and efficient markets—is subject to rebalancing.

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