Professional Perspective

Proposed SEC Rules Provide Exemption for Finder's Fees

Chris Sloan, Baker Donelson

Bloomberg Law

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Contributed by Chris Sloan, Baker Donelson

Startups raising money are always happy to have assistance in finding sources of capital. Frequently, a startup will meet an individual with many connections to prospective investors and who is willing to help the company raise money in exchange for a fee. Unfortunately, unless that "finder" has the appropriate license to act as a broker, securities laws prohibit paying that person "transaction-based compensation," which is any compensation that is tied to the success of the transaction.

If the company chooses to proceed anyway, those investors will have a right of rescission, meaning that they can require their company to pay back the investment, with interest, at any time on demand.

This scenario repeats itself many times each year. Both the finder and the company have honorable intentions, but the current state of the law makes it difficult or impossible to structure the relationship the way both parties would like. Sometimes, the parties choose not to move forward with the finder relationship. In other cases, the parties attempt an uncertain or less favorable workaround. And just as often, the parties will move forward despite that risk. For the company, the risk is that their investors will have a right of rescission, meaning that they can require the company to pay back the investment, with interest, at any time on demand.

For years, entrepreneurs and investors have requested an exemption to address this situation. Some help might finally be on the way. This article focuses on the impact of a proposed Securities and Exchange Commission exemption for finder's fees.

On October 7, 2020, the SEC proposed a limited exemption from broker registration for certain types of finder activities. The proposed rule provides an exemption for two categories of finders—Tier I and Tier II. Tier I finders are only allowed to provide contact information for potential investors, and can only do this for a single offering for a single company within any 12-month period.

Tier II finders can perform some limited additional activities, including identifying, screening, and contacting potential investors, distributing company materials to those investors, discussing information that is included in those materials, and arranging or participating in meetings with the investors. Finders in both categories are prohibited from doing any of the following:

- Handling customer funds or securities
- Binding the issuer or any investor
- Participating in the preparation of any sales materials
- Performing any independent analysis of the sale
- Engaging in any due diligence
- Assisting or providing any financing for the purchase of the offered securities
- Providing advice on the valuation or financial advisability of the investment

Neither category of finder may provide any advice concerning the valuation or the advisability of the investment.

For both Tier I and Tier II finders, the exemption would apply when the following are true:

- The issuer conducting the offering is not required to file reports under the Securities Exchange Act of 1934 (Exchange Act)
- The offering is being conducted pursuant to an exemption from registration under the Securities Act of 1933 (Securities Act)
- The potential investors the finder refers to the issuer or contacts regarding the offering are accredited investors
- The finder does not engage in general solicitation of potential investors

- The finder and issuer have entered into a written agreement that describes the services the finder will provide and his or her compensation for such services
- The finder is not an associated person of a broker-dealer
- The finder is not subject to a statutory disqualification, as defined in the Exchange Act

Tier II finders would additionally be required to provide potential investors with a specific set of disclosures:

- Their name and the name of the issuer
- Their relationship with the issuer
- A statement that the finder will be compensated for their solicitation activities and a description of their compensation arrangement
- Any material conflicts of interest resulting from the compensation arrangement or their relationship with the issuer
- A statement the finder is acting as an agent of the issuer, is not acting as an associated person of a broker-dealer, and is not undertaking to act in the prospective investor's best interests

These disclosures can initially be provided orally, but they must also be provided in writing on or before the time the investor makes an investment in the issuer. The finder must obtain from each investor a written acknowledgment of these disclosures.

The limitations and disclosures may seem onerous at first, but in reality, they are not that different from how some finders and companies work together already in an attempt navigate around the current broker-dealer registration requirements. Most importantly, if these rules are adopted and finders and their issuer clients comply with these restrictions, both sides will have a clear and certain path forward that has not been available in the past.

Unfortunately, it is not all smooth sailing and clear skies from here. For starters, two of the SEC Commissioners voted against the proposed rules and wrote very strong dissents. In addition, a number of commenters have come out strongly against the proposed rules. Lastly, while these proposed rules would address the situation on the federal level, they do not preempt state laws. Accordingly, finders and issuers would still have to ensure that they are able to comply with any state laws that are applicable to a proposed transaction.

If these proposed rules are enacted, they would provide welcome clarity to what is currently an overly restrictive and somewhat murky set of restrictions that make it harder for small businesses to engage the services of finders to raise capital that may be vital to their success.