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Clarity on the Horizon for Finders

By Andrew M. Walsh

Persons who introduce investors to companies seeking capital, participate in discussions on deal terms, and receive "transaction-based compensation," are often surprised and disappointed to learn that they must go through the onerous process of registering as a broker-dealer, since they are "engaged in the business of effecting transactions in securities for the account of others," under Section 15(a) of the U.S. Securities Exchange Act of 1934.

Currently, there is no registration requirement if a "finder" merely introduces parties and receives a flat fee. However, some companies and participants agree to go beyond these minimal activities without registration, risking increased scrutiny from regulators and future investors, and even investor rescission — all on a handshake or through a deliberately ambiguous contract.

In October 2020, the Securities and Exchange Commission acknowledged that finders play an important role (particularly in regions that lack a robust venture capital or angel investor network) and proposed an exemption to the registration requirements, in support of its objective to facilitate capital formation for smaller businesses.

Under the proposal, the SEC would create two types of finders:

Tier I finders would be limited to providing the contact information of potential investors in connection with a single transaction by a single issuer within a 12 month period, and may not solicit investors on behalf of an issuer.

Tier II finders would be permitted to solicit investors, but their activities would be limited to:

- Identifying, screening and contacting prospective investors.
- Distributing offering materials.
- Discussing the contents of offering materials without advising on valuation or attractiveness of the investment.
- Arranging and participating in meetings with the issuer and investor.

A Tier II finder would need to satisfy disclosure and recordkeeping requirements, and the arrangement would be required to be documented in an agreement.

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The finder would *not* be permitted to:

- Be involved in structuring the transaction or negotiating the terms of the investment.
- Handle funds or securities, or have the power to bind the issuer or investor.
- Participate in the preparation of any sales materials.
- Perform any independent analysis of the sale.
- Engage in any due diligence activities.
- Assist or provide financing.
- Provide advice as to the valuation or financial advisability of the investment.

Issuers eligible to hire a finder would be those that are not required to file reports under Section 13 or Section 15(d) of the Securities Exchange Act, and are engaged in an exempt offering not involving general solicitation, among other requirements.

The exemption, as currently proposed, applies only to natural persons, and not to entities. One of the questions the SEC has proposed for public comment, however, is whether this should be the case. Without the limited liability protections of a corporate or LLC structure, many finders, who are often higher-net-worth individuals, may think twice before putting their personal assets at risk for the sake of a finder's fee. If the exemption ultimately does not extend to entities, a finder would be well advised to negotiate strong indemnification provisions in the finders agreement in the event of an investigation or litigation.

This was prepared by Anderson Kill P.C. to provide information of interest to readers. Distribution of this publication does not establish an attorney-client relationship or provide legal advice. Prior results do not guarantee a similar outcome. Future developments may supersede this information.

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