Public Statement

Statement on Proposed Exemptive Relief for Finders

Commissioner Caroline A. Crenshaw

Oct. 7, 2020

Thank you, Chairman Clayton, and thank you to my fellow Commissioners.

The Notice we are considering today purports to provide clarity regarding a grey area in the broker-dealer regulatory regime.[1] But what it in fact proposes is a radical departure from established registration requirements. It would expand the scope of investor solicitation activities by unregistered and unsupervised agents in private markets. This continues two disturbing Commission trends. First, encouraging the growth of opaque private markets at the expense of better-lit public markets.[2] Second, eroding the investor protections provided by our tried and true regulatory framework.[3] For these reasons, I cannot support the proposed approach.[4]

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First, today's Notice seeks to facilitate capital raising in the private markets. However, as with other recent actions in this space,[5] I question why the Commission is encouraging activity in these markets absent sufficient visibility into how they operate. The Notice provides no meaningful description of the current state of these markets, nor does it include any data supporting the need for this relief. To a significant extent, this is because the Commission lacks this information. [6] I cannot support deliberately expanding markets that even our expert staff cannot accurately assess or analyze.

This is particularly true given that what we do know about the private markets indicates that when compared to public markets, they are less liquid, impose higher transaction costs, are more susceptible to valuation errors, and are more prone to fraud. [7] Finders in particular are often associated with fraudulent activity.[8] And these are some of the exact market problems that our existing regulatory framework has successfully addressed. Rather than use our proven regulatory tools, the Notice encourages expansion in these opaque private markets without adequate oversight.[9]

Second, in an area of the securities markets that is already prone to fraud, the proposed approach would eliminate the important investor protections the established broker-dealer framework provides. In fact, the permitted activities include what regulators and courts have described as core broker conduct[10] – actively soliciting and recruiting investors on behalf of issuers, and receiving commissions for doing so.[11] However, the Finders engaging in this business under the proposed approach would not be subject to the basic registered broker-dealer rules – rules such as Regulation Best Interest, for example, and other requirements related to disclosure, supervision, and compensation.[12]

Not only would Finders be exempt from basic sales practice rules under the proposed approach, they would not be required to register with the SEC or FINRA, and they would not need to notify the SEC of their intent to rely on this relief. Moving forward, Finders would not be subject to periodic inspections or examinations, nor would they be required to maintain records of their activities. In fact, we will have no idea if they are complying with any of the conditions set forth in the Notice. Further, while the Notice provides a clear statement of what activities Finders would be *permitted* to engage in, it is does not explain what, if any, activities are actually *prohibited*, meaning that regulatory uncertainty and enforcement challenges in this space are likely to remain.[13]

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Although the Notice pays lip service to meeting the needs of small issuers and women and minority-owned businesses, it provides no data indicating that underrepresented issuers, in particular, would benefit. Further, the Notice does not impose any limitations on the amounts that can be raised from investors, the size of the offerings, or the types of issuers that can take advantage of the relief. Instead, under the proposed approach, issuers of any size would be permitted to employ Finders to raise unlimited amounts of capital, [14] outside of the broker-dealer regulatory regime.[15]

I am not opposed to clarifying grey areas in our regulatory framework, especially where doing so may facilitate capital formation for smaller issuers and women- and minority-owned businesses. However, any effort to provide clarity in this space should begin with collecting more data and information about the private markets where these Finders operate.

I am glad that the public will have an opportunity to comment on the Notice, and I encourage them to do so. But without a meaningful analysis of the impact of the proposed approach, I worry that there is little for commenters to engage with or react to.

I appreciate the hard work of the staff in the Division of Trading and Markets on this Notice.[16] My criticism is not a reflection on the staff's hard work; rather, it reflects my concern with the policy choices reflected in the Notice. [17] It is my hope that commenters will engage with this proposal and that it will be improved with their help and feedback. However, because of my deep substantive and procedural concerns regarding the proposed approach, I cannot support it. I respectfully dissent.

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[1] *See* 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, Exchange Act Release No. [] (Oct. 7, 2020) at 10 (the "Notice").

[2] *See, e.g.,* Amending the "Accredited Investor" Definition, Release Nos. 33-10824; 34-89669 (Aug. 26, 2020); Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release Nos. 33-10763; 34-88321 (proposed Mar. 4, 2020).

[3] *See, e.g.,* Temporary Exemptive Order Granting a Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Registered Municipal Advisors, Release No. 34-89074 (June 16, 2020).

[4] I am also concerned about the use of exemptive relief to make these significant changes, rather than notice-and-comment rulemaking.

[5] *See* Commissioners Allison Herren Lee and Caroline Crenshaw, Joint Statement on the Failure to Modernize the Accredited Investor Definition (Aug. 26, 2020).

[6] *See*, *e.g.*, Concept Release on the Harmonization of Securities Offering Exemptions, Release Nos. 33-10649; 34-86129; IA-5256; IC-33512 (June 18, 2019) at 24 ("Due to data limitations, it is…difficult to draw rigorous conclusions about the average magnitude of investor gains and losses in exempt securities offerings."). In 2013,

the Commission put out a rule proposal aimed in part at enhancing our visibility into private offerings claiming exemptions from registration pursuant to Regulation D. *See* Amendments to Regulation D, Form D, and Rule 156, Release No. 33-9416 (July 10, 2013). We never completed that rulemaking, and our lack of visibility into that market persists. The Commission could require issuers and Finders to provide information about their activities in these markets as a condition of relying on the exemptive order, but has not proposed to do so.

[7] *See* NASAA, Comment Letter on Proposed Rule to amend the "Accredited Investor" definition (Mar. 16, 2020) (noting that "private offerings are often characterized by opaque disclosures, related party transactions, illiquidity, minimal financial information and, unfortunately, fraud."). *See also* NASAA, Legislative Agenda for the 116th Congress (Mar. 5, 2019) ("NASAA Report") at n. 10 ("There is a well-documented relationship between private offerings sold by brokers and an elevated risk of fraud, and a disproportionate percentage of persons acting as brokers in the private offering marketplace are brokers with red flags in their record.") (*citing* Jean Eaglesham and Coulter Jones, A Private Market Deal Gone Bad: Sketchy Brokers, Bilked Seniors and a Cosmetologist, The Wall Street J. (May 7, 2018)).

[8] *See* Advisory Committee on Small and Emerging Business, Notable by Their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation, (June 3, 2015) (stating that, in many cases, "persons acting as finders represent 'the dark side' of the securities business: purveyors of fraudulent shell corporations; front-end fee con artists; purported Regulation S specialists who send stock off-shore and wait to dump it back into the U.S. through unscrupulous brokerage firms or representatives who are receiving under-the-table payments for promoting stocks and micro-cap manipulators."); American Bar Association, Report and Recommendations of the Task Force on Private Placement Broker-Dealers at 13 (June 20, 2005) (noting that the SEC brings "dozens" of cases annually involving fraudulent activity by finders, that state regulators bring "well over 100," and that these cases are likely "the tip of the iceberg"). For a recent example of fraudulent conduct by unregistered individuals in the private markets, *see* Complaint, *SEC v. Brook Church-Koegel, et al.*, No. 1:20-cv-21001 at 2 (S.D. Fla. 2020) (as part of a Ponzi scheme, three unregistered brokers were "responsible for raising… approximately $444 million between June 2014 and December 2017, from thousands of investors in more than 40 states…in unregistered transactions").

[9] The Notice proposes to require that Finders solicit investments only from accredited investors. But the Commission recently declined to modernize the definition of accredited investor, instead choosing to continue to rely on a decades-old wealth threshold that has not kept pace with inflation. *See* Commissioners Allison Herren Lee and Caroline Crenshaw, Joint Statement on the Failure to Modernize the Accredited Investor Definition (Aug. 26, 2020). Relying on that definition here leaves vulnerable seniors, families, and other retail investors without the protections of our broker-dealer regulatory framework.

[10] *See* Notice at 11-12 (stating that the courts and the Commission have identified "actively soliciting or recruiting investors" and "receiving commissions, transaction-based compensation or payment other than a salary for selling the investments" as indicators of broker status); NASAA Report at 5 ("The securities laws correctly recognize that individuals who receive compensation directly tied to the sale of securities are functioning as securities brokers, regardless of any actual or apparent differences in the services or functions performed by particular securities salespersons and promoters.").

[11] Notice at 22-24. The proposed exemption would create two different classes of Finders: Tier I and Tier II. Tier I is largely consistent with existing no-action relief that allows finders to provide a list of potential investors in connection with only one issuer once every twelve months and without communication with those investors regarding the investment opportunities. Tier II Finders would be permitted to engage in a much broader range of activities, such as contacting potential investors on behalf of an issuer, distributing offering materials and discussing those materials with investors, and participating in meetings with the issuer and investors. Both categories of Finders would be allowed to receive transaction-based compensation.

[12] *Id.* at n. 87 ("A Tier I Finder or Tier II Finder that complies with the requirements of the proposed exemption would not be subject to broker-dealer sales practice rules, including Regulation Best Interest."). While I worry about whether Regulation Best Interest will provide sufficient protection to investors, investors interacting with

Finders would not even be afforded the protections that have been promised under that rule. Nor would Finders be required to comply with FINRA's Suitability or Know Your Customer rules.

[13] While the proposed approach requires Finders to meet certain conditions in order to take advantage of the safe harbor, the safe harbor is non-exclusive, and the Notice specifically states that conduct that does *not* comply with the terms of the order may still be permissible. *See id.* at 17 ("The proposed exemption would provide a non-exclusive safe harbor from broker registration… no presumption shall arise that a person has violated Section 15(a) of the Exchange Act if such person is not within the terms of the proposed exemption.").

[14] Subject to the requirements of the relevant exemption from registration under the Securities Act of 1933.

[15] The Notice proposes to make this significant change to our regulatory framework through exemptive relief, without the benefit of notice-and-comment rulemaking. The Notice does not include an analysis of the likely costs and benefits of the change, nor does it reflect any consideration of the potential competitive effects on registered broker-dealers.

[16] I am also thankful to the staff from several other Offices and Divisions who contributed to today's proposal, including: the Office of the Advocate for Small Business Capital Formation; the Division of Corporation Finance; the Division of Enforcement; the Division of Investment Management; the Office of the General Counsel; and the Office of Compliance Inspections and Examinations.

[17] It also reflects my concern with the choice to use exemptive relief rather than notice-and-comment rulemaking.