Public Statement

Regulating in the Dark: What We Don't Know About Finders Can Hurt Us

Commissioner Allison Herren Lee

Oct. 7, 2020

The Commission proposes today to create a new exemption that will permit individuals to engage in traditional brokerage activity without the important investor protections that come with registration as a broker-dealer, effectively creating a new category of unregistered financial professionals.[1] Further, we propose to do this through exemptive relief, thus circumventing important economic analysis that should accompany a proposed policy shift of this significance. I could have supported a proposed rulemaking that offered a scaled registration model for finders that tailored investor protections to the new risks the model creates. Instead, today we simply propose to permit unregistered activity that meets the traditional definition of brokerage without adding basic protections such as recordkeeping requirements or the ability to inspect for compliance.

Before I discuss my concerns in more detail, I want to thank the staff in the Division of Trading and Markets for their work on today's proposal.[2] I remain impressed with the staff's dedication and professionalism despite the continued difficult circumstances. My concerns with today's proposal are not a reflection on the staff or the staff's work. To the contrary, much of my concern is centered on how the Commission's proposal today would undermine longstanding staff interpretations about when registration as a broker-dealer is warranted in order to protect investors.[3]

Investor Protection

Today's proposed exemption would create two different classes of finders: Tier I and Tier II.[4] Tier I essentially codifies prior no-action relief and generally allows finders to provide a list of potential investors in connection with only one issuer once every 12 months and without communication with those investors regarding the investment opportunities.[5] This makes sense, largely because such finders do not carry on a regular business of connecting issuers with investors, and their activities are strictly limited.

My concern is with the expansive nature of the unregistered conduct which we propose to allow for Tier II finders.[6] Under the terms of the proposed order, a Tier II finder would be permitted to engage in a wide range of activity that the Commission has long held constitutes brokerage activity. For example, the order would permit Tier II finders to contact potential investors on behalf of an issuer, distribute offering materials and discuss those materials with investors, participate in meetings with the issuer and investors, and receive transaction-based compensation.[7] The only supposed limitation here is one of form over substance: a finder may not "provide advice as to the valuation or advisability of the investment."[8]

Imagine a discussion in which a finder, who stands to gain proportionately for every dollar invested, finds an investor, teams up with an issuer to present offering materials and analysis, and sings the praises of a proposed investment. All she needs to do to avoid registration is refrain from concluding the presentation with the words "you should invest." The issuer itself can handle that last step, if it is even needed. This situation implicates the quintessential "salesman's stake" in a potential transaction that the Commission and staff have long understood warrants registration with all of its attendant investor protections, including the requirements under Regulation Best Interest. Indeed, many of the past no-action letters in this space emphasize this point, stating: "Registration helps to ensure that persons who have a 'salesman's stake' in a securities transaction operate in a manner that is consistent with customer protection standards governing broker-dealers and their associated persons."[9]

Today's proposal makes clear that finders would not be subject to Reg BI,[10] suggesting that investor protection will not be undermined because finders may solicit only accredited investors.[11] However, when the Commission adopted Reg BI, it explicitly rejected the suggestion that accredited investors are less in need of the protections afforded by the rule.[12] Rather, the definition of "retail customer" adopted at that time made clear that all natural persons, regardless of wealth, are entitled to a financial intermediary who owes them an obligation to act in their best interest.[13] Today, the Commission proposes to carve out this conduct, a mere three months after the compliance date for Reg BI.[14]

Moreover, reliance on the accredited investor definition in this context exposes another disconnect in the Commission's policy choices. Less than two months ago, the Commission expanded the definition of accredited investor to include new categories of individuals.[15] In justifying that expansion, the Commission relied explicitly on the applicability of Reg BI to suggest that the expansion did not raise investor protection concerns.[16] Now, one month later, we propose to strip accredited investors of those very protections when dealing with finders who would be permitted to engage in solicitation and receive transaction-based compensation, but have zero obligations under Reg BI to act in the interests of those investors.[17] Our policy-making advances as a one-way ratchet; with each new rule, we abandon the claimed foundations for prior policies and continue to roll back investor protections.

Rulemaking / Economic Analysis

In addition to the substantial investor protection concerns presented by this proposal, the Commission's use of an exemptive order effects an end-run around the rulemaking process,[18] including the requirement that the Commission support its policy choices with empirical evidence and consider the effects of our actions on efficiency, competition, and capital formation.[19] By proceeding in this manner, we avoid the need to wrestle with the ways in which the proposed order may affect the broker-dealer business model, something the Commission went to great lengths to protect in adopting Reg BI. Furthermore, despite speculating that the relief could benefit women- and minority-owned businesses, the release contains no empirical evidence supporting that supposition, and nothing in the proposed order is tailored to that purpose. It simply asserts that this change, broadly applicable to all businesses, large and small, may benefit women- and minority-owned businesses, despite the fact that the proposed exemption is not tailored in any way to address the systemic issues that have persistently prevented such businesses from benefitting to the same extent as others from our rules.[20] And, given the absence of requirements for reporting or even notifying the Commission of reliance on the proposed order, this approach would exacerbate the agency's lack of insight into the private markets, leaving the Commission with no basis to evaluate the order's use or abuse.

By way of contrast, a rulemaking would provide the Commission with greater flexibility to consider a scaled approach to the relevant regulatory requirements, an approach that enjoyed support from the very sources upon which this proposal purports to rely. The proposal points repeatedly to two

different sources of support for the action today: first, a report from the Treasury Department that outlines the White House's regulatory priorities;[21] and second, a report from an American Bar Association task force on private placement broker-dealers.[22] The proposal fails to acknowledge, however, that neither report actually supports the approach the Commission takes today. The Treasury report recommended that the Commission "propose a new regulatory structure for finders . . . For example, a 'broker-dealer lite' rule that applies an appropriately scaled regulatory scheme on finders."[23] Likewise, the ABA report specifically rejected the approach taken today, saying that "providing a broker-dealer registration national exemption is not going to address all of the current abuses involving unlicensed financial intermediaries" and that "creating an exemption is not currently a better alternative to a more narrowly focused regulatory scheme."[24]

I could have supported a rulemaking process that proposed a scaled registration format that required, at a minimum, some form of record keeping and examination authority. This would provide important insight into whether these new finders are, for example, truly not making recommendations or handling investor funds or securities. As it stands, however, we will have no visibility into these issues unless and until fraud occurs and is discovered.

The proposal relies far too heavily on the continued applicability of antifraud provisions as comfort regarding investor protection. This is tantamount to removing auto safety protocols but finding comfort in the fact that we still have ambulances. Antifraud protection is critical but insufficient. Once fraud has occurred, the damage has been done. Despite outstanding work from our Division of Enforcement, recovering funds essentially stolen by fraudsters is immensely challenging, and investors often see only pennies on the dollar in terms of recovery.

The Commission's proposal today is flawed in both substance and procedure. As to substance, the proposal would greatly expand the activities in which finders may engage without registration, while failing to deploy even minimal protections for investors. As to procedure, our exemptive authority is plainly not suited to the nuance and scale that this issue requires, and the lack of economic analysis means that the Commission proceeds with little to no empirical support. I must 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. [Forthcoming] (Oct. 7, 2020) ("Proposed Order").

[2] In particular, I want to thank Division Director Brett Redfearn, Emily Westerberg Russell, Roni Bergoffen, Joanne Rutkowski, Timothy White, Geeta Dhingra, and Darren Vieira. Staff from several other Offices and Divisions also contributed to today's proposal: from the Office of the Advocate for Small Business Capital Formation: Director Martha Miller, Jenny Riegel, Julie Davis, Colin Caleb, and Jessica McKinney; from the Division of Corporation Finance: Jennifer Zepralka and Charles Guidry; from the Division of Enforcement: Charles Buford and Margaret Cain; from the Division of Investment Management: Melissa Gainor and Melissa Harke; from the Office of the General Counsel: Meredith Mitchell, Robert Teply, Sean Bennet, Bryant Morris, and Evan Jacobson; and from the Office of Compliance Inspections and Examinations: Carrie O'Brien and Christine Sibille.

[3] The Commission and the staff have long held the view that the receipt of transaction-based compensation is a strong indicator of broker status and likely warrants registration. *See, e.g.*, Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration, Exchange Act Release No. 61884 (Apr. 9, 2010) ("Indeed, the receipt of transaction based compensation often indicates that such a person is engaged in the business of effecting transactions in securities."); Brumberg, Mackey & Wall, PLC, SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010) ("Section 15(a)(l) of the Exchange Act generally provides that any broker effecting transactions in securities, or inducing or attempting to induce the purchase or sale of securities, must be registered with the Commission pursuant to Section 15(b) of the Exchange Act. A person's receipt of transaction-based compensation in connection with these activities is a hallmark of broker-dealer activity. Accordingly, any person receiving transaction-based compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer."); 1st Global, SEC No-Action Letter, 2001 WL 499080 (May 7, 2001) ("Receipt of transaction-based compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer . . . [T]he Division has taken the position that the receipt of securities commissions or other transaction related compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of 'broker' or 'dealer' generally is required to register as a broker-dealer.") (internal quotations and ellipses omitted); David W. Blass, Chief Counsel, Division of Trading and Markets, SEC, Speech at the American Bar Association Trading and Markets Subcommittee: A Few Observations in the Private Fund Space (Apr. 5, 2013) ("The SEC and SEC staff have long viewed receipt of transaction-based compensation as a hallmark of being a broker. This makes sense to me as the broker regulatory structure is built, at least in large part, around managing the conflict of interest arising from a broker acting as a securities salesman, as compared to an investment adviser which traditionally acts as a fiduciary and which should not have that same type of conflict of interest."). *See also SEC v. Helms*, 2015 WL 5010298 at *17 (W.D. Tex. Aug. 21, 2015) ("In determining whether a person 'effected transactions [for purposes of the Exchange Act registration requirements],' courts consider several factors, such as whether the person: (1) solicited investors to purchase securities, (2) was involved in negotiations between the issuer and the investor, and (3) received transaction-related compensation."); SEC v. Earthly Mineral Solutions, Inc., 2011 WL 1103349 (D. Nev. Mar. 23, 2011) ("[A]ctivities that indicate a person may be a 'broker' are: (1) solicitation of investors to purchase securities, (2) involvement in negotiations between the issuer and the investor, and (3) receipt of transaction-related compensation.").

[4] *See* Proposed Order, *supra* note 1, at 17-18.

[5] *See id.* at 22-23. *See also* Paul Anka, SEC No-Action Letter, 1991 WL 176891 (July 24, 1991) (providing assurance to Paul Anka that the staff would not recommend enforcement action under Section 15(a) provided that Mr. Anka's involvement in the offering was limited to providing the issuer with a list of names and telephone numbers for individuals that he reasonably believed were accredited investors). In *Paul Anka*, the finder's involvement was exceptionally limited, and while the staff did not object to the finder's receipt of transaction-based compensation under those limited circumstances, the letter makes clear that the staff's determination was based in large part on representations that the finder would not engage in any solicitation or even have contact with potential investors.

[6] The release frames the proposed exemptive order as a non-exclusive safe harbor and repeats in four separate places that non-compliance with the terms of the order will not create a presumption that a finder has violated Section 15(a) of the Exchange Act. *See* Proposed Order, *supra* note 1, at 17, 23 n.77, 25 n.85, 29 n.93. Among the problems with this approach is that it will almost certainly provide more comfort than is warranted to non-complying finders about what might be permitted without registration as a broker-dealer. To be clear, while the question of broker-dealer status is generally one that depends on the facts and circumstances, the scope of conduct permitted by this order quite clearly meets the threshold for registration. A finder that engages in this conduct but chooses its own path—even one modeled on, but not in compliance with the terms of this order—would likely violate Section 15(a). To the extent that the Commission claims today to provide clarity to finders and issuers, it undercuts that goal by not only failing to emphasize the importance of complying with the terms of the order, but also by suggesting that deviation from those terms might not have consequences.

[7] This proposed list of permitted activities clearly meets the threshold for registration in Exchange Act Section 15(a) as that section has been interpreted by the Commission and courts. *See*, e.g., Proposed 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, Exchange Act Release No. 87204 at 8-9 (Oct. 2, 2019) ("[A] municipal advisor that identifies and assesses potential providers for direct placements by a Municipal Issuer client could be viewed

as engaging in solicitation, a factor relevant to a determination of broker status. This is particularly true in light of the fact that service providers in municipal securities transactions, including municipal advisors, typically are paid from the proceeds of the securities offering and thus routinely receive transaction-based compensation. The receipt of transaction-based compensation has been considered by courts as a factor indicating that registration as a broker may be required."); SEC v. Earthly Mineral Solutions, Inc., *supra* note 3, at *3 ("[A]ctivities that indicate a person may be a 'broker' are: (1) solicitation of investors to purchase securities, (2) involvement in negotiations between the issuer and the investor, and (3) receipt of transaction-related compensation.").

[8] *See* Proposed Order, *supra* note 1, at 24.

[9] *See, e.g.*, Brumberg, Mackey & Wall, PLC, SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010) (denying no-action relief based on the facts that: 1) the applicant intended to screen investors for potential investment interest prior to introducing to the issuer; and 2) the applicant would receive transaction-based compensation); Herbruck, Alder & Co., SEC No-Action, 2002 WL 1290291 (June 4, 2002) (denying no-action relief based, at least in part, on the fact that employees' transaction-based compensation would be passed-through their non-broker-dealer employer and used to offset employee overhead at the non-broker-dealer employer); 1st Global, SEC No-Action Letter, 2001 WL 499080 (May 7, 2001) ("Persons who receive transaction-based compensation generally have to register as broker-dealers under the Exchange Act because, among other reasons, registration helps to ensure that persons with a 'salesman's stake' in a securities transaction operate in a manner consistent with customer protection standards governing broker-dealers and their associated persons, such as sales practice rules."). *See also* Hallmark Capital Corp., SEC No-Action Letter, 2007 WL 1879799 (June 11, 2007) (declining to provide no-action assurance where a finder was paid both an upfront retainer and a fee based on the outcome of the transaction in return for introducing small issuers to a broker-dealer; the staff further observed that "it appears that [the applicant] would be required to register with the Commission as broker-dealer"); John W. Loofbourrow Associates, Inc., SEC No-Action Letter, 2006 WL 3933273 (June 29, 2006) (declining to provide no-action assurance where a finder would be paid a referral fee tied to the size of the transaction as compensation for introducing the issuer to a broker-dealer).

[10] *See* Proposed Order, *supra* note 1, at 26 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.").

[11] *See id.* at 20-21 ("The accredited investor requirement is intended to ensure that Finders solicit only potential investors who have a sufficient level of financial sophistication to participate in investment opportunities that do not have the additional protections provided by registration under the Securities Act . . . We believe the targeted approach we are proposing would address the capital raising needs of smaller issuers while maintaining appropriate investor protections."). Today's proposal would mean that, when dealing with a Tier II finder, accredited investors would lack the protections of both the Securities Act and Exchange Act.

[12] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 at 113 (June 5, 2019) ("Reg BI Adopting Release") ("[W]e believe conflicted recommendations can also result in harm to high net-worth individuals. We believe the benefits of Regulation Best Interest justify compliance costs as these individuals could benefit from the protections included in Regulation Best Interest regardless of their net worth, which may not necessarily correlate to a particular level of financial sophistication."). The Commission's decision in Regulation Best Interest related to the determination not to refine the scope of "retail customer" to exclude individuals who would fall within the definition of "institutional account" in FINRA Rule 4512(c), which includes any person with total assets of at least $50 million. *See id.* at 112 n.238. While the Commission chose to retain protections for those with at least $50 million in that context, the proposal today would undermine protections for a vastly broader group of accredited investors.

[13] *See* Reg BI Adopting Release, *supra* note 12, at 17 ("Importantly, regardless of whether a retail investor chooses a broker-dealer or an investment adviser (or both), the retail investor will be entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor."). While the proposal purports to restrict a finder's ability to "provide advice as to the valuation or advisability of [an] investment," that restriction is not a clear prohibition on "recommendations" as that term is described in Reg BI. In declining to adopt a definition of "recommendation" in Reg BI, the Commission stated that whether a broker-dealer has made a recommendation turns on the facts and circumstances and is not susceptible to a bright line definition. *See id.* at 79. The Commission continued, "Factors considered in determining whether a recommendation has taken place include whether the communication 'reasonably could be viewed as a call to action' and 'reasonably would influence an investor to trade a particular security or group of securities.' The more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a 'recommendation.'" *Id.* at 79-80 (internal quotations omitted). One can certainly foresee how a finder might avoid specifically providing advice as to the valuation or advisability of an investment consistent with the proposed exemption, but nonetheless fall squarely within the interpretation of a recommendation for purposes of Reg BI. The very act of solicitation by a finder, especially one with whom an investor has a preexisting relationship, will carry with it an implicit "call to action" that would reasonably be expected to influence an investor's decision as to whether to invest in a particular issuer. These are the precise circumstances in which a best interest obligation is most important, and yet the Commission's proposal would expose investors to financial professionals who owe them neither a duty of loyalty nor a duty of care.

[14] *See* Reg BI Adopting Release, *supra* note 12, at 371 (providing a compliance date of June 30, 2020).

[15] *See* Amending the "Accredited Investor" Definition, Securities Act Release No. 10824 (Aug. 26, 2020) ("Accredited Investor Adopting Release").

[16] *See id.* at 135-136 ("[A]s a result of Regulation Best Interest, a broker-dealer's recommendation of a private offering to a retail customer is required to be in the retail customer's best interest, without putting the financial or other interest of the broker ahead of the interest of the retail customer, which we expect will lead to a reduction of unmitigated conflicts of interests.").

[17] The release expresses concerns about the so-called "gray market" in which finders currently operate. *See* Proposed Order, *supra* note 1, at 6 ("Observers have described a 'gray market,' reflecting a 'major disconnect' between the various laws and regulations applicable to securities brokerage activities, and the methods and practices by which capital is raised to fund early stage businesses in the United States. As a result of this uncertainty, individuals potentially could be engaging in unregistered brokerage activity, or alternatively, not serving the market because of the regulatory uncertainty associated with playing even a limited role in a capital raise."). In carving out large swaths of conduct from the Commission's regulatory jurisdiction and oversight, the Commission suggests that it is merely providing clarity. However, as I have noted in prior contexts where this argument is asserted, the Commission can just as easily achieve clarity with a plainly defined, but appropriately tailored, regulatory framework with strong compliance requirements. *See* Statement of Commissioner Allison Herren Lee on Amendments to the Volcker Rule (Sept. 19, 2019) ("Instead, we have reduced the rule's scope and weakened compliance requirements ostensibly in the name of simplicity and clarity. Yes, the Volcker Rule is complex, just as the businesses and operations of large financial institutions are complex. Both could do with some simplification and clarity. But let's be clear—we can just as easily achieve simplicity and clarity with a plainly defined but appropriately broad scope and stronger compliance requirements. A speed limit of 55 is every bit as clear as a speed limit of 95.").

[18] The Commission's Fall 2019 Regulatory Flexibility Agenda included an item with the title "Regulation of Finders." *See* Securities and Exchange Commission, Agency Rule List – Fall 2019, https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPubId=201910&showStage=longterm&agencyCd=3235&csrf_token=74377F97AF7921471B45063871CE36407CAA740919 That agenda item had the following description: "The Division is considering recommending that the Commission propose rules concerning the status of

finders for purposes of Section 15(a) of the Exchange Act." *See* RIN 3235-AM33 (Fall 2019), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201910&RIN=3235-AM33. Nowhere in this release, however, has the Commission addressed why that approach was abandoned or why a simple exemptive order is more appropriate to address such a complex, nuanced issue

[19] *See* Exchange Act, Section 3(f), 15 U.S.C. 78c(f) ("Whenever pursuant to this chapter the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."). *See also* Memorandum Regarding Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012) ("High-quality economic analysis is an essential part of SEC rulemaking. It ensures that decisions to propose and adopt rules are informed by the best available information about a rule's likely economic consequences, and allows the Commission to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule. The Commission has long recognized that a rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest.").

[20] Today's proposed order is only one of several proposals in the past year in which the Commission claims that a broadly applicable change will somehow particularly benefit women- and minority-owned businesses. *See* Proposed Order, *supra* note 1, at 5 ("Finders may also help bridge gaps between traditionally underrepresented founders, such as women and minorities and VC and start-up capital."); Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 10763 at 66 & n.134 (Mar. 4, 2020) (stating that proposed changes may help bridge funding gaps for certain businesses and claiming, "For example, diverse founders, including women-owned and minority-owned businesses may have less access to start-up capital and venture capital ('VC') funding."); Accredited Investor Adopting Release, *supra* note 15, at 138 ("In particular, small businesses owned by underrepresented minorities may benefit from a larger pool of accredited investors."). As with these prior actions, nothing in today's proposed order is tailored to address the systemic issues that have traditionally acted as barriers to capital-raising for such issuers. Instead, the Commission simply assumes that such issuers will benefit from reduced regulation in the same manner as other issuers, ignoring the fact that women- and minority- owned businesses face challenges that are different in source and scope than those other issuers.

[21] U.S. Department of Treasury, A Financial System that Creates Economic Opportunities: Capital Markets (Oct. 2017) ("2017 Treasury Report").

[22] Report and Recommendations of the American Bar Association Business Law Section Task Force on Private Placement Broker-Dealers (June 20, 2005) ("ABA Task Force Report").

[23] *See* 2017 Treasury Report, *supra* note 21, at 44.

[24] *See* ABA Task Force Report, *supra* note 22, at 47-48.