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November 13, 2020

Vanessa A. Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: 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, File No. S7-13-20

Dear Ms. Countryman:

This letter is submitted on behalf of Financial Industry Regulatory Authority, Inc. (FINRA)<sup>1</sup> with respect to the Commission's proposed order granting a conditional exemption from the broker registration requirements under the Securities Exchange Act of 1934 (Exchange Act) for certain activities of finders (the Proposal).<sup>2</sup> FINRA applauds the efforts of the Commission and its staff to provide more clarity in this area, as well as the work of the SEC Small Business Capital Formation Advisory Committee, and we share the Proposal's goal to increase opportunities for capital raising by small businesses. However, we believe there is another approach that better affords these benefits without sacrificing appropriate regulatory oversight of these activities.

### **Summary of Comments**

As discussed below, FINRA plays a significant role in protecting investors from potential harm through its registration and oversight of private placement broker-dealers and their associated persons. Nevertheless, FINRA only regulates broker-dealers' private placement activities; most private placements occur either directly with investors or through intermediaries

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<sup>1</sup> FINRA is a not-for-profit self-regulatory organization authorized by federal law to help protect investors and ensure the fair and honest operation of securities markets. Under the oversight of the Securities and Exchange Commission (Commission or SEC), FINRA regulates the activities of U.S. broker-dealers and performs market regulation pursuant to its own statutory responsibility and under contract for certain exchanges. The comments set forth in this letter reflect the views of FINRA staff and have not been approved by FINRA's Board of Governors.

<sup>2</sup> See Exchange Act Release No. 90112 (File No. S7-13-20) (October 7, 2020), 85 FR 64542 (October 13, 2020) (Proposing Release).

other than broker-dealers.<sup>3</sup> While private placements provide an important source of capital for issuers, particularly small companies, and offer potential opportunities to investors, FINRA has found that the sale of private securities entail similar, if not greater, risks to investors than the sale of registered securities.

The Proposal may increase these risks by creating a separate category of exempt private placement brokers that would not be identified to regulators, subject to examination, or subject to the regulatory requirements that govern brokers involved in the sale of securities. Accordingly, FINRA recommends that the Commission instead work with state securities regulators and FINRA to create separate rules for private placement broker-dealers that are tailored to these firms' limited business models in a manner that facilitates the Commission's goals.

### **FINRA's Role in Regulating Private Placements**

Over many years under the supervision of the Commission, FINRA has developed regulatory requirements for broker-dealers that offer and sell securities, whether registered or unregistered. Investor confidence is absolutely essential to capital raising by issuers, and FINRA's regulatory requirements are designed to protect investors and preserve their confidence in the securities markets. Before firms can register as a broker or dealer under the Exchange Act, they must be approved by FINRA after undergoing an important evaluation process. The goals of the new member application process are to exclude bad actors from the broker-dealer industry, ensure that broker-dealer personnel meet minimum competency standards, and confirm that new members have the knowledge and resources to conduct business in compliance with the federal securities laws and FINRA rules.

A significant number of FINRA's member firms are involved in the offer and sale of unregistered securities. At year-end 2019, almost 500 of FINRA's 3,517 member firms were grouped as primarily engaging in private placement activities, and another approximately 850 firms were grouped as engaging primarily in merger and acquisition (M&A) and investment banking activities, which often involve the sale of unregistered securities.<sup>4</sup> In addition, some member firms have elected to be regulated as Capital Acquisition Brokers (CABs), which are broker-dealers that engage in a limited range of activities, including advising companies and private equity funds on capital raising and corporate restructuring, and acting as placement agents for sales of unregistered securities to institutional investors. Firms that elect CAB status

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<sup>3</sup> Most private offerings are sold pursuant to one of three safe harbors under Securities Act Regulation D (Reg D). See 17 CFR 230.504, 230.506(b), and 230.506(c). Among other things, Reg D requires companies and funds to file a Form D through the Commission's EDGAR system when selling unregistered securities based on a claimed Reg D exemption. The most recent data published by the Commission's Division of Economic and Risk Analysis indicates that issuers make approximately 20,000 new offering Reg D filings with the SEC each year. Of this total, only approximately 4,000 new offerings identify an intermediary, such as a broker or finder, as participating in the offering. See *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, available at [https://www.sec.gov/dera/staff-papers/white-papers/dera\\_white\\_paper\\_regulation\\_d\\_082018](https://www.sec.gov/dera/staff-papers/white-papers/dera_white_paper_regulation_d_082018).

<sup>4</sup> See "2020 FINRA Industry Snapshot," pp. 31-33, available at <https://www.finra.org/rules-guidance/guidance/reports-studies/2020-industry-snapshot>.

are subject to a streamlined rulebook that is more narrowly focused on CABs' business models and institutional customer base.<sup>5</sup>

To help FINRA staff identify private placements sold by FINRA members that may raise risks for investors, FINRA Rule 5123 (Private Placements of Securities) requires member firms that help place private securities to file with FINRA any private placement memorandum, term sheet or other offering document used in connection with a private placement of securities. Offerings sold only to institutional investors are generally exempt from this filing requirement.<sup>6</sup> FINRA received 2,445 unique Rule 5123 filings in 2019. FINRA uses analytics to conduct a risk-based review of these filings to determine if further investigation or regulatory action is needed.

FINRA also reviews private placement retail communications that it receives from members for compliance with applicable standards.<sup>7</sup> Among other things, FINRA focuses on whether private placement retail communications include prohibited projections of performance or unreasonable forecasts,<sup>8</sup> or fail to balance promotional content with the key risks associated with the investment, such as the speculative nature of the securities and the lack of liquidity of the investment.<sup>9</sup>

FINRA also reviews member private placement activities through both its cycle examinations of member firms and "cause" examinations that review specific potential misconduct. As part of these examinations, FINRA reviews a firm's policies and procedures and specific transactions to determine whether the firm's private placement activities are conducted in compliance with applicable federal laws and SEC and FINRA rules. If material violations of the laws and rules governing private placements by members are brought to light in these reviews or through other sources, FINRA will take enforcement action.

A special area of focus are contingency offerings. At times, issuers offer unregistered securities in a contingency offering subject to the satisfaction of an underlying condition.

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<sup>5</sup> See Regulatory Notice 16-37 (October 2016). As of year-end 2019, 56 firms had elected CAB status. See "2020 FINRA Industry Snapshot," p. 26. FINRA also regulates 59 funding portals that operate pursuant to Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012, the Commission's Regulation Crowdfunding, and FINRA's funding portal rules. Funding portals serve as online crowdfunding platforms that issuers use to raise private capital under limited conditions.

<sup>6</sup> See FINRA Rule 5123(b). FINRA Rule 5122 (Private Placements of Securities Issued by Members) also requires firms to file specified information concerning private offerings by member firms and their affiliates. However, the vast majority of private placement filings occur through Rule 5123.

<sup>7</sup> FINRA receives these communications through four channels: (i) new member and voluntary filings; (ii) referrals from examiners and surveillance groups; (iii) spot checks; and (iv) FINRA Enforcement.

<sup>8</sup> See FINRA Rule 2210(d)(1)(F).

<sup>9</sup> See Regulatory Notice 20-21 (July 2020) (FINRA Provides Guidance on Retail Communications Concerning Private Placement Offerings), for a more in-depth discussion of problems frequently found in private placement sales material.

Broker-dealers that participate in a private offering on a best efforts basis are subject to Commission rules designed to protect investors that purchase shares in these offerings.<sup>10</sup>

FINRA also notes the conflicts of interest that may arise in private offerings. For example, an issuer may be affiliated with the entity offering its securities, or the issuer may be owned or managed by individuals who are owners of, or persons associated with, the entity promoting its securities. The issuer may pay the entity substantial remuneration for sales of its securities, which also can create conflicts of interest.

In its supervision of member sales of private offerings, FINRA has observed instances of problems as frequently, if not more frequently, as in sales of publicly traded securities. FINRA believes that its members, who are subject to regular review of their activities and active enforcement of regulatory requirements, generally strive to act in compliance with regulatory requirements and to appropriately serve their customers' needs and interests. From this experience, FINRA is concerned that promotional activities for private offerings that are not subject to comparable regulatory requirements and oversight will inevitably entail increased instances of problematic transactions for investors.

### **Concerns with the Tier II Finder Proposal**

Given the problems FINRA has observed in promotion of private placements, we are concerned that allowing unregistered finders, not subject to the many investor protections applicable to broker-dealers, to engage in similar private offerings activities will increase the potential for investor harm. Our main concerns, which focus on Tier II Finders, are summarized below.

#### Lack of Regulatory Oversight

FINRA's primary concern is that, without registration and the obligations that it entails, Tier II Finders would engage in capital raising activities similar to those of registered broker-dealers, but without any regulatory authority overseeing or examining their activities on a routine basis. Given the constraints on the SEC's and state securities regulators' resources, it is possible that finders would believe that they could engage in noncompliant conduct undetected by regulators.

Like registered broker-dealers engaged in private placement activities, the Proposal would allow Tier II Finders to identify, screen and contact potential investors, distribute issuer offering materials, discuss issuer information included in the offering materials (so long as the Tier II Finder does not make a recommendation), and arrange and participate in meetings between the issuer and potential investor. Many private placement broker-dealers perform exactly the same kinds of activities as Tier II Finders, but with the Exchange Act, SEC regulations, FINRA rules and state laws and regulations setting appropriate limits and requiring specified standards of conduct when dealing with customers, and regulatory authorities examining for and enforcing compliance. While a Tier II Finder would be required to provide a short disclosure (which could be oral) to the potential investor prior to or at the time of the

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<sup>10</sup> See 17 CFR 240.10b-9 and 17 CFR 240.15c2-4.

solicitation, in FINRA's experience, investor disclosures need to be backed by strong oversight to ensure compliance, reduce investor confusion, and avoid potential harm to investors.

Tier II Finders would not have to possess any minimum knowledge or competency with respect to securities to qualify for the exemption, nor would they have to pass any examinations or undergo any training or continuing education to serve as a finder. Because the exemption would allow virtually any individual to promote sales of unregistered securities so long as the individual was not statutorily disqualified, there would be no assurance to the investor, the issuer, or the securities market at large that such individuals have the knowledge, skills, integrity or competency to serve investors or issuers in capital raising activities.

Although the Proposal would not allow a Tier II Finder to handle customer funds or securities, it is not clear whether a Tier II Finder could be involved in a contingency offering.<sup>11</sup> If a Tier II Finder were permitted to be involved in a contingency offering, it would be difficult to enforce rules requiring the Finder or other parties to escrow or segregate investor funds, and requiring funds to be returned to investors should a contingency not be met.<sup>12</sup>

Moreover, Tier II Finders would not need under the federal securities laws to notify regulatory authorities of their activities, or to keep any records of their activities, communications, or finances, making it extremely difficult for the Commission or any other regulator with jurisdiction over Tier II Finders to determine whether they were complying with the exemptive order or other applicable laws and standards. There would be no database, such as BrokerCheck, for investors to learn more about a Finder's background, including any customer complaints or past crimes or disciplinary actions that do not trigger disqualification.

### Misleading Sales Material

Although the proposed exemption would not allow Finders to participate in the preparation of issuer sales materials, in our experience persons involved in sales often are involved in the preparation of the sales materials that they will use to promote an offering. (It is not clear from the Proposal whether a Finder may provide investors with projections of the price performance of a privately offered security, which generally is not permissible for broker-dealers.)

Because there would be no regular oversight of the use of these materials or standards applicable to such sales materials other than general anti-fraud laws, there remains a risk that Finders may be involved in preparing sales materials that are designed to maximize sales at the cost of compliance with standards requiring such communications to be fair and balanced. Moreover, because Finders would not need to have any background in the securities industry or

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<sup>11</sup> Many private placement broker-dealers are involved with contingency offerings despite net capital requirements that prohibit such firms from handling customer funds or securities. Absent further guidance from the Commission, one might assume that a Tier II Finder could be involved in contingency offerings provided that they "promptly transmit" customer funds to either the issuer or some other third-party account, similar to broker-dealers that are exempt from the Exchange Act's rules governing customer protection and custody of securities. See 17 CFR 240.15c3-3(k)(1)(iii).

<sup>12</sup> See 17 CFR 240.10b-9 and 17 CFR 240.15c2-4.

pass minimum knowledge or competency examinations, it is possible that Finders would not even recognize when they are providing misleading content to investors.

### Difficulty in Enforcing Prohibition on Recommendations

Although the Proposal would not permit Tier II Finders to make recommendations to prospective investors, in practice this prohibition would be difficult to detect or enforce. Frequently, the line between solicitation (which Tier II Finders could perform) and advice (which is supposed to be prohibited) is quite fine and is always based on the facts and circumstances of particular communications. Given that no regulator would be routinely examining or reviewing their activities, a Tier II Finder may overstep that fine line in persuading investors to close a sale.

### Due Diligence

The Proposal would prohibit a Tier II Finder from performing independent analysis of the sale of securities or engaging in any due diligence activities prior to soliciting investors for a private placement. A registered broker-dealer that recommends securities to an investor is required to perform reasonable diligence to understand the security, including its risks, and to assess, based on that understanding, whether it is appropriate for at least some investors.<sup>13</sup> As part of these obligations, the SEC and federal courts have long held that this due diligence is a key requirement for broker-dealers involved in promoting a security to investors.<sup>14</sup> Although the Proposal formally restricts a Tier II Finder from recommending securities to an investor, this prohibition on recommending while soliciting would be difficult to identify or enforce until after harm is done to investors.

The prohibition on investigating or performing reasonable diligence on an issuer or its securities may in fact provide a shield from liability for a Tier II Finder should an investor claim in court or arbitration that he or she suffered losses from the Finder's solicitation activities. In this regard, the Tier II Finder could assert that he or she was restricted from investigating or performing due diligence on the issuer, and thus any claims by an investor that the Finder should have known about any fraud or investment risk related to the private placement would run counter to the Finder's obligations.

### Unclear Roles of Finders

The Proposal would not permit Finders to be associated persons of broker-dealers. Nevertheless, it is unclear whether a Tier II Finder could be an employee of an unregistered affiliate of a broker-dealer. As discussed above, many broker-dealers involved in the private placement marketplace have a variety of affiliates that are used for particular transactions. For

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<sup>13</sup> See FINRA Rule 2111.05(a); see also Regulation Best Interest, 17 CFR 240.15l-1(a)(2)(ii)(A) (a broker-dealer that recommends a securities transaction or investment strategy involving securities to a retail customer must have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers).

<sup>14</sup> See, e.g., Hanly v. SEC, 415 F.2d 589, 595-596 (2d Cir. 1969); see also Regulatory Notice 10-22 (April 2010) (Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings).

example, an affiliated funding portal may serve as the platform for crowdfunding offerings that meet the requirements of SEC Regulation Crowdfunding. An affiliated unregistered online platform authorized by section 201 of the JOBS Act may serve as the intermediary for some private offerings made pursuant to Reg D. It is unclear if these kinds of arrangements could include Tier II Finders if they are not employees of a broker-dealer.

The Proposal also is silent as to whether a Tier II Finder may be either a registered investment adviser (RIA) or a supervised person of an RIA. Since the Proposal does not specifically prohibit RIAs from being Tier II Finders, one could also envision situations in which an individual provides investment recommendations concerning a private placement while acting as an RIA or supervised person of an RIA, and then “switches hats” from a regulated RIA to an unregulated Tier II Finder when receiving transaction-based compensation from the issuer once the sale is completed. It is likely that an investor would not understand the different roles that the Finder was playing, or the difference in regulation between those roles.

### Impact on Broker-Dealer Industry

As discussed above, many currently registered broker-dealers engage in largely the same private placement activities that would be permissible for Tier II Finders. If the Proposal is adopted, it will present a dilemma for these firms. Either they can continue to operate as registered broker-dealers with the corresponding compliance, regulatory, and other costs associated with this status, or they can de-register as broker-dealers and operate as Tier II Finders. Because a Tier II Finder would not be subject to broker-dealer regulation, it is possible some currently registered broker-dealers will drop their registrations and continue to do business as Tier II Finders. Not only would this trend reduce regulatory oversight, it also would place firms that remain registered broker-dealers at a competitive disadvantage.

### Comparison to 2005 ABA Task Force Report

The Proposal cites a 2005 American Bar Association task force report for the proposition that small issuers have difficulty attracting capital and that there is a “gray market” reflecting a disconnect between the laws governing securities brokers and the practices by which capital is raised to fund early stage business in the U.S.<sup>15</sup> The Proposal did not cite the ABA Task Force’s recommendations to the Commission. FINRA believes that the Commission should closely consider those recommendations before proceeding, as they largely align with FINRA’s recommended alternative discussed below.

The ABA Task Force Report observed that there are a number of unregistered securities brokers that raise funds for small businesses or engage in mergers and acquisition activities on a commission basis, which it refers to as Private Placement Broker-Dealers (PPBDs). The report acknowledged that PPBDs’ activities are of critical importance to small businesses seeking early stage funding, but that they are violating the laws governing broker-dealers. The Task Force also stated that its goals include effective licensing of “honest and ethical” PPBDs, in part to diminish the number of unlawful securities brokers and to distinguish the good from the bad actors in this

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<sup>15</sup> See Proposing Release at page 4, note 9 and page 6, note 16 and accompanying text. See also 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).

space.<sup>16</sup> To achieve these goals the Task Force recommended that the Commission work with FINRA and state securities regulators to establish a simplified system for registration of PPBDs, which would be subject to a limited range of activities, as well as a smaller, modified set of rules to govern those activities.<sup>17</sup>

### **Alternative Approach**

FINRA agrees with the direction of the ABA Task Force Report. A goal of a private-offering regulatory regime should be to make it easier for intermediaries such as finders to assist small businesses in raising early stage capital. But the Commission should seek to achieve this goal through a narrowly tailored approach that protects investors and issuers, and that maintains public confidence in this business model. FINRA's CAB program provides the basis for this system.

CABs can advise issuers on securities offerings and other capital raising activities, as well as on purchases, sales, and mergers of private businesses. And CABs can act as finders or placement agents in connection with the sale of newly issued unregistered securities or in connection with a change of control of a private company. Like the ABA Task Force's recommendations, CABs are not permitted to participate in public offerings, sell securities to persons who are not accredited investors,<sup>18</sup> or handle customer funds or securities.

CABs are subject to a focused set of FINRA rules, and these rules could be revised to better accommodate a category similar to Tier II Finders. Assuming the Commission supports this approach, FINRA would adopt appropriate changes to FINRA's CAB rules, some of which have been under discussion with SEC staff. FINRA members have identified unnecessary constraints in the CAB rules as a partial reason for their limited use of the CAB structure. They also have identified certain Commission rules and other securities law requirements as unnecessarily burdening CAB operations.

To address these concerns without wholly excluding Tier II Finders from Commission and FINRA oversight, the Commission could use its exemptive authority, as in the Proposal, to free Tier II Finders from securities law requirements that are not appropriate for their finder activities. The Commission's use of exemptive authority in coordination with FINRA rule revisions could address the regulatory requirements that impede the capital raising activities of Tier II Finders, without the Commission needing to engage in extensive rulemaking. For example, CABs that are Finders could have a more streamlined new member application process that focuses on their limited business model, a shorter and better aligned filing form to replace Form BD, tailored financial reporting requirements, and more focused examinations.

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<sup>16</sup> See ABA Task Force Report at 2.

<sup>17</sup> See id. at 3-6.

<sup>18</sup> Currently the CAB Rules only allow a CAB to act as a finder or placement agent for the sale of newly issued unregistered securities if they are sold to institutional investors as defined in those rules, which is a narrower standard than the accredited investor definition under Reg D. See CAB Rules 016(c)(1)(F) and 016(c)(i).

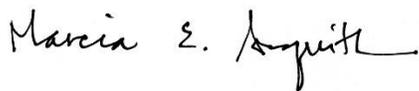
Nonetheless, CABs still would be subject to core regulatory requirements, such as requirements to have a supervisory system reasonably designed to achieve compliance with applicable laws and regulations, to maintain business-related records, and to conduct their activities in a manner that is consistent with just and equitable principles of trade. Associated persons of CABs would be required to pass appropriate qualification exams depending on their activities, and regulators could ensure that bad actors other than those that have been statutorily disqualified remain outside the securities industry. In addition, unlike the Proposal, this approach would permit private placement brokers and finders to provide appropriate recommendations to investors, which we believe is more workable than the proposed Tier II standards.

The benefits of such a regulatory model are clear. Rather than wholly exempting Tier II Finders from the regulatory system subject to limitations that are difficult to monitor or enforce, a revised CAB regulatory regime would reduce the burdens on finders and private placement brokers that seek to operate in a compliant manner. At the same time, however, it would ensure that the Commission, FINRA and state securities regulators know these participants in the brokerage business, continue to require persons entering the industry to meet minimum standards regarding industry knowledge and regulation, check such persons' backgrounds to identify those that could pose risks to investors and issuers, and examine them for compliance with the applicable requirements.

## **Conclusion**

FINRA appreciates the opportunity to comment on the Proposal to create an exemption from broker-dealer registration for finders. As discussed above, however, FINRA remains concerned that this exemption would unnecessarily create risks to investors and issuers alike and reduce public confidence in the securities markets. Accordingly, FINRA recommends that the Commission consider adopting an alternative approach that would create an appropriate regulatory regime that improves access to capital for small businesses while continuing to protect investors. Should you have any questions or wish further to discuss FINRA's views, please contact Robert Colby, Executive Vice President & Chief Legal Officer, FINRA, at [REDACTED].

Sincerely,



Marcia Asquith  
Executive Vice President, Board & External Relations  
FINRA