Consumer Federation of America

November 10, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-13-20, Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements for Certain Activities of Finders

Dear Secretary Countryman:

I am writing on behalf of Consumer Federation of America (CFA)[1] to express our strong opposition to the Commission's proposed exemptive order dramatically expanding the ability of unlicensed individuals, so-called "finders," to engage in a broad array of brokerage activities on behalf of private issuers, and to be compensated through transaction-based payments, without being subject to appropriate regulations or oversight. Even if you assume that clarifying the regulatory status of finders would benefit small company capital formation, this proposal is not the way to go about it, and acting through an exemptive order is not the proper means to achieve that end. This proposal, at least as it pertains to Tier 2 Finders, should therefore be withdrawn.

The Commission proposes to adopt this radical policy change through an exemptive order, despite the fact that an alternative is available – working with FINRA and state securities regulators to adopt a regulatory regime tailored for these private market intermediaries – that could win broad-based support. That is the approach that the Treasury Department recommended in its 2017 report, when it suggested adoption of "a 'broker-dealer lite' rule that applies an appropriately scaled regulatory scheme on finders."[2] Similarly, that is the approach advocated by an American Bar Association Task Force in a 2005 report that was subsequently endorsed by the SEC's Advisory Committee on Smaller Public Companies, among others.[3] And, while both

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[1] The Consumer Federation of America (CFA) is a non-profit association of more than 250 national, state and local pro-consumer organizations. It was established in 1968 to advance the consumer interest through research, advocacy, and education.

[2] U.S. Department of Treasury, A Financial System that Creates Economic Opportunities: Capital Markets (Oct. 2017), available at https://bit.ly/3kBsnm7. ("Treasury recommends that the SEC, FINRA, and the states propose a new regulatory structure for finders and other intermediaries in capital-forming transactions. For example, a 'broker-dealer lite' rule that applies an appropriately scaled regulatory scheme on finders could promote capital formation by expanding the number of intermediaries who are able to assist smaller companies with capital raising.")

[3] Gregory C. Yadley, "Notable by the Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation" (Jun. 3, 2015), https://bit.ly/2HvdWSD. ("The thrust of the ABA Task Force Report and its

Democratic SEC Commissioners voted against releasing the Commission's proposed exemptive order, one explicitly stated that she would have been willing to support a proposal to create a tailored regulatory regime, and the other made clear that she viewed such an approach as the minimum necessary to protect investors.[4] In short, this is one more example of the Commission's recent track record of shunning consensus in favor of extreme deregulatory proposals and special interest hand-outs.

There are sound reasons why a variety of stakeholders have advocated adoption of a "broker-dealer lite" regulatory approach for finders, rather than the broad safe harbor for unregistered activity proposed here. Adopting a streamlined regulatory regime seeks to "facilitate capital formation by small businesses *and* … reduce as much as possible the illegal activities of unregistered finders."[5] (Emphasis added.) As attorney Gregory C. Yadley explained, and as the SEC surely must understand, some of those operating as unregistered 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."[6]

Investors aren't the only ones put at risk by these activities. Issuers who deal with unscrupulous finders may never see any funding materialize. Even when they do receive funding, dealing with unscrupulous finders can present significant problems for the issuer. "They can taint an offering by creating the basis for rescission rights, raise enforcement concerns, make fraudulent representations and engage in general solicitation which disqualifies the offering for exemption from registration."[7] And yet the Commission doesn't even acknowledge here that fraudulent activity by finders is a problem it should seek to address. That is an abrogation of both its central investor protection mission and its capital formation mandate. Because, unless the Commission also deals with the fraud problem, simply clarifying the regulatory status of finders is unlikely to promote healthy capital formation.

Ensuring that private market intermediaries are subject to appropriate regulatory oversight takes on added urgency in light of the Commission's continued expansion of private issuers' ability to market their securities to financially unsophisticated retail investors. In the absence of both complete and reliable disclosures and effective regulatory oversight of this

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Recommendation was for the SEC, FINRA (then, the NASD) and State Administrators to work to establish a simplified system for registration of private placement brokers ("PPBs"), that recognized their engagement in only very limited activities.")

[4] *See,* Regulating in the Dark: What We Don't Know About Finders Can Hurt Us, Statement of Commissioner Allison Herren Lee (Oct. 7, 2020), https://www.sec.gov/news/public-statement/lee-proposed-finders-exemption-2020-10-07. ("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."); Statement of Commissioner Caroline Crenshaw on Proposed Exemptive Relief for Finders (Oct. 7, 2020), https://www.sec.gov/news/public-statement/crenshaw-finders-2020-10-07 ("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.")

[5] Yadley, Notable by the Absence.

[6] *Id.*

[7] *Id.*

market to ensure fair dealing, these investors, many of them older, are often ill-equipped to determine whether the securities being offered represent fair value, let alone to protect themselves from deceptive and abusive solicitation activities.[8] And yet, the Commission fails to give any serious consideration to how these investors would be affected by its proposal or whether an alternate approach could better achieve the Commission's goals by promoting capital formation without sacrificing investor protection.

We therefore urge the Commission to withdraw this radical, one-sided, anti-investor proposal. If it determines, based on concrete evidence, that regulatory action is warranted, it should start from scratch on formal rulemaking to develop an appropriately tailored regulatory regime for finders, with robust input from all interested parties, and guided by the fundamental understanding that healthy, sustainable capital formation will not be fostered unless investors and issuers alike are appropriately protected from unscrupulous operators.

1) The premise of the proposal is unsound.

The Commission appears to take for granted in this proposal that any activity that promotes capital raising by private issuers will necessarily promote sustainable, job creating capital formation. We have discussed in earlier comment letters why this is an unfounded assumption.[9] As former SEC Commissioner Luis Aguilar put it, "Capital formation is much more than just capital raising. By itself, selling a bond or a share of stock doesn't add a thing to the real economy, no matter how quickly or cheaply you do it. True capital formation requires that the capital raised be invested in productive assets – like a factory, store, or new technology – or otherwise used to make a business more productive. The more productive those assets are, the greater the capital formation from the investment – and, importantly, the more jobs created."[10]

In selling the purported benefits of this proposal, it is therefore not enough to repeat statistics about the number of jobs small businesses create, as the Commission does here, without also taking into account conflicting data. As John Haltiwanger, Ron S. Jarmin, and Javier Miranda wrote in a 2013 article in the Massachusetts Institute of Technology (MIT) journal, Review of Economics and Statistics, the "perception … that small businesses create the most private sector jobs," while "popular among politicians of different political persuasions, small business advocates, and the business press," is based on evidence that suffers from "statistical and measurement pitfalls."[11] One of the most common of these pitfalls is a tendency to focus on gross job creation, while ignoring small companies' role in job destruction. To get a more accurate picture of small companies' role in job creation, it is important to look not just at gross job creation, but also at staying power, or net job creation over time. As a CRS study found,

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[8] *See, e.g.,* Jean Eaglesham and Coulter Jones, Firms With Troubled Brokers Are Often Behind Sales of Private Stakes, Wall Street Journal (Jun. 24, 2018), https://on.wsj.com/2Mnkf81; Eaglesham and Jones, Regulators Step Up Scrutiny of Sales of Private Stakes, Wall Street Journal (Jul. 2, 2018), https://on.wsj.com/2n8uLIg. Eaglesham and Jones, A Private-Market Deal Gone Bad: Sketchy Brokers, Bilked Seniors and a Cosmetologist, Wall Street Journal (May 7, 2018), https://on.wsj.com/2lEZ34Y.

[9] *See, e.g.,* Barbara Roper and Micah Hauptman, Comment Letter Regarding the Concept Release on Harmonization of Securities Offering Exemptions (Oct. 1, 2019) at 60-64, https://consumerfed.org/wp-content/uploads/2019/10/CFA-Private-Offering-Comment-Letter-10.1.19.pdf.

[10] SEC Commissioner Luis Aguilar, "Capital Formation from the Investor's Perspective" (Dec. 3, 2012), http://bit.ly/2lB97MF.

[11] John Haltiwanger, Ron Jarmin, and Javier Miranda, Who Creates Jobs? Small Versus Large Versus Young, The Review of Economics and Statistics, Vol. XCV, No. 2 (May 2013), http://bit.ly/2mIqR8P.

business startups "have a more limited effect on net job creation over time because fewer than half of all startups are still in business after five years."[12] While access to capital may play a role in some such cases, these companies' high failure rates cannot be attributed to lack of access to capital alone.

In weighing the likely benefits of this proposal, the key question for the Commission to consider, then, is whether finders will be effective in directing financing to companies with staying power – those that will be able to use that financing effectively to grow and prosper and create jobs over the long term. Or will they undermine capital formation by steering money toward companies with no real prospects for success – companies, for example, that failed to attract financing from more sophisticated investors for very good reasons, such as a fundamental flaw in the business plan, poor prospects for profitability, or the existence of a competitor with a better product? This question is particularly pertinent to capital raising through exempt offerings, where the absence of detailed and reliable disclosures increases the risk that capital will not be put to its best uses. If finders are ineffective in steering capital to those companies with the best potential to put that funding to good use, or worse, if they are detrimental because they steer capital to companies that are destined to fail, the proposal is likely to exacerbate the churn and burn of job creation and destruction all too common among small companies, and not promote the healthy capital formation the Commission purportedly seeks to advance.

And yet, the Commission ignores that question entirely in this Release. For example, the Commission has made no effort to analyze the experience of private issuers that are most likely to rely on finders to attract investors. If it were genuinely interested in weighing the likely effect of this proposal, the Commission could, and should, have analyzed information about companies that have in recent years relied on finders in order to determine what the distinctive characteristics of such companies are, how successful those efforts are in raising capital, what factors determine their success or failure, whether the issuers go on to grow and prosper, and how successful those investments end up being for the investors who are identified through finders. Such an analysis would permit the Commission to tailor its proposed approach to maximize its potential benefits, something it has failed to do here. Without that information, the Commission has no reasonable basis to conclude its proposal will be effective in promoting healthy capital formation.

The Commission cannot reasonably advance this proposal without considering more carefully than it has here the validity of its underlying assumptions regarding the beneficial impact of this exemptive order. In making that assessment, the Commission must acknowledge that the less it does to curb fraudulent activities by finders, the less likely its regulatory approach is to promote sustainable capital formation.

2) **The stated intent of the proposed safe harbor to clarify existing policy with regard to finders is misleading.**

The Commission maintains that the exemptive order is needed "to provide clarity with respect to the ability of a Finder to engage in certain activities without being required to register

[12] Robert Jay Dilger, Small Business Administration and Job Creation, CRS Report, Updated September 11, 2019, http://bit.ly/2lOq06v. (The study adds that "Larger startups, and startups that survive past the five year threshold, tend to have a positive effect on net job growth in part due to young firms growing faster than their mature counterparts.")

as a broker under Section 15(a).” Toward that end, the exemptive order proposes to create a safe harbor for two different classes of private market intermediaries: Tier 1 Finders, who limit their activities to those traditionally associated with finders (e.g., providing issuers with contact information for potential investors); and Tier 2 Finders, private market intermediaries who would be permitted to engage in a wide array of solicitation activities beyond acting as a mere finder, including contacting potential investors on behalf of an issuer, distributing offering materials and discussing those materials with investors, and participating in meetings between the issuer and investors.[13] Both would be permitted to receive transaction-based compensation.

If the proposed exemptive order were limited to the provisions applicable to Tier 1 Finders, it would be reasonably accurate to characterize it as a clarification of Commission policy. Because Tier 1 Finders would be limited to participating in a single transaction per 12-month period, the proposed safe harbor for Tier 1 Finders would not be available to those who are “in the business” of “effecting transactions.” Importantly, by limiting Tier 1 Finders to providing issuers with contact information for potential investors, and prohibiting them from communicating with investors on the issuer’s behalf, the proposal would not permit Tier 1 Finders to engage in the kind of solicitation activities that have long been considered markers of brokerage activity.[14] We are not certain to what extent this aspect of the proposal is actually needed to clarify the existing Commission policy regarding permitted activities of unregistered finders, but it does at least appear to be generally consistent with the Commission’s prior no-action relief.[15] As such, we do not oppose its adoption.

When it comes to the proposed safe harbor for Tier 2 Finders, however, the proposal is designed, not to clarify what is permitted, but to dramatically expand the ability of individuals to engage in a broad array of brokerage activities, in return for transaction-based compensation, without having to comply with registration and other regulatory requirements appropriate to that role. Unlike Tier 1 Finders, Tier 2 Finders would not be limited to participating in a single transaction in a 12-month period, so the safe harbor for Tier 2 Finders would be available to those who are “in the business.” Furthermore, these Tier 2 Finders would be permitted to actively solicit or recruit investors, participate in negotiations between the issuer and the investor, and discuss the merits of the investment – all long recognized as markers of brokerage activity – without being subject to any regulatory oversight. As Commissioner Allison Herren Lee pointed out in her statement of dissent, “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

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[13] Statement of Commissioner Lee.

[14] Release at 12. (“Over the years, the courts and the Commission have identified certain activities as indicators of broker status, including: (1) actively soliciting or recruiting investors; (2) participating in negotiations between the issuer and the investor; (3) advising investors as to the merits of an investment or opining on its merits; (4) handling customer funds and securities; (5) having a history of selling securities of other issuers; and (6) receiving commissions, transaction-based compensation or payment other than a salary for selling the investments. This is not an exhaustive list of the relevant factors, and no one factor is dispositive.”)

[15] Statement of Commissioner Lee (“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.”)

investment.'"[16] As we discuss further below, however, the Commission will have no means of determining compliance with even this most minimal of restrictions.

In the past, the Commission has taken the position that the combination of such activities – indeed, activities far less extensive than those permitted under the proposed exemption – with the receipt of transaction-based compensation would give the finder a "salesman's stake" in the potential transaction that warrants registration and application of investor protection rules.[17] It is therefore misleading to characterize this as a mere clarification of the activities these individuals would be permitted to engage in without registration. Furthermore, the Commission offers no justification or evidence to support its decision to reverse that past interpretation here. In place of evidence, it offers unsupported statements of belief that the proposed conditions are sufficient to address investor protection concerns. They are not.

Ironically, the Release does not even deliver the promised clarity. It explicitly states that the exemptive order is designed to clarify that finders are *permitted* to engage in certain activities without being required to register as a broker. But, as the Release makes clear, it does not follow that any activities not specifically identified in the Release are *prohibited*. As the Release explains, "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." Instead, whether a particular activity would require registration would depend on the facts and circumstances of the situation, consistent with how questions under Section 15(a) have previously been evaluated. As a result, as Commissioner Caroline Crenshaw indicated in her statement, significant uncertainties are likely to remain. In that uncertain environment, issuers and finders who want to test the limits of the Commission's tolerance will continue to do so, with potentially harmful consequences for issuers and investors alike.

3) The conditions proposed by the Commission are inadequate to protect investors or issuers from unscrupulous finders.

If the Commission believes small company capital formation could benefit from expanding the role that finders can play as private market intermediaries, it has an obligation to

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[16] Statement of Commissioner Lee. (To illustrate just how insubstantial this proposed limitation really is, Commissioner Lee went on to describe a hypothetical scenario 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.'")

[17] *See,* Statement of Commissioner Lee, footnote 9, citing 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,* Brumberg, Mackey & Wall, PLC, SEC Denial of No-Action Request (May 17, 2010), https://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf. ("The Staff believes that the introduction to EMPS of only those persons with a potential interest in investing in EMPS's securities implies that BMW anticipates both 'pre-screening' potential investors to determine their eligibility to purchase the securities, and 'pre-selling' EMPS's securities to gauge the investors' interest. Moreover, the Staff believes that the receipt of compensation directly tied to successful investments in EMPS's securities by investors introduced to EMPS by BMW (i.e., transaction-based compensation) would give BMW a 'salesman's stake' in the proposed transactions and would create heightened incentive for BMW to engage in sales efforts. Accordingly, the Staff believes that your proposed activities would require broker-dealer registration.")

propose a regulatory framework for those activities that is appropriate to that expanded role. It has failed to do so here. That failure takes two forms: 1) it has failed to impose adequate restrictions as a condition of the safe harbor, particularly with regard to the activities of Tier 2 Finders, and 2) it has failed to take any meaningful steps to ensure compliance with the restrictions it does impose, let alone with antifraud provisions or other investor protection measures that would also apply. For there to be any hope that the proposal will have a positive, rather than negative, impact on sustainable small company capital formation, both of these fundamental failings need to be addressed.

A. The conditions of the safe harbor are inadequate.

In providing a broad safe harbor permitting finders and private market intermediaries to avoid registration, the Commission imposes conditions which it suggests are adequate to target the relief to small issuers raising small amounts of capital through exempt offerings, to prevent bad actors from relying on the exemptive order, to prevent general solicitation by finders, to limit sales to accredited investors only, and, for Tier 2 Finders, to ensure that investors are aware of the capacity in which the individual is operating and any associated conflicts of interest. Separately, it suggests that the exemptive order has the potential to "help bridge gaps between traditionally underrepresented founders, such as women and minorities, and VC and start-up capital." For a variety of reasons, the conditions it imposes are inadequate to achieve any of these goals, not least because it has provided no mechanism to ensure compliance with the safe harbor's conditions, as we discuss further below.

1. The conditions do not limit reliance on the safe harbor to the small companies or underrepresented founders the Commission identifies as most in need of the relief.

The Commission proposes to limit the safe harbor to non-reporting companies raising funds through an exempt offering, and suggests that this will help to ensure that both smaller companies and underrepresented founders, such as women and minorities, will benefit. However, as the Commission is aware, non-reporting companies raising money through an exempt offering include a significant and growing number of large companies. Moreover, as Commissioner Crenshaw noted in her statement, the safe harbor "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, outside of the broker-dealer regulatory regime." In other words, the Commission has failed to propose any restrictions that could be effective at targeting the relief to the companies that the Commission suggests are most in need of relief.

Similarly, the Commission fails to provide a shred of supporting evidence for its claim that the proposal would benefit women- and minority-owned businesses that struggle to raise capital. Commissioner Lee identified the fundamental fallacy behind this claim when she noted that the Release "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." If the Commission were serious about benefitting women- and minority-owned businesses, it would seek to determine what particular barriers to success they face when raising capital and tailor the

safe harbor accordingly. If the Commission were able to present a credible plan for benefitting these businesses, that would be a strong argument in favor of action. But it is the worst sort of cynicism to claim such benefits without making any effort either to target the proposed relief or even to verify the validity of that claim.

If the Commission believes smaller companies and those with women and minority founders are in need of this relief, and if it has evidence that they would benefit from that relief without putting investors at undue risk, it should, at the very least, tailor its exemption appropriately to meet the needs of such companies. It can't credibly claim any such benefits based on the evidence, or lack thereof, presented here.

2. The exemptive order's conditions are not adequate to prevent bad actors from relying on the safe harbor.

Individuals who are subject to a statutory disqualification would not be permitted to serve as either Tier 1 or Tier 2 Finders. While this provision is appropriate as far as it goes, it is unlikely to be effective in preventing bad actors from acting as finders. First, only the most serious of securities law violations result in a statutory disqualification. An individual with a history of abusive conduct and law violations could still qualify to rely on the safe harbor if, for example, those violations don't rise to the level necessary to trigger a statutory disqualification or don't involve violations of the securities laws. Second, those with a history of law breaking are unlikely to voluntarily abide by the restriction, and the exemptive order doesn't include any regulatory requirements sufficient to limit such individuals' participation or any enforcement provisions sufficient to ensure compliance. As such, there is every reason to believe that unscrupulous actors will continue to operate as unregistered finders, and unsophisticated issuers and investors will remain at risk as a result. With fraud already an increased risk in private securities sales, it is irresponsible for the Commission to move forward with this exemptive order without, at a bare minimum, doing more to reduce the risk that the safe harbor will be relied on by unscrupulous operators.

3. The conditions are not sufficient to prevent general solicitation in offerings that rely on the exemptive order's safe harbor.

The proposed exemptive order would prohibit Tier 2 Finders from engaging in general solicitation on behalf of the issuer. However, there are several reasons why this condition is unlikely to be effective in restricting the activities of Tier 2 Finders. First, the Commission has recently adopted rule changes that exempt demo days from the prohibition on general solicitation, with minimal and ineffective safeguards, despite the fact that demo days clearly constitute general solicitation. Thus, Tier 2 Finders would presumably be free to participate in demo days without violating the terms of the rule. The recent rule change allowing private issuers to engage in testing the waters communications presents similar concerns. Without any regulatory supervision in place, the Commission will have no way of knowing whether Tier 2 Finders who participate in such communications knowingly or unknowingly cross the line into communications that constitute general solicitation. In short, the continued expansion of the marketing issuers are permitted to engage in to promote supposedly "private" offerings, troubling in its own right, poses particular risks when unlicensed, unregistered, and unsupervised finders are also permitted to take part.

Furthermore, although the Release provides too little detail to make this entirely clear, the exemptive order would appear to allow finders to engage in general solicitation to compile their lists of potential investors, as long as they don't engage in general solicitation on behalf of a particular issuer. Thus, a Tier 2 Finder would presumably be permitted to engage in general solicitation in which they promise to match up investors with unspecified "exciting," "exclusive" investment opportunities in order to identify a pool of potential investors and establish a "substantive relationship." They could then turn around and separately solicit those who respond on behalf of the issuer for whom they are acting as a Tier 2 Finder, using methods allowed under the safe harbor. If this would not be permitted under the safe harbor, the Commission needs to clarify that here. Otherwise, the prohibition on general solicitation will be just one more example of form over substance in this proposal.

4. The conditions of the safe harbor are not sufficient to prevent sales to non-accredited investors.

Under the proposed exemptive order, Tier 1 and Tier 2 Finders would be required to have a "reasonable belief" that the potential investors identified by the finder are accredited investors. The Release provides no clarification regarding what is required as the basis for that reasonable belief, other than to suggest that, "Finders can look to the methods that other market participants currently use to establish a reasonable belief regarding an accredited investor's status in other contexts." This approach is insufficient for several reasons.

First, as Commissioner Lee explained in her dissent to the recently finalized rule expanding private offering exemptions, the verification requirements for Rule 506(b) "potentially permit [issuers] to rely on no more than self-certification by investors."[18] As we have discussed elsewhere, many investors are unlikely to know whether they satisfy the accredited investor definition. For investors whose qualification as an accredited investor relies on their net worth, their accredited investor status may fluctuate with changes in the market. And some investors may provide inaccurate self-certifications in order to circumvent legal restrictions. By citing current market practices as adequate to satisfy the "reasonable belief" standard, the Commission implies that the same inadequate reliance on self-certification is likely to be permissible for finders who rely on this safe harbor.

And yet, the Commission has no knowledge of whether self-certification and other common verification methods are effective in limiting sales to accredited investors. Indeed, even as it acted recently to relax the verification requirements for Rule 506(c) offerings, the Commission failed to undertake any efforts to determine these methods' effectiveness. Without conducting such an analysis, the Commission has no way of knowing, and thus no reasonable basis for concluding, that these methods are effective in preventing sales to non-accredited investors.

Even if the Commission were to determine that these verification methods are generally effective when relied on by issuers, it would not automatically follow that they would be effective when relied on by unlicensed, unregistered individuals engaged in unsupervised solicitation activities. Will such individuals have a sophisticated understanding of the accredited

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[18] Commissioner Allison Herren Lee, Statement on Amendments to the Exempt Offering Framework (Nov. 2, 2020), https://www.sec.gov/news/public-statement/lee-harmonization-2020-11-02.

investor definition and the requirements for verification? With their compensation dependent on making the sale, will they have an incentive to comply? After all, the rule provides little if any accountability for finders who are not rigorous in their verification practices, and it includes no enforcement requirements designed to detect or deter violations. The lack of regulatory oversight for finders is exacerbated by the over-arching lack of effective regulatory oversight of private offerings, ensuring that any violations of this requirement will rarely if ever be identified before the harm is done, if they are identified at all.

5. Even if the conditions were sufficient to limit sales to accredited investors, this limitation would not be a sufficient justification for the exemptive order's lack of meaningful regulatory protections.

The Release states that 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." But, as the Commission well knows, the accredited investor definition as it pertains to natural persons provides no such assurance of financial sophistication. It is based instead on financial thresholds that are supposed to reflect an individual's ability to withstand financial risks. In fact, as research has shown, a significant percentage of individual accredited investors cannot pass a basic financial literacy test. Fewer still have the high level of financial sophistication necessary to fend for themselves without the protections afforded in the public markets.[19]

Furthermore, as a result of the eroding value of the definition's financial thresholds, an increasing percentage of accredited investors can ill afford to weather the potential losses associated with private offerings. These include many older investors who rely on their investments for retirement income and would be unable to replace that income if they suffered financial losses. The lack of meaningful protections is, therefore, of particular concern when the investments in question are in the riskiest of small private companies – those that have been unable to attract more sophisticated backers and must rely on finders to raise capital.

As Commissioner Lee noted in her statement, the failure to incorporate even the most basic investor protection rules in the exemptive order is inconsistent with the Commission's recent argument that expanding the definition of accredited investor did not raise investor protection concerns because Regulation Best Interest (Reg BI) would still apply.[20] She called out

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[19] *See, e.g.,* FINRA Investor Education Foundation, Investors in the United States, A Report of the National Financial Capability Study (Dec. 2019) at 25, https://www.usfinancialcapability.org/downloads/NFCS_2018_Inv_Survey_Full_Report.pdf (Among those with portfolio values of $50,000 and above, the average score on a 10-question test of investor knowledge was 4.8 for those with a portfolio value of $50,000 to $250,000 and 5.3 for those with a portfolio value of over $250,000); *See, also,* Recommendation of the SEC Investment Advisory Committee, Accredited Investor Definition, adopted Oct. 9, 2014, https://bit.ly/22HoUHw. (FN 4 states: "For example, high income individuals got an average score of 3.42 on the FINRA Investor Education Foundation's 2009 National Survey of Financial Capability in the United States, which uses a 5-point scale, compared with an overall average of 2.72. However, the survey tests knowledge of such basic concepts as the effect of inflation, compound interest, diversification, mortgages, and the correlation between interest rates and bond prices; it does not measure financial sophistication at a level relevant to this issue.").

[20] Statement of Commissioner Lee ("Less than two months ago, the Commission expanded the definition of accredited investor to include new categories of individuals. 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.")

the inconsistency in the Commission's policy, stating: "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." In fact, as Commissioner Lee noted, it is not just sales practice rules, such as Reg BI, that are missing; virtually none of the protections of the '33 Act or '34 Act would apply.

In short, the Commission has no reasonable basis for its belief that restricting sales to accredited investors will be sufficient to ensure that those investors have the financial sophistication necessary to fend for themselves without the protections afforded in the public markets. In light of that fact, its failure to include even the most minimal investor protections cannot be justified.

6. The disclosure requirement for Tier 2 Finders is completely inadequate.

In a proposal that would turn unlicensed and unregistered individuals loose to operate without supervision in the opaque and poorly supervised private markets, the only affirmative "investor protection" the Commission proposes to include is a disclosure requirement for Tier 2 Finders. These individuals would have to disclose to the potential investors they solicit that they are acting as agents of the issuer and are "not undertaking a role to act in the investor's best interest." Finders would also have to describe the nature of their relationship with the issuer, a description of the terms of their compensation arrangement, and any material conflicts of interest resulting from their arrangement or relationship with the issuer. Despite its claims to the contrary, the Commission has no basis to believe such disclosures would be effective in "direct[ing] an investor's attention to important information … in order to facilitate the investor's ability to evaluate the role of the Tier II Finder."

First, as the Commission well knows, many investors do not read disclosures. The Commission cannot base conclusions about the likely effectiveness of its regulatory approach on an assumption that they will. Second, as we have discussed at length in previous comment letters, even well designed disclosures are notoriously ineffective in providing investors with information they can use to understand the nature, extent, and implications of conflicts of interest.[21] And these are not well designed disclosures.

One key flaw is the method of "delivery" for these disclosures. Specifically, the exemptive order would permit the disclosures to be provided orally at the point of solicitation, as long as they are subsequently provided in writing by the time of the sale. But information of this nature cannot be effectively conveyed orally, and the Commission will have no way of verifying whether the oral disclosures were provided or whether the information provided orally was accurate and not misleading. Written disclosures that come at the point of sale are not only too late to influence the investor's decision, they are all too likely to get lost amidst other paperwork. As a result, the proposed approach to disclosure all but ensures that investors will not get this information in a usable form early enough in the process to give them adequate time to consider the information. Requiring an acknowledgement from the investor that they have received the

[21] *See, e.g.,* Letter from Barbara Roper and Micah Hauptman, Standard of Conduct for Investment Advisers and Broker-Dealers (Sep. 14, 2017), https://consumerfed.org/wp-content/uploads/2017/09/cfa-letter-to-sec-on-standard-of-conduct-rfi.pdf.

disclosure will do nothing to rectify that fundamental weakness in the disclosure requirement. On the contrary, it is more likely to be used against the investor, as proof that they were made aware of the risks, than it is to enable them to make an informed decision.

In light of decades of research calling into question the likely effectiveness of these disclosures, the Commission cannot reasonably move forward with this exemptive order without at least testing the proposed disclosures. That testing should be designed to determine whether the disclosures effectively convey the information that the finder is acting on behalf of the issuer, has a strong financial stake in promoting the transaction, is subject to no regulatory oversight, and has no legal obligation to the investor beyond an overarching obligation not to engage in fraud. Unless it can show that oral disclosure can adequately convey that information, the Commission should, at an absolute minimum, require the disclosures to be provided in writing at the first point of contact between the finder and the investor in which the finder engages in any solicitation activity on behalf of the issuer.

Unless and until it undertakes these additional steps, the Commission cannot reasonably assume that the proposed disclosures will enable investors to understand the nature of the finder's incentives or the limits of their legal obligations to the investor. As a result, the Commission cannot reasonably assume the proposed disclosures will enable investors to make an informed investment decision.

B. The proposal includes no mechanisms to detect or deter non-compliance.

Imposing requirements without providing any means to detect and deter violations of those requirements is an empty gesture, creating the appearance, but not the reality, of regulatory protections. The proposed exemptive order takes this problematic approach one step further. First, it fails to impose adequate regulatory requirements as conditions of the safe harbor, and then it fails to back even its meagre requirements with any meaningful incentive for compliance or mechanisms for accountability. As a result, the safe harbor will be subject to abuse, including in ways that harm issuers and investors alike. Thus, even if the Commission were to repair all the many shortcomings discussed above in the conditions of the safe harbor, it would not be enough to repair the fundamental flaws in the Commission's proposed approach. The Commission would still need to adopt an appropriately tailored regulatory regime to enforce those conditions.

1. The lack of any regulatory oversight renders the safe harbor's conditions moot.

In addition to outlining certain activities Tier 2 Finders would be permitted to engage in without registration, the safe harbor specifies a limited number of brokerage activities Tier 2 Finders would be prohibited from participating in. For example, it prohibits Tier 2 Finders from being involved in: structuring the transaction or negotiating the terms of the offering; handling customer funds or securities; participating in the preparation of any sales materials; performing any independent analysis of the sale; engaging in any due diligence activities; assisting or provide financing for such purchases; or providing advice as to the valuation or financial advisability of the investment. These limitations are appropriate, as far as they go.[22] And it is reasonable for the Commission to conclude that, in light of these limitations, it is not necessary

[22] However, as noted above, the Commission has intentionally left vague what additional activities not specified in the Release finders might be permitted to engage in without being required to register, depriving regulators of a bright line test of whether the exemptive order has been violated.

to impose the full range of regulatory requirements applicable to broker-dealers on Tier 2 Finders.

However, it does not follow that none of the basic tools of regulation or sales practice rules associated with broker-dealer regulation are warranted. As Commissioner Crenshaw stated, activities Tier 2 Finders would be permitted to engage in "include what regulators and courts have described as core broker conduct – actively soliciting and recruiting investors on behalf of issuers, and receiving commissions for doing so." Not only would finders not be required to register with the SEC or FINRA when they engage in these activities, they would not even 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," she warned.

We share Commissioner Crenshaw's concerns. If finders are not required to register, for example, there will be no easy method to prevent bad actors from relying on the safe harbor. Without a registration and inspection requirement, no one will be in a position to monitor their activities to determine whether they comply with the relevant restrictions, such as the prohibition on engaging in general solicitation or the requirement to provide timely disclosures. Without that deterrent, the risk of both unintentional and intentional violations increases dramatically. And because their compensation will depend on making the sale, finders will have a strong incentive to cross the line.

As Commissioner Lee noted in her statement, many of the Commission's past no-action letters have emphasized this precise 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." These basic regulatory tools are even more important in the context of private offerings, where regulatory oversight is minimal and the risks, including risks of fraud, are heightened.

The lack of a registration requirement is far from the only problem with the Commission's proposed approach. When problems do emerge in offerings assisted by Tier 2 Finders, as they inevitably will, the lack of any recordkeeping or inspection requirement will deprive regulators of the basic tools necessary to determine whether or how the rules have been violated. The lack of regular inspections will also deprive regulators of the ability to identify emerging trends, including early warning signs of problematic practices, or to monitor how the exemptive order is being utilized. If the Commission wishes to determine in the future whether the exemptive order has achieved its intended goal, or whether it has had unintended consequences, the lack of a recordkeeping requirement will deprive regulators of the data necessary to make that assessment.

In the Release, the Commission points to two main incentives for compliance, neither of which is remotely adequate to deter misconduct. First, finders who violate the conditions of the order may lose the right to rely on the safe harbor and may therefore have to register as brokers. But given the lack of clarity regarding what is prohibited, and the lack of any registration, inspection, or recordkeeping requirements, how does the Commission expect to determine that a finder has failed to comply with the conditions of the order, such that they would trigger the requirement to register as a broker? More often than not, we suspect the Commission will either

never be alerted to the violation, will learn of it only after millions in investor funds have been lost, or will be unable to document that a violation has occurred.

Second, although they are exempt from registration as brokers, finders would still be required to "comply with all other applicable laws, including the antifraud provisions of the Securities Act and the Exchange Act, such as the obligations under Section 10(b) and Rule 10b-5 under the Exchange Act, and state law." Here again, however, the lack of any enforcement mechanism or regulatory oversight ensures that this obligation will only come into play after a fraud has occurred, when it is too late to prevent the potentially devastating financial consequences for investors and issuers. And, here again, without any recordkeeping requirements, the burden on regulators to prove that a violation has occurred will be far greater than it should be. Finally, if this exemptive order is adopted, state regulators will undoubtedly come under immediate pressure to conform their state-level requirements to the SEC's non-regulatory approach, stripping investors and issuers of the few remaining regulatory protections.

The Commission therefore has no reasonable basis for concluding that these provisions will be sufficient to ensure compliance with the conditions of the exemptive order.

2. If the Commission believes regulatory action is warranted, it should adopt a streamlined regulatory approach appropriate to the role played by finders.

For all of the reasons outlined above, the Commission should withdraw the proposed exemptive order and start from scratch to address the issue. Before determining whether to move forward with a new, more balanced regulatory approach, the Commission should first seek to determine, based on evidence rather than speculation, whether an expanded role for private market intermediaries is warranted and what form any such role should take. If it determines that action is warranted, it should seek to structure its regulatory approach in a way that maximizes the likelihood that these private market intermediaries play a beneficial role in directing capital to small companies with reasonable prospects for success, rather than steering investors toward those companies that are most desperate to attract capital, regardless of their future prospects.

If the Commission determines, based on that analysis, that allowing finders to play an expanded role in our private markets would benefit healthy small company capital formation, the proper course would be to develop a streamlined regulatory regime that is tailored to the role these private market intermediaries play. In 2005, an ABA Task Force outlined a fairly detailed proposal for such a regulatory regime. While there is some overlap between the ABA proposal and the conditions outlined in the Commission's proposed exemptive order – such as a requirement to sell only to accredited investors, disqualification for bad actors, and required disclosures – the ABA Task Force proposed to back those requirements with a "simplified system for registration of private placement brokers (PPBs), that recognized their engagement in only very limited activities."[23]

Specifically, the Task Forced called for these PPBs to be required to register with the SEC and the state regulators, pass an examination and keep certain records, but not to have to

[23] Yadley, citing American Bar Association Section of Business Law, Committee on Small Business, Committee on Federal Regulation of Securities, Committee on Negotiated Acquisitions, Committee on State Regulation of Securities, Report and Recommendations of the Task Force on Private Placement Broker-Dealers (Jun. 20, 2005), https://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf.

meet other requirements of broker-dealer regulation not pertinent to their activities.[24] We agree these basic registration, licensing, recordkeeping, and inspection requirements are essential to ensure that any proposed limitations on and requirements for the private market intermediaries will be adhered to. Along these lines, the ABA Task Force emphasized the importance of enforcement, in order to "both enhance capital formation and protect investors." It noted that, as a practical matter, "while the SEC can lead the effort, the cooperation of FINRA and NASAA is critical to success." Finally, it identified a number of other issues the Commission should consider in adopting such an approach, including possibly limiting the size of any transactions PPBs would be permitted to participate in. These issues, along with any special conditions designed to benefit minority- and women-owned businesses, would be a good place for the Commission to start in designing a more robust regulatory approach, should it determine that an expanded role for finders is warranted.

It is not just investors who would benefit from such a regulatory approach. As attorney Spencer G. Feldman wrote in a recent article, posted on the Harvard Law School Forum on Corporate Governance, "a registration process would make it possible for small businesses to locate registered finders, review their regulatory and disciplinary histories and ascertain their experience." In contrast, under the Commission's proposed approach, any individual could hold himself out as a finder, and there would be "no central registry of registered finders similar to FINRA's BrokerCheck program and no verified historical records that might reveal a pattern of questionable dealings by an unscrupulous finder." He noted that "competent finders" might also prefer to "be sure of their status by being registered, instead of operating in the present gray market."

Given the broad-based support that a tailored regulatory regime has garnered, it is frankly incomprehensible why the Commission has chosen to ignore that consensus in favor of the unbalanced, radically deregulatory approach presented here.

4) **Using an exemptive order, rather than formal rulemaking, to adopt such a sweeping regulatory change is a gross abuse of process.**

Finally, we strongly oppose the Commission's decision to proceed with the proposed policy change through an exemptive order. As we have noted above, it is misleading to characterize the proposed exemptive order as "clarifying" the activities finders are permitted to engage in without having to register as broker-dealers. In reality, at least with regard to Tier 2 Finders, the proposal would dramatically expand the solicitation activities these private market intermediaries would be permitted to engage in, in return for transaction-based compensation, without having to register or otherwise be subject to regulatory oversight. As such, it is a gross abuse of process for the Commission to adopt this sweeping policy change through exemptive relief.

As Commissioner Lee noted in her statement, this constitutes "an end-run around the rulemaking process, 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." It also allows the Commission to avoid its obligation to consider reasonably available regulatory alternatives and provide an analysis of why it has selected the proposed

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[24] *Id.*

approach. In light of the broad support for a tailored regulatory regime, the latter would be an impossible bar for this proposal to clear. Finally, as Commissioner Lee explained, 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." We strongly agree.

Accordingly, the Commission cannot reasonably move forward with this proposal to expand the activities unregistered finders can engage in through the rushed and opaque process of an exemptive order.

Conclusion

The stated goal of this exemptive order is to better enable finders to bridge "the gap between small businesses that need capital and investors who are interested in supporting emerging enterprises." In particular, the Commission offers this proposal as an answer to the challenges small businesses can encounter connecting with investors in the exempt market, "particularly in regions that lack robust capital raising networks" and particularly when "the amount sought (e.g., less than $5 million) is below a level that would attract venture capital or a registered broker-dealer, but beyond the levels that can be provided by friends and family and personal financing."

We are frankly skeptical of the need for this proposal. Certainly, the Commission provides no evidence that "investors who are interested in supporting emerging enterprises" face any challenges in identifying potential opportunities under the existing rules. Meanwhile, private markets are already awash in money and exemptions exist to enable issuers of every size and stage of development to raise capital from both institutional investors and members of the general public. In light of that fact, the Commission has an obligation to consider, more carefully than it has here, whether these companies' struggles to raise capital relate to shortcomings in our market mechanisms that can be addressed through an expanded role for private market intermediaries or whether they simply reflect a lack of widespread investor interest in investing in companies that present such out-sized risks.

We are even more skeptical that the effect of this proposal would be beneficial, either for investors or for issuers. As the Commission knows, but refuses to address, accredited investors eligible to invest in these offerings often lack both the financial sophistication to protect their own interests and the wealth to withstand potential losses. It has failed to take adequate steps to insure that they are protected if finders are given an expanded role. But the Commission also fails to provide compelling evidence that its proposal would support healthy, sustainable small company capital formation. It is particularly troubling, given the high failure rate among smaller companies, that the Commission has made no effort to ascertain whether finders can be expected to play a useful role in steering investors toward companies with better prospects for success or whether their incentives and lack of legal obligations to the investor are more likely to make them indifferent to the company's future prospects and intent only on making a sale.

In light of these fundamental shortcomings in the Commission's analysis, it would be irresponsible to move forward with this proposal in its current form. If the Commission determines, based on evidence and analysis, that an expanded role for private market intermediaries is warranted, it should work with FINRA and state securities regulators to adopt a

streamlined regulatory approach tailored to fit the limited functions these intermediaries perform. And it should both structure its proposed regulatory approach in a way that would target the specific problem it is trying to address and include mechanisms to ensure compliance, thus maximizing the potential benefits and minimizing the potential risks.

Changes of that magnitude cannot be adopted through an exemptive order, with limited time for public input, and without adequate analysis of the proposal's impact. Rather, such an approach would require the Commission to engage in a fully transparent rulemaking process, with ample opportunity for input from all interested parties. That rulemaking process would need to include a robust economic analysis that takes into account, not only the potential impact on capital formation, but also the implications of the Commission's chosen approach for investor protection and competitiveness. The good news is that such an approach, if well designed to promote both healthy capital formation and investor protection, could likely win broad-based support.

Respectfully submitted,

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