

# BACKGROUND

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## Let Entrepreneurs Raise Capital Using Finders and Private Placement Brokers

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### Abstract

*A finder or private placement broker is a person who is paid to assist small businesses to find capital by making introductions to investors. Finders are particularly important to Main Street small business people who do not have access to many highly affluent “accredited investors.” In 2000, the Securities and Exchange Commission created a regulatory cloud surrounding finders and issuers that use finders. It is time to clarify the regulatory status of finders. Legislation to provide a safe harbor for finders and a reasonable regulatory regime for more active private placement brokers would have a positive impact on the ability of Main Street entrepreneurs to raise capital.*

A “finder” is a person who is paid to assist small businesses to find capital from time to time by making introductions to investors—either as an ancillary activity to some other business (e.g., the practice of law, public accounting, insurance brokerage, etc.); as a Main Street business colleague or acquaintance (Main Street business in this report refers to a privately held, non-financial business); or as a friend or family member of the business owner. They are sometimes called private placement brokers,<sup>1</sup> although this term is probably best used to describe people that are in the business of making introductions between investors and businesses. They are typically paid a small percentage of the amount of capital that they helped the business owner to raise.

Finders play an important role in introducing entrepreneurs to potential investors, thus helping them to raise the capital necessary to launch or grow their businesses.<sup>2</sup> For regulatory purposes, neither finders nor private placement brokers should be treated the same as Wall Street investment banks (e.g., a large registered broker-dealer).

### KEY POINTS

- A “finder” is a person who is paid to assist small businesses to find capital by making introductions to investors, either as an ancillary activity to some other business, as a Main Street business colleague or acquaintance, or as a friend or family member of the business owner.
- Finders play an important role in introducing entrepreneurs to potential investors, thus helping them to raise the capital necessary to launch or grow their businesses.
- It is time to clarify the regulatory status of finders. Legislation to provide a safe harbor for finders and a reasonable regulatory regime for private placement brokers would have a positive impact on the ability of Main Street entrepreneurs to raise capital.
- The Unlocking Capital for Small Businesses Act would provide a reasonable, scaled regulatory regime for finders and private placement brokers that would improve the ability of small firms in less affluent communities to raise capital.

This paper, in its entirety, can be found at <http://report.heritage.org/bg3328>

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## Broker–Dealer Registration

Section 15 of the Securities Exchange Act makes it unlawful for a broker or a dealer to effect a securities transaction without being registered with the Securities and Exchange Commission (SEC).<sup>3</sup> Although the definition of broker and dealer goes on for an absurd 2,300 words, the core of the broker–dealer concept is to be “engaged in the business” of “effecting transactions in securities for the account of others.”<sup>4</sup> The current SEC position on who should be required to register as a broker–dealer is overbroad and significantly exceeds the scope of the statutory registration requirement. The SEC’s *Guide to Broker–Dealer Registration* illustrates this point.<sup>5</sup>

The *Guide* suggests that those “finding investors,” “making referrals,” “finding buyers and sellers of businesses,” or participating “in important parts of a securities transaction” “may need to register” as brokers. This is significantly beyond the scope of the statutory definition of a broker, to wit, “any person engaged in the business of effecting transactions in securities for the account of others.”<sup>6</sup>

The current SEC criteria are so broad that just about anybody involved in the transaction would, in principle, be required to register as a broker–dealer. The issuer’s accountant and attorney, after all, play an “important part” in a securities transaction. Presumably, so too

might a finder or business broker.<sup>7</sup> But the “important part” standard has no basis in the statute. Merely “making referrals” or “finding investors” is not what Congress had in mind when it enacted the Securities Exchange Act—and it is not in keeping with the plain meaning of the statute. Making introductions and finding investors does not constitute *effecting securities transactions*.

It is also the case (contrary to what the SEC currently claims) that the current SEC position is a relatively recent innovation, dating, most notably, from the withdrawal of the 1985 *Dominion Resources* no-action letter in 2000.<sup>8</sup> For the previous six-and-a-half decades, the SEC position was substantially different than the position it has adopted in this century.

The inconsistency of the current SEC position with both the underlying statute and previous SEC practice combined with the lack of clear regulatory standards have introduced significant regulatory uncertainty into the analysis of whether registration is required and what activities unregistered persons may engage in.

The SEC appears to believe that structuring compensation so that it is transaction-based will almost always result in the necessity of registration in the absence of some other specific statutory exemption (for example, those for banks in section 3 of the Securities Exchange Act). This is both an incorrect reading of the law<sup>9</sup> and bad public policy.

1. Particularly by those familiar with the work and proposals of the American Bar Association Task Force on Private Placement Broker-Dealers. See American Bar Association, “Report and Recommendations of the Task Force on Private Placement Broker-Dealers,” June 20, 2005, <http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf> (accessed June 27, 2018).
2. Gregory C. Yadley, “Notable by their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation,” presentation to the Advisory Committee on Small and Emerging Businesses, U.S. Securities and Exchange Commission, June 3, 2015, <http://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf> (accessed June 27, 2018).
3. Securities Exchange Act of 1934, 15 U.S. Code § 78o, <http://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20of%201934.pdf> (accessed June 27, 2018).
4. Securities Exchange Act, § 4(a)(4) defines “broker” and § 4(a)(5) defines “dealer.”
5. See “Who is a Broker?” in the *Guide to Broker–Dealer Registration*, Division of Trading and Markets, U.S. Securities and Exchange Commission, April 2008, <http://www.sec.gov/divisions/marketreg/bdguide.htm#II> (accessed June 27, 2018).
6. Securities Exchange Act, § 3(a)(4).
7. David R. Burton, “Don’t Overregulate Business Brokers,” Heritage Foundation *Background* No. 2883, February 19, 2014, <https://www.heritage.org/government-regulation/report/dont-overregulate-business-brokers>; Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2017, H.R. 477, 115th Cong., 1st Sess. (passed the House 426–0 on December 7, 2017); and U.S. Securities and Exchange Commission, “No Action Letter” to Faith Colish et al., February 4, 2014, <https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf> (accessed June 27, 2018).
8. See, e.g., the American Bar Association, “Report and Recommendations of the Task Force on Private Placement Broker-Dealers,” for a discussion of previous SEC practice. See also, e.g., John Polanin, Jr., “The ‘Finder’s’ Exception from Federal Broker-Dealer Registration,” *Catholic University Law Review*, Vol. 40, No. 4 (Summer 1991), pp. 787–827, <http://scholarship.law.edu/cgi/viewcontent.cgi?article=1758&context=lawreview> (accessed June 27, 2018).
9. Some courts have so found. See, for example, *SEC v. Kramer*, 778 F. Supp. 2d 1320 (M.D. Fla., 2011). Others have found that people claiming to be finders are actually unregistered broker–dealers. See, for example, *SEC v. Crawford*, 861 F.3d 760 (8th Cir., 2017). Given the uncertain state of the law and the varying factual situations, this is unsurprising.

There is absolutely no mention in the statutory definition of a broker or a dealer of the type of compensation involved. The primary focus of the law is whether the person is “engaged in the business” of “effecting transactions in securities” for the account of others.<sup>10</sup> Ergo, the focus on transaction-based compensation is an unwarranted regulatory creation of the SEC.

SEC staff analysis appears to center on concerns about “conflict of interest.”<sup>11</sup> But in the context of small businesses trying to raise capital, success-based compensation usually creates a commonality of interest between the finder or private placement broker and his or her principal rather than a conflict of interest. With success fee compensation, the finder has the same interest as the small business principal—finding capital. With other forms of compensation, the finder or private placement broker simply has an interest in getting paid (whether or not he or she actually performed a service of value to the paying business).

Real estate brokers, commodities brokers, or insurance brokers raise substantially the same issue. As long as it is made clear for whom the broker works (i.e., it is not a case of dual agency),<sup>12</sup> these industries and their regulators do not regard transaction-based compensation as giving rise to a conflict of interest or as otherwise suspect. A finder representing a seller does not have a fiduciary duty to the buyer. They have a duty of fair and honest dealing, as does the issuer, imposed by other provisions in the securities law<sup>13</sup> and, for that matter, the common law and a host of state statutes. But that constraint creates no conflict of interest.

As a matter of public policy, success-based compensation is generally preferable to other forms of compensation in the context of small firms. Allowing small business owners to pay a finder’s fee or private placement brokerage fee to someone who actually did what he said he would do and brought capital to a business is one thing; forcing business owners into having to pay finders whether or not they were successful is another. If the aim of regulation is to prevent misrepresentation, fraud, and false dealing, it is preferable to pay people for actually doing what they promise rather than forcing business owners into the quandary of guessing whether the person will deliver. Moreover, capital-starved small businesses are not generally in a position to pay high-priced consultants who do not deliver. If, in contrast, the capital is raised, then the small business will have the means to pay.

The effort to channel these activities into either registered broker–dealers (with their attendant large fees) or consultants, who bill on some basis other than actual success, benefits large issuers and broker–dealers but harms small businesses seeking to grow. Wall Street is tolerant of large regulatory costs because it creates a major barrier to entry and forces those seeking capital to engage heavily regulated Wall Street firms.

## Finders

Finders can reduce the cost of raising capital and increase the likelihood of raising needed capital, particularly for entrepreneurs who have a limited number of pre-existing relationships with affluent accredited investors.<sup>14</sup> Under Regulation D, accredited investors must have an income of \$200,000 annually

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10. Securities Exchange Act, § 3(a)(4). See also Jeffrey D. Chadwick, “Finders Sleepers: Why Recent State Regulation of Financial Intermediaries Should Rouse the Federal Government from Its Slumber,” *Richmond Journal of Law and the Public Interest*, Vol. 12, No. 1 (November, 2008), <http://www.williamsmullen.com/sites/default/files/wm-url-files/Chadwick%20-%20Finders%20Sleepers.pdf> (accessed June 27, 2018).

11. “The SEC and SEC staff have long viewed receipt of transaction-based compensation is 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.” David W. Blass, “A Few Observations in the Private Fund Space,” presentation before the Trading and Markets Subcommittee, American Bar Association, April 5, 2013, <https://www.sec.gov/news/speech/2013-spch040513dwg.htm> (accessed June 27, 2018).

12. Dual agency is when a broker represents both parties to a transaction and, often, accepts compensation from both parties. In this case, there is a clear conflict of interest because the broker is representing opposite parties in the same transaction.

13. Most notably, § 10 of the Securities Exchange Act.

14. Title II of the JOBS Act (relating to general solicitation seeking accredited investors in Rule 506 offerings) may reduce the importance of finders in the intermediate and long term because entrepreneurs will be able to use the Internet and publications to seek accredited investors with whom they do not have a pre-existing relationship. In the real world, however, personal relationships (in this case of the finders) will always matter.

(\$300,000 joint) or a residence-exclusive net worth of \$1 million or more.<sup>15</sup> As the American Bar Association (ABA) Task Force on Private Placement Broker-Dealers has noted, “The activities of PPBDs (private placement broker-dealers) is of critical importance to the efforts of a vast number of small businesses, and without their assistance it is unlikely that a great percentage of such businesses would ever be successful in raising early stage funding.”<sup>16</sup> Finders are of particular importance to entrepreneurs who live in cities or states where relatively few people are affluent enough to qualify as accredited investors.

The SEC’s regulatory position impedes small firms’ ability to access needed capital both by restricting the availability of finders and by causing potential problems when successful small firms later seek venture capital or public financing and encounter counsel-raising questions about their prior use of finders.<sup>17</sup> The current SEC stance makes the market less efficient by increasing transaction costs considerably—and has a disproportionately adverse effect on small firms trying to raise small amounts of capital.

A business owner should be able to compensate people for helping him or her to find and raise capital. He should be able to offer, for example, a 2 percent finders’ fee to those that help him identify investors. In the real world, people respond to incentives, and being able to offer a financial reward will make people more willing to take the time and effort necessary to help small business owners find the capital that they need.

Whether it is intentional or not, the impact of the SEC’s current policy is to protect broker-dealers from competition and to force business owners to use broker-dealers—rather than finders—to find investors.

## A Legislative Solution

A statutory exemption is needed for small finders who are not “engaged in the business” of “effecting transactions in securities for the account of others” or of “buying and selling securities.” As an integral

component of that exemption, it is necessary to create a bright-line “small finder” safe harbor such that small finders are deemed not to be engaged in the business of being a securities broker or dealer. Such a bright-line safe harbor would eliminate much of the regulatory uncertainty associated with the use of finders.

For those “larger” finders that really are holding themselves out as in the business of being a “private placement broker,” something more akin to the ABA proposal to have finder registration and limited regulation of private placement brokers may make sense. Some states have pursued this approach, but so long as the SEC holds to its current position, these licensing regimes will be of limited utility except in the case of intrastate offerings.<sup>18</sup>

Specifically, an exemption should be created for finders from the section 15 registration requirement providing a safe harbor such that a finder is deemed not to be engaged in the business of “effecting transactions in securities for the account of others” if the finder meets one or more of the following criteria:

1. The finder does not receive finder’s fees exceeding a specified amount in any year;
2. The finder does not assist an issuer in raising more than a specified amount in any year;
3. The finder does not assist any combination of issuers in raising more than a specified amount in any year; or
4. The finder does not assist any combination of issuers with respect to more than a specified number of transactions in any year.

It would be reasonable to prohibit finders from engaging in certain activities to be eligible for this exemption on the grounds that such activities would constitute crossing the line to effecting transactions in securities or providing investment advice (thus

15. 17 Code of Federal Regulations § 230.501(a) (2016).

16. See, e.g., the American Bar Association, “Report and Recommendations of the Task Force on Private Placement Broker-Dealers.”

17. Many counsel or venture capital firms will demand that the issuer buy back or offer to rescind transactions involving a finder’s due to the SEC’s creation of regulatory uncertainty.

18. Michigan Department of Licensing and Regulatory Affairs, “Finders and Solicitors,” [http://www.michigan.gov/lara/0,4601,7-154-35299\\_61343\\_32915\\_59945\\_60133-269112--,00.html](http://www.michigan.gov/lara/0,4601,7-154-35299_61343_32915_59945_60133-269112--,00.html) (accessed June 27, 2018), and Texas Administrative Code, Title 7, Part 7, Ch. 115, § 115.11, “Finder Registration and Activities,” (2017), [http://txrules.elaws.us/rule/title7\\_chapter115\\_sec.115.11](http://txrules.elaws.us/rule/title7_chapter115_sec.115.11) (accessed June 27, 2018).

triggering investment advisory registration requirements). Among those proscribed activities would be:

1. Holding investor funds or securities;
2. Recommending the purchase of specific securities;<sup>19</sup> and
3. Participating materially in negotiations between the issuer and investors.

### Unlocking Capital for Small Businesses Act

Representative Ted Budd (R-NC) has introduced the Unlocking Capital for Small Businesses Act (H.R. 6127),<sup>20</sup> which would address the problems caused by the Securities and Exchange Commission and help Main Street businesses raise the capital that they need to launch and to grow. The legislation would provide for a scaled registration regime. It would provide clarity and reasonable rules in an area of the law that the SEC has allowed to remain in disarray for nearly two decades. The bill would exempt finders from registration, and private placement brokers would be more lightly regulated than broker-dealers. All anti-fraud laws would remain in place and apply to finders, private placement brokers, and broker-dealers.

Both finders and private placement brokers would be permitted to introduce issuers to prospective buyers.<sup>21</sup> Both would be prohibited from handling or taking possession of customer funds or securities and from engaging in any activity requiring registration as an investment adviser.<sup>22</sup> Private placement brokers would

be required to make various written disclosures to all parties to the transaction.<sup>23</sup> The legislation would provide that finders do not have to register as broker-dealers.<sup>24</sup> It would define a finder as a person that received transaction-based compensation: (1) of equal to or less than \$500,000 in any calendar year; (2) in connection with transactions that result in a single issuer selling securities valued at equal to or less than \$15 million in any calendar year; (3) in connection with transactions that result in any combination of issuers selling securities valued at equal to or less than \$30 million in any calendar year; or (4) in connection with fewer than 16 transactions that are not part of the same offering or are otherwise unrelated in any calendar year.<sup>25</sup>

Those that engage in activities beyond the scope of the finder safe harbor would be required to register as private placement brokers under a registration regime that would be substantially less burdensome than the broker-dealer registration regime.<sup>26</sup> Private placement brokers would be required to be members of a national securities association, which in practice means the Financial Industry Regulatory Authority.<sup>27</sup> Finders would not.<sup>28</sup>

The legislation provides that transactions cannot be voided simply because a finder or private placement broker was involved in the transaction<sup>29</sup> and ensures that state regulators may not impose a greater burden on finders or private placement brokers than does federal law.<sup>30</sup>

### Conclusion

In 2000, the SEC created a regulatory cloud surrounding finders and issuers that use finders. Find-

19. Analogous to personalized investment advice provisions in Advisers Act Rule 203A-3, 17 Code of Federal Regulations § 275.203A-3 (a)(3)(ii) (2011), <https://www.law.cornell.edu/cfr/text/17/275.203A-3> (accessed June 27, 2018).

20. Unlocking Capital for Small Business Act of 2018, H.R. 6127, 115th Cong., 2nd Sess., <https://www.congress.gov/bill/115th-congress/house-bill/6127> (accessed June 27, 2018).

21. Securities Exchange Act of 1934, proposed § 15(p)(4)(A)(i). Note: § 15 of the Securities Exchange Act is codified at 15 U.S. Code § 789(o).

22. Unlocking Capital for Small Business Act of 2018, H.R. 6127, 115th Cong., 2nd Sess., proposed § 15(p)(4)(B) of the Securities Exchange Act of 1934.

23. *Ibid.*, proposed § 15(p)(3) of the Securities Exchange Act of 1934.

24. *Ibid.*, proposed § 15(q)(1) of the Securities Exchange Act of 1934.

25. *Ibid.*, proposed § 15(q)(3) of the Securities Exchange Act of 1934.

26. *Ibid.*, proposed § 15(p)(1) of the Securities Exchange Act of 1934.

27. *Ibid.*, proposed § 15(p)(2) of the Securities Exchange Act of 1934.

28. *Ibid.*, proposed § 15(q)(2) of the Securities Exchange Act of 1934.

29. *Ibid.*, § 2(b).

30. *Ibid.*, § 3.

ers are particularly important to Main Street small business people who do not have access to many highly affluent “accredited investors.” It is time to clarify the regulatory status of finders. Legislation to provide a safe harbor for finders and a reasonable regulatory regime for private placement brokers would have a positive impact on the ability of Main Street entrepreneurs to raise capital. The Unlocking Capital for Small Businesses Act would provide a reasonable, scaled regulatory regime for finders and private placement brokers that would improve the ability of small firms in less affluent communities to raise capital.

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