HEALTHY MARKETS
TRANSPARENCY & TRUST

November 12, 2020

Via Electronic Mail
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-13-20; Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders[1]

Dear Ms. Countryman:

The Healthy Markets Association[2] objects to the above-referenced proposal to exempt brokers engaged in certain activities in private market securities from having to be registered as brokers.

As described more fully below, the Proposed Order is contrary to the text of the Securities Exchange Act of 1934, the Commission's mission, and the Commission's obligations under the Administrative Procedures Act.

We urge you to rescind the Proposed Order.

The Proposed Order

In just thirty-seven pages, the Proposed Order would revise significantly the longstanding protections afforded to investors and issuers arising from the Commission's and FINRA's broker-dealer registration and oversight regime.

Specifically, without a statutory directive and without engaging in a formal rulemaking, the Commission would -- by order -- create two classes of brokers that it would then exempt from registration as brokers: "Tier I Finders" and "Tier II Finders."

Tier I Finders could

> provid[e] contact information of potential investors in connection with only one capital raising transaction by a single issuer within a 12-month period, provided the Tier I Finder does not have any contact with the potential investors

[1] *Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders*, SEC, Exch. Act Rel. No. 34-90112, Oct. 7, 2020, *available at* https://www.sec.gov/rules/exorders/2020/34-90112.pdf.

[2] To learn about Healthy Markets or our members, please see our website at http://healthymarkets.org.

> about the issuer. The contact information may include, among other things, name, telephone number, e-mail address, and social media information.[3]

Tier II Finders could

> engage in solicitation-related activities on behalf of an issuer, that are limited to: (i) identifying, screening, and contacting potential investors; (ii) distributing issuer offering materials to investors; (iii) discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and (iv) arranging or participating in meetings with the issuer and investor[4]

Both Tier I Finders and Tier II Finders could rely on the new exemption only if

- The issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;
- The issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act;
- The Finder does not engage in general solicitation;
- The potential investor is an “accredited investor” as defined in Rule 501 of Regulation D or the Finder has a reasonable belief that the potential investor is an “accredited investor”;
- The Finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
- The Finder is not an associated person of a broker-dealer; and
- The Finder is not subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, at the time of his or her participation.[5]

Background

The Securities Exchange Act of 1934 demands registration of any broker, and defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[6] In addition to being subject to a number of Commission

[3] Proposed Order, at 22-23.
[4] Proposed Order, at 24.
[5] Proposed Order, at 18.
[6] Section 3(a)(4) of the Exchange Act.

rules, registration also carries with it an obligation to become a member of the Financial Industry Regulatory Authority ("FINRA") and subject to its rules.

The purpose for this broker-dealer registration and regulatory regime is to

> provide important safeguards to investors. Investors are assured that registered broker-dealers and their associated persons have the requisite professional training and that they must conduct their business according to regulatory standards. Registered broker-dealers are subject to a comprehensive regulatory scheme designed to ensure that customers are treated fairly, that they receive adequate disclosure and that the broker-dealer is financially capable of transacting business.[7]

More specifically, the broker-dealer regulatory regime provides, amongst other things, assurances that brokers (1) have basic levels of professional proficiency (i.e., they take and pass tests), (2) are subject to clear ethics and other rules of conduct, (3) are subject to reviews of communications and sales materials, to ensure their accuracy and fairness, (4) are required to comply with detailed customer data protection and information security protocols, and (5) are subject to oversight and enforcement actions by both the SEC and FINRA.

Nevertheless, over the years, the Commission staff[8] and Congress[9] have relaxed these requirements for those who engage in very limited private markets transactions. In 1991, for example, the Commission staff offered a no-action letter to a broker based on the representation that the person would not:

1. solicit the prospective investors or have any contact with them regarding the proposed investment;
2. participate in any advertisement, endorsement, or general solicitation;
3. participate in the preparation of any sales materials;
4. perform any independent analysis of the sale;
5. engage in any "due diligence" activities;

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[7] *Persons Deemed Not To Be Brokers*, SEC, Exch. Act Rel. No. 34-22172, SEC Docket 685, at 686, *available at* https://www.sec.gov/rules/final/1985/34-22172.pdf. See also Robert L.D. Colby, Lanny A. Schwartz, and Zachary J. Zweihorn, Broker Dealer Reg., *Ch. 2: What is a Broker-Dealer?*, *available at* https://www.davispolk.com/files/whats_a_broker_dealer_2.pdf (initially published in Sept. 2010, and updated through July 2016) (stating that the purpose of these rules is to ensure brokers "satisfy professional standards, have adequate capital, treat their customers fairly, and provide adequate disclosures to investors.").

[8] *See, e.g.*, *Roadshow Broadcast, LLC*, SEC Staff No-Action Letter, May 6, 2011, *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2011/roadshowbroadcast050611-15a.pdf. *See also* M&A Brokers, SEC Staff No-Action Letter Jan. 31, 2014, *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf (revised Feb. 4, 2014).

[9] *Jumpstart Our Business Startups (JOBS) Act of 2012*, Pub. L. No. 112-106 (2012), § 201(c)(2).

6. assist or provide financing for such purchases;
7. provide advice as to the valuation or financial advisability of the investment; or
8. handle any funds or securities in connection with the investment.[10]

A handful of advocates have continued to press the Commission to expand upon its staff's no-action letters by adopting a rule to provide an exemption from the broker-dealer registration for so-called finders. To date, the Commission has declined to take up and adopt such a rule. Similarly, members of Congress have been pressed to pass legislation to effectuate a broad "finders" exemption. Again, no such sweeping exemption has been adopted.[11]

However, three years ago, the Trump Treasury Department's 2017 Capital Markets Report recommended that "the SEC, FINRA, and the states propose a new regulatory structure for finders and other intermediaries in capital-forming transactions."[12] In doing so, the 2017 Capital Markets Report explained that raising capital for small businesses is particularly challenging

> if 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. The number of registered broker-dealers has been falling, and few registered broker-dealers are willing to raise capital in small transactions. Thus, finders, individuals or firms who connect a firm seeking to raise capital with an investor for a fee, can play an important role in filling this gap to help small businesses obtain early stage financing.[13]

Notably, the 2017 Capital Markets Report did not explain how the revised regulatory regime would assist small businesses in raising capital. Nor did it assess impacts of the revisions on issuers, investors, or other market participants. Lastly, the report recommended that the SEC coordinate with other regulators to "maintain[] an appropriate regulatory structure for finders" that ensures "[i]nvestor confidence in the integrity of markets, supported by robust disclosure and regulatory protections."[14]

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[10] Proposed Order, at 15 n.49 (citing *Paul Anka*, SEC Staff No-Action Letter, July 24, 1991, *available at* https://securities.utah.gov/docs/Anka_Letter.pdf).

[11] The only statutory revision was the narrow provision of the JOBS Act. See Pub. L. No. 112-106 (2012), § 201(c)(2).

[12] U.S. Department of Treasury, *A Financial System that Creates Economic Opportunities: Capital Markets*, Oct. 2017, *available at* https://home.treasury.gov/system/files/136/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf (hereinafter, "2017 Capital Markets Report").

[13] 2017 Capital Markets Report, at 43-44.

[14] 2017 Capital Markets Report, at 7.

Analysis

The Proposed Order purports to rely upon the Commission's exemptive powers under Sections 15(a)(2) and 36(a)(1) of the Exchange Act to exempt brokers from having to register as brokers, provided certain conditions are met. This reliance is misplaced.

The Commission's exemptive powers may be exercised only to the extent that such actions are "in the public interest" and "consistent" with the "protection of investors."[15] The Commission has offered neither adequate evidence nor reasonable analysis to conclude that the Proposed Order satisfies these requirements. Worse, as discussed below, there is significant evidence and analysis to suggest that the Proposed Order fails to meet this threshold. Accordingly, the Commission's adoption of the Proposed Order would exceed its statutory authority.

The logical underpinnings for the Proposed Order go awry with the very first sentence of the introduction, which declares that "The Commission's mission includes facilitating capital formation—not only for public companies, but also for the small businesses that are active participants in our private markets."[16] We are not aware of the Commission previously declaring that its mission is to exempt market participants from its rules.

To the contrary, the Commission's mission is to "protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation," not just the facilitation of "capital formation."[17] In fact, in adopting the various iterations of the broker registration requirements, Congress and the Commission have repeatedly stated that the requirements exist to protect investors. Even more pointedly, the Commission has explained that

> Exemptions from registration [of brokers] have traditionally been narrowly drawn in order to promote both investor protection and the integrity of the brokerage community.[18]

If the Commission wishes to now exercise its exemptive powers to ignore the plain statutory language, intent of the law, and decades of its own interpretations and analysis regarding the importance of broker-dealer regulation, it will have to offer more

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[15] Sections 15(a)(2) and 36(a)(1) of the Exchange Act.

[16] Proposed Order, at 3.

[17] Proposed Order, at 19 (The proposal "is intended to address concerns that have been raised over the years regarding the perceived inability of smaller companies to engage the services of a broker-dealer to assist with opportunities to raise capital in exempt offerings."). By way of contrast, the phrase "investor protection" doesn't appear in the thirty-seven page release until page nine.

[18] *Persons Deemed Not To Be Brokers*, SEC, Exch. Act Rel. No. 34-22172, SEC Docket 685, at 686, *available at* https://www.sec.gov/rules/final/1985/34-22172.pdf. See also Robert L.D. Colby, Lanny A. Schwartz, and Zachary J. Zweihorn, Broker Dealer Reg., *Ch. 2: What is a Broker-Dealer?*, *available at* https://www.davispolk.com/files/whats_a_broker_dealer_2.pdf (initially published in Sept. 2010, and updated through July 2016) (stating that the purpose of these rules is to ensure brokers "satisfy professional standards, have adequate capital, treat their customers fairly, and provide adequate disclosures to investors.").

than unsupported declarations that do not reasonably connect the agency's proposed actions to its desired outcome.

The Commission's reference to "our private markets"[19] is also misleading. The reference to "our" markets implies that the Commission has an ownership or other meaningful oversight relationship with respect to those markets. While the Commission's aggressive deregulation of capital raising may be responsible for the dramatic expansion of the private markets, the Commission certainly does not have an ownership stake nor conduct comprehensive oversight of them. The Commission does not have significant, reliable information about securities offered and traded in the private markets, or even know for certain how big these markets are.[20]

Both the 2017 Capital Markets Report and Proposed Order offer surprisingly little information about how relieving potential intermediaries of the burden of broker-dealer regulation would materially increase the number of intermediaries or change those intermediaries' incentives or actions in ways that benefits issuers, investors, or the markets overall.

The Proposed Order boldly asserts that "[t]he exempt market supports the capital needs of many small companies that contribute substantially to our economy."[21] However, it offers no data to support that. But even if it did, the Proposed Order does not offer any data or analysis to demonstrate how exempting brokers from regulation would help small companies.

Put another way, the Proposed Order doesn't even attempt to explain a potential relationship between exempting brokers from oversight and spurring "capital formation." We are left to speculate how the Proposed Order would potentially achieve its desired outcome.

To address this question, we must first explore the incentives and challenges for the brokers that the Commission is seeking to deregulate. As one lawyer has explained to the Commission,

> The risks involved in undertaking a small transaction are often similar to those of a large one, without a commensurate upside. The legal costs are often comparable to a larger transaction because of the lack of sophistication and internal recordkeeping and control systems of smaller issuers and the amount of work that must be done to prepare a private placement memorandum competently. The issuer's financial and other information is often not as

[19] Proposed Order, at 3.

[20] The Commission itself is left to estimate the size of these private markets. *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, SEC, 85 Fed. Reg. 17956, 17957 (Mar. 31, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-03-31/pdf/2020-04799.pdf.

[21] Proposed Order, at 3.

> complete or accurate and almost never audited by independent certified public accountants. Smaller issuers often lack the expertise and experience to adequately deal with external issues, including securities law compliance.[22]

How would allowing a broker avoid registration and oversight impact those costs and burdens? What is the mechanism? The Commission does not answer those questions.

The Proposed Order shockingly implies further that the new exemption could help "traditionally underrepresented founders, such as women and minorities."[23] We are particularly interested in supporting women and minority entrepreneurs, but we see no reasonable relationship between that objective and this Proposed Order. The Proposed Order does not explain how relieving an intermediary of a perceived regulatory burden could be expected to further the funding for traditionally underrepresented founders. Nor has the Commission offered any relationship between its proposal and its desired outcome -- other than simply declaring that the to-be-exempted brokers "may" provide some services to them. Neither the Proposed Order nor any of the materials cited therein identify or quantify with any specificity any impacts of the proposed deregulation of "finders" on any market participants at all -- much less women and minorities.

While the Proposed Order makes no effort to even offer a mechanism through which it could effectuate its purported objectives (much less quantify the impacts), the Proposed Order would clearly create significant risks for issuers. As Commissioner Lee noted in her dissent to the Proposed Order, finders can dramatically negatively impact issuers, including that they may "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."[24] Put simply, finders can create disasters for issuers.

Without subjecting "finders" to broker-dealer regulations, what other assurances will issuers have that their finders won't create such a mess for them? And if a finder creates a mess for the company, what recourse does the company have? How will another company know that a particular finder is a "bad" one? These questions regarding impacts on issuers are largely unaddressed in the Proposed Order. In order to establish that the proposal is in the public interest, these questions must be answered.

But perhaps more importantly, what would be the impact of the Proposed Order on investors? The Commission has heard that

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[22] Remarks of Gregory C. Yadley, before the SEC Advisory Committee on Small and Emerging Companies, at 3, June 3, 2015, *available at* https://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf.

[23] Proposed Order, at 5.

[24] Hon. Allison Herren Lee, *Regulating in the Dark: What We Don't Know About Finders Can Hurt Us*, SEC, Oct. 7, 2020, *available at* https://www.sec.gov/news/public-statement/lee-proposed-finders-exemption-2020-10-07.

> in many … cases, persons acting as finders represent "the dark side" of the securities business: purveyors of fraudulent shell corporations; front-end fee con artists; purported Regulation S specialists who send stock off-shore and wait to dump it back into the U.S. through unscrupulous brokerage firms or representatives who are receiving under-the-table payments for promoting stocks and micro-cap manipulators.[25]

Unfortunately, we are aware of many frauds involving unregistered intermediaries acting at "finders" in what are purportedly private market transactions.[26] Because the Commission does not generally oversee the private markets, the state securities regulators are often on the front lines of enforcement for frauds in the exempt markets.

The 2020 Enforcement Report for the North American Securities Administrators Association should be eye-opening for the Commission. That report listed unregistered securities as a top area of enforcement activity.[27] A staggering 161 out of 208 reported state enforcement actions that were classified as "elder fraud and exploitation" involved unregistered securities.[28] Worse, many unregistered securities cases involved unlicensed intermediaries. NASAA reported 738 actions against unregistered actors in 2019, up approximately 15% from 2018. The Proposed Order would essentially expose investors to greater risks.

Shockingly, the Proposed Order offers no material economic analysis of any of these impacts or concerns. The Commission's analysis is instead unsubstantiated, ideological conjecture and forty-five questions. That is not a record upon which the Commission may make a reasoned, evidence-driven determination.

In reviewing the Commission's action, a court must "hold unlawful and set aside agency action, findings, and conclusions found to be … arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; … in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; [or] unwarranted by the facts."[29]

The Proposed Order fails all three tests. First, to satisfy the "arbitrary and capricious" standard, "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and

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[25] Yadley, at 3.

[26] See, e.g., Jay Weaver, *Florida real estate schemer pleads guilty to $1.3 billion fraud. Most victims were retirees*, Miami Herald, Aug. 8, 2019, *available at* https://www.miamiherald.com/news/local/article233611332.html.

[27] NASAA 2020 Enforcement Report, North American Securities Administrators Association, *available at* https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf.

[28] Id., at 6.

[29] 5 U.S.C. § 706(2)(A), (C), and (F).

the choice made.'"[30] The Proposed Order fails to identify, much less address, relevant data on how the proposed exemptions would impact the exempted firms, investors, issuers, and the markets overall.

Second, as the Proposed Order makes no effort to address the clear investor protection concerns (including those raised in Commissioner Lee's dissent to the proposal),[31] the Commission cannot rely upon its broad exemptive authorities, because its proposal is inconsistent with the protection of investors and the public interest. On this record, the Proposed Order is simply outside of the Commission's authority.

Lastly, the Proposed Order offers essentially no facts regarding how the Proposed Order would impact various market participants. It offers unsupported conjecture and asks questions. At the same time, the Commission is aware of facts regarding significant fraud and abuses by unregistered brokers in the private and public markets. The Commission is aware of the material risks to issuers and investors of having "finders" not comply with its broker registration and ongoign regulatory requirements. Nevertheless, despite these facts, the Commission has Proposed taking this unprecedented action.

Conclusion

Despite massive investor opposition and a stunning lack of data and economic analysis, the Commission has recently adopted several sweeping reforms to expand the private markets. We are not surprised that the Commission is now seeking to again ignore both investor opposition and its procedural obligations to exempt a newly-minted class of market participants from its oversight as well.

The Commission's ideologically-driven effort to exempt brokers engaged in offering and selling securities from oversight is in contravention of its authority, its mission, and common sense. The Commission should rescind this ill-advised, inadequately supported, and poorly drafted Proposed Order without delay.

If you have any questions or would like to follow up with any of us, please feel free to contact me at [redacted] or [redacted]. Thank you for your consideration.

Sincerely,

Tyler Gellasch
Executive Director

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[30] *Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442 (D.C. Cir. 2017) (citing to *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962))).

[31] Hon. Allison Herren Lee.