Robert D. Strahota
[redacted]

November 12, 2020

Submitted via email to: rule-comments@sec.gov

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

Re: Comments on the Commission's Proposed Exemptive Order for Finders, Release No. 34-90112; File No. S7-13-40

Dear Ms. Countryman:

I. My Background and Interest

I appreciate the opportunity to provide these comments on the above-referenced, proposed exemptive order (proposed order). I commend the Commission on the steps it has taken and, I am sure, will continue to take to further small business capital formation consistent with the public interest and the protection of investors. These include the recent amendments to the definition of "accredited investor",[1] implementation of the crowdfunding provisions of the JOBS Act, amendments to Reg. D, and other rulemaking that has reduced regulatory burdens for public offerings by small business issuers.

As you can see from the one-page resume included as Appendix A to these comments, I am a retired securities lawyer; from a large multinational law firm in 1990 and from the Commission in 2005. Much of my private practice focused on private offerings of securities under federal and state securities laws, so I have always had a professional interest in this area. As an active member of the ABA State Regulation of Securities Committee and a member the ABA Federal Securities Law Committee, I participated in some of the Commission's early small business forums, I submitted individual comments on the Commission's proposals that lead to adoption of Reg. D in 1982, and I contributed to the wording and proposal of a counterpart, state Uniform Limited Offering Exemption.

In retirement, I manage my own investments and continue to follow the Commission's activities. I have always admired the dedication, talent, and creativity of the Commission's staff, which is reflected in Commission's regulatory actions. Indeed, I have

---

[1] Monetary thresholds for individual accredited investor status should be adjusted upwards for inflation, both past since 1982, and forthcoming.

never had serious concerns during my 15+ years of retirement regarding any Commission proposals until I read Release No. 34-90112. I am providing these comments independently without assistance, affiliation, or association with, or compensation from any person.

II. Overview of Proposed Order

I agree there is a consensus that the Commission should consider what I would describe as the presence of finders and others engaged in unregulated brokerage activity with respect to unregistered securities offerings, primarily under Section 4(a)(2) of the Securities Act of 1933 (Securities Act) and Rule 506 of Reg. D. The Commission deserves credit for finally taking up this issue.

Unfortunately, after thoroughly reading the proposed order, the documentation cited in support of its adoption, and also considering the current requirements of Reg. D, Rule 506 as well as prior American Bar Association (ABA) proposals for a "broker-dealer lite" regime to address these "gray market" activities and current FINRA and state initiatives, I am disappointed and troubled that a majority of the Commission has voted to publish the proposed order.

Here is a list of some (not all) of the proposed order's shortcomings along with my suggestions regarding what the Commission should be doing instead. These are referenced to explanations I provide in my Major Comments in Part III below.[2]

- Disrespect for individual investors' privacy rights, including protections against "cold calling" and compromising Commission investor protection initiatives. (Comment 1)
- Failing to offer a logical explanation why higher risk finders' activities should be unsupervised while solicitors for investment advisors would continue to be subject to comprehensive oversight described in Release IA-5407. (Comment 2.A)
- Failing to appreciate that adoption of the proposed order would exacerbate unregistered finders' problems under state securities regulation. (Comment 2.B)
- Overlooking the applicability of Securities Act §17(b) to finders' compensation disclosure. (Comment 2.C)
- Overlooking the need to address conflicts of interest that may arise from finders' ownership of issuers' securities and from issuer-finder transactions. (Comment 2.D)
- Not addressing whether and how the proposed order would affect issuers' reasonable belief requirements under Rules 506(b) and (c) of Reg. D. (Comment 2.E)
- Overlooking that furthering unsupervised activities of unqualified founders is likely to lead to increased court litigation and voidable transactions instead of arbitration that would apply if finders were subject to a broker-dealer lite regime. (Comment 2.F)
- Not addressing Commission independence requirements applicable to accountants considering registered or unregistered broker-dealer activity. Comment 2.G)

[2] As explained in Part IV below, I address the 45 questions included at the end of the proposed order by cross referencing the Major Comments, and, in some cases, adding additional commentary in response to specific questions.

- Failing to address how compensated, unsupervised finders' activity would be impacted by FINRA Rule 2040. (Comment 2.H)
- Failing to impose as a *condition* applicable to unregistered finders, a requirement that finders will not have *access* to customer funds or securities and that any best efforts, Mini-Max contingent offering for which they act as finders must comply with the escrow requirements of Exchange Act Rule 15c2-4. (Comment 2.I)
- Failing to note that registered broker/dealers participating in other issuers' Reg. D, Rule 506 offerings are not subject to limitations on compensation under FINRA's corporate financing rules; and that there have been SEC enforcement cases vs. unregistered finders, revealing obscene amounts of compensation. (Comment 2.J)
- Proposed statutory disqualification provisions are inadequate and should be augmented by the "bad boy" provisions of Reg. D Rule 508. Comment 2.K)
- Distorting the claimed viability of the Paul Anka no-action letter, and incorrectly suggesting that five M&A no-action letters cited in n. 50 of the proposed order are supportive when none of them pertain to finders receiving compensation for connecting potential investors with issuers seeking to solicit such investors. (Comment 3)
- Failing to cite a number of enforcement cases where the Commission has successfully obtained relief against unregistered finders for violation of the broker-dealer registration provisions of Exchange Act §15(a). (Comment 3)
- Failing to appreciate why a "broker-dealer lite" regulatory regime for finders, along the lines proposed by American Bar Association (ABA) lawyers in a 2005 report,[3] and initiatives taken by FINRA are markedly preferable to an exemptive order for the reasons explained below. (Comment 4.A)
- The Commission majority approving the proposed order overlooks that a broker-dealer lite regime, imposing affirmative qualification requirements tailored to finder activities, is the only regulatory approach, augmented by Commission and state enforcement actions, that will reduce the size of the undesirable element that is currently a significant part of the finder universe, acting unlawfully and not promoting capital formation for anyone but themselves. (Comment 4.B)
- FINRA Capital Acquisition Broker rules not mentioned in the proposed order are oriented primarily to a finder that would be a legal entity registered under a broker-dealer lite regime. Other FINRA rules, also not mentioned in the proposed order, provide two registration categories, Private Securities Offerings Representative and Private Securities Offerings Principal that would permit individual finders, at very little cost to qualify via examinations for these categories, associate with any FINRA member firm that would have them and engage lawfully in a broader category of private offering activities than permitted under the proposed order. (Comment 4.C)
- Concerns expressed about the costs and other burdens of a finder becoming a FINRA Capital Acquisition Broker do not take into consideration the alternative of individual finders associating with other currently registered broker-dealers. However the fact that not many finders have elected to register under either FINRA alternative suggests

[3] Report and Recommendations of the American Bar Association Business Law Section Task Force on Private Placement Broker-Dealers (June 20, 2005), *available at* https://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf (hereinafter 2005 ABA Task Force Report").

that there may be other undisclosed concerns on the part of both finders and registered broker-dealers that impede the process, rather than the publicly stated assertion of small business advocates that Reg. D financings are too small to be considered by registered broker-dealers. (Comment 4.D)

- The Commission's Office of Small Business Advocacy and annual small business forums seem to have shifted towards a populist view that the Commission's job is to ensure access to capital by all small businesses. However, what is a statutory mandate for the Office of Small Business Advocacy is not a statutory mandate for the Commission or other Commission divisions and offices. The Commission should consider competing viewpoints as to what is best in terms of investor protection and its more generally stated mandate to promote capital formation. Such mandate does indicate that the Commission should decide who gets capital. I respectfully suggest that the Commission's more general capital formation mandate is to ensure that there are federal securities laws and regulations in place that support a fair and efficient market infrastructure, which provides full disclosure to investors and permits capital to be allocated to productive undertakings that may produce returns for investors consistent with their tolerance for risk. (Comment 5)
- Despite widespread assertions that small business is a driver of jobs grown, there is compelling evidence that this is only true of small firms that contribute to technological innovation; that is, technology-based startups. (Comment 6.A)
- Rather than supporting a broader small business jobs growth thesis, the article cited in n. 3 of the proposed order actually supports the above conclusion because the article's research model was limited to firms that are technology-based startups. (Comment 6.B)
- SBA statistics regarding small businesses failure rates suggest that a stand-alone purchase of illiquid, restricted securities of a small business issuer under a Reg. D, Rule 506 offering, may exceed the risk tolerance of many individual accredited investors, particularly those close to the base income and net worth levels required for accredited investor status. (Comment 7.A)
- The Commission's proposed order would result in issuers and unregistered, unqualified finders encouraging accredited investors to invest in individual issuers' standalone Reg. D private offerings. However, the Commission's statistics regarding Reg. D usage show that accredited investors, many of whom are actually individual qualified purchasers with not less than $ 5million of investments, have chosen overwhelmingly to make more prudent Reg. D investments in private investment funds, presumably because the private funds offer diversification or risk and professional management in selecting investments. Given these circumstances, and without any empirical evidence that Reg. D issuers are net creators of jobs, how is the proposed order consistent with the Commission's investor protection mandate? (Comment 7.B)
- Before proceeding with an exemption that may do more harm than good, the Commission should direct its Division of Economic and Risk Analysis to gather empirical evidence regarding how U.S. corporate issuers that are not Exchange Act reporting companies and have used Reg. D Rule 506 to raise equity capital during 2009-2019, have fared in terms of increasing employment, by running their names in other data bases that would show annually the number of employees. (Comment 7.C)

- Form D is a useful tool that I understand is used by some states and should be used by Commission to identify finders receiving compensation in Reg. D offerings who do not have CRD numbers indicative of association with a registered broker-dealer. This is an initiative that should be undertaken now to drive unregistered finders into FINRA registration categories that accommodate lawful participation in private securities offerings. (Comment 7.D)
- Even though the Commission has the legal authority to propose this broad-based finders' exemption as an order, concerns of fair process should have prompted it to opt for a rulemaking similar to Release IA-5407 for solicitors, and undertaken only after the Commission has empirical support any actions it proposes. (Comment 8)
- This Overview, my comments in Part III and responses under Part IV indicate why the proposed order falls substantially short of satisfying the public interest and investor protection determinations that are required to support its issuance. The proposed order should be withdrawn. (Comment 9)

III. Major Comments

1. <u>Privacy concerns and conflicts with the Commission's investor protection guidance</u>. Some of my concerns regarding the proposed order are piqued by the fact that my spouse and I are senior citizens who meet the relatively modest thresholds for individual accredited investor status and live in an affluent suburb of Washington, DC where our presence brings down average family income and net worth. When I read the Village listserv and see that a number of my affluent, well-educated neighbors, many of whom are also senior citizens, seek assistance in finding reliable plumbers and other home service providers, I wonder who are the persons they rely on in making investment decisions. But that is something that most people regard as a private matter because, among other reasons,[4] they do not wish to be the subject of unsolicited investment proposals, especially when they come from unregulated persons. Indeed, it has been the Commission's policy to warn all investors about unlicensed persons.

Thinking about this issue causes me to realize how vulnerable the age of the Internet has made access to our names, addresses, phone numbers and emails for use by unscrupulous issuers, unregistered finders, and many other con persons and "flim-flam" artists. It prompts me to ask:

> A. Why has the Commission issued a proposed order that would exacerbate cold calling by sanctioning participation of unregistered finders, and further promote an "open season" environment for solicitation of individual accredited investors by unregistered issuers, many of whom are offering securities of dubious investment merit for any class of investor?
> B. Why should Rule 506 small business and other issuers, their unregistered finders and others being compensated for making offers and sales be permitted to

[4] My neighbors are not parsimonious. Indeed, email traffic on the Listserv reveals a remarkable number of charitable and public service activities that many neighbors are supporting by donating their money and time and recommending that others do so.

engage in cold calling activity that is significantly limited for registered securities professionals?
C. Doesn't the Commission approved FINRA telemarketing rule regarding cold calling apply to all individual investors, including accredited investors?[5]
D. Isn't the cold calling that would be permitted under the proposed order inconsistent with the investor protection guidance the Commission provides to protect investors from cold calling?[6]
E. How does the Commission reconcile the proposed order exempting Finders receiving transaction-based compensation from broker-dealer regulatory safeguards intended to protect senior investors, which are described by the Commission's Office of the Investor Advocate and predicated upon the presence of sound broker-dealer regulation?[7]
F. How does the Commission reconcile its proposed order with investor alerts issued by its Office of Investor Education and Advocacy, which recommend "Make Sure Your Investment Professional Is Licensed."[8]
G. When unregistered and, as is likely, unqualified persons receiving transaction-based compensation are permitted to participate in nonpublic offerings of securities, don't investors lose some of the safeguards built into the investor protection infrastructure, such as FINRA's Broker/Check System?

In this age of the Internet and cybersecurity concerns, the Commission should recognize that public mood regarding privacy rights has become more vocal and protective since the Paul Anka no-action letter was issued in 1991.This trend has not gone unnoticed by the U.S. Congress or state legislatures. Nowadays, many people, including myself, would find it offensive and a breach of our rights to privacy that Commission considers it consistent with its investor protection mandate and investors' privacy rights to issue an order that exempts unregulated finders from broker-dealer registration and legitimizes

---

[5] *See* FINRA Rule 3230 discussed in FINRA Regulatory Notice 12-17, SEC Approves Consolidated Telemarketing Rule (June 29, 2012) available at https://www finra.org/rules-guidance/notices/12-17, which includes a link to the FINRA manual. The FINRA rule was required by the Telemarketing Consumer Fraud and Abuse Prevention Act of 1994, 15 U.S.C. 6101-6108, and is required to be similar to a Federal Trade Commission (FTC) telemarketing rule required by the same Act. Unfortunately, there is a difference in effect when one telemarketing rule applies to registered broker-dealers (FINRA's) and the FTC rule applies to otherwise unregulated telemarketers. Most persons who have phones and receive numerous cold calls daily cannot take much comfort from the FTC rule and its Do Not Call Registry. In fairness, the FTC's resources may limit its ability to pursue many telemarketing frauds and concentrate on nationwide telemarketing scams, which generally would not involve private placements of securities.
[6] *See* https://www.sec.gov/fast-answers/answerscoldhtm html
[7] *See* Stephen Deane, "How the SEC Works to Protect Senior Investors", SEC Office of Investor Advocate (May 2019) available at https://www.sec.gov/files/how-the-sec-works-to-protect-senior-investors.pdf. Among the senior investor safeguards predicated on broker-dealer status are the Commission's broker-dealer examination program, FINRA Rules 2165 and 4512, the federal Senior Safe Act of 2018, and protections for senior citizens adopted by 21 states, such as the NAASA Model Act to Protect Vulnerable Adults from Exploitation.
[8] *See e.g.* "Three Tips for World Investor Week 2019: Investor Bulletin (Oct. 1, 2019) This bulletin and others are available on the Commission's website, www.sec.gov under Office of Investor Education and Advocacy. One the reasons for the advice given in this bulletin is: "Unlicensed, unregistered persons commit much of the investment fraud in the United States and Canada, so this is an important first step if you are considering an investment professional."

their ability to augment unregistered issuers' ability to purchase lists of accredited investors, make cold calls and engage in other unsolicited contacts. See also Comment 3.

2. Some significant shortcomings and omissions in the proposed order

I believe that any Commission majority has the right to propose rules or orders that reflect a change in its prior rules, orders, or interpretations, provided they have the statutory authority to do so under the laws that sanction their activities, and they comply with federal laws and rules designed to ensure fair administrative process.
My Comments 2.A through 2.K and Comment 3 below reflect my opinion that the proposed order has many shortcomings and omissions. The proposed order is presented in a manner that it does not even afford interested persons an opportunity to see the exact wording that states specifically what the proposed order would do, and to understand what effects adoption of the order would have on many requirements and policies focused on investor protection, which are not even mentioned in the proposed order.[9] See also Comment 8 below.

2.A. Supervision and Note 26 of the proposed order. I am particularly troubled by the dubious reasoning in n. 26 of the proposed order. The note purports to distinguish oversight responsibilities for solicitors proposed under Release IA-5407 from oversight responsibilities for Finders under the proposed order by stating that the former would be supervised by registered investment advisers while the latter would not be subject to such oversight. Doesn't this simply beg the question why Finders who would receive transaction-based compensation and engage in offering activities that would deem them broker-dealers under current Commission interpretative guidance and enforcement actions now should be given a "free pass"? Why is the Commission giving up on investor protection and now suggesting that finders should not be required to be associated persons of a registered broker-dealer under a broker-dealer lite registration regime that has been previously proposed and exists now under FINRA rules approved by the Commission, which are not even mentioned in the proposed order ? See Comment 4.C.

Assuming, as I believe to be the case, that most persons being solicited regarding an investment advisory relationship would be accredited investors, let me rephrase the question. Why does the Commission apparently believe that there is less risk of loss to accredited investors who invest in the securities of a non-fund Rule 506 issuer where the investor has interacted with an unregistered, possibly unqualified finder, than there is risk of loss to an investor who is solicited to place funds with a registered investment adviser who is likely to invest most of the investor's money in a diversified portfolio of publicly traded securities?

[9] Most of the 45 questions at the end of the proposed order do a much better job identifying some of the potential problems presented by the described terms and conditions for the Tier I and Tier II Finders. The Questions also ask essentially "What have we missed?" They fall short of referring to or explaining in the proposed order requirements that may conflict with the proposed order even though some of the omitted requirements appear be the basis for a number of the questions.

I agree with Chairman Clayton that when the Commission has to consider fulfilling both its capital formation and investor protection mandates, we should not view the two as offsets in a zero-sum game.[10] However, I respectfully suggest that there should not be a failure of common sense that turns considerations of liquidity vs. illiquidity, risk diversification, risk tolerance and modern portfolio theory upside down. The case for supervision of unregistered finders as broker-dealers appears stronger than the case for supervision of solicitors in the investment management business. See also the SBA's failure rates for small businesses under Comment 7.A below.

2.B. The proposed order would exacerbate problems for unregistered finders under most state securities laws because the receipt of transaction-based compensation would preclude them from relying on agent of issuer registration provisions and leave them exposed as unregistered broker-dealers.[11]

Most of the fifty states and the District of Columbia have adopted one of two versions of a Uniform Securities Act. Unfortunately, due to amendments adopted by individual states, these laws have become less uniform than most securities practitioner would prefer. More than half of the states have a law based on the Uniform Securities Act of 1956, and many of these states have adopted uniform amendments to the original act that the North American Association of Securities Administrators (NAASA) has recommended as necessary to keep it up to date. For example, many states adopted amendments in response to the securities registration and broker-dealer regulation provisions of the National Securities Markets Act of 1996 (NSMIA) that preempted significant parts of their acts. The second uniform act is the Uniform Securities Act of 2002, which has been adopted in at least a dozen states. Its provisions no doubt have also been amended by individual states. The third uniform act is the Revised Uniform Securities Act of 1985 (RUSA), which has been adopted in only a few states, primarily because the ABA and National Conference of Commissioners on Uniform State Laws have never endorsed RUSA. Finally, there are some states that prefer to "do their own thing" in securities law. These include California and New York.

As the most efficient method to determine precisely how many states would preclude unregistered Finders from agent of issuer registration because of receipt of transaction-based compensation or for other reasons, I recommend a two-step process. First, in an electronic or hard copy of CCH Blue Sky Law Reporter, reading relevant parts of each of the uniform acts above. These include the definition of agent or the comparable sales term in RUSA. the registration requirements and exemptions applicable to these persons

[10] *See* Statement of SEC Chairman Jay Clayton on "Harmonizing, Simplifying and Improving the Exempt Offering Framework; Benefits to Small and Medium-Sized Business and Their Investors", (Nov. 2, 2020) available at https://www.sec.gov/news/public-statement/clayton-harmonization-2020-11-2.

[11] I regret that during Covid-19 I do not have access to a library that has the CCH Blue Sky Reporter service so that I might be more specific in the text. In reading this discussion, it is important to bear in mind that NSMIA amendments to the broker-dealer provisions of the Exchange Act do not preempt states' ability to define that a finder is a broker-dealer or agent of issuer, and to specify requirements applicable to agents of issuers as well as un-preempted requirements applicable to broker-dealers.

and the Official Comments appearing under these sections of the acts. Second, research each jurisdiction’s law sections that correspond to the above provisions.[12]

At the time that the 2005 ABA Task Force Report was issued, only one state, Michigan, addressed the separate registration of finders under its securities law. The 2005 ABA Task Force Report describes Michigan's provision and suggests that it might serve as a starting point for development of a coordinated broker-dealer lite registration regime for finders.[13] As explained below, California, New York, and Texas have taken up finders' regulation. (I have not surveyed other states.) California and Texas already have in place regulations regarding permissible finder's activities that differ from the terms and conditions permitted under the proposed order. New York has proposed that finders must comply with the state's broker-dealer registration requirements.[14]

California.[15] California's regulation differs from the terms and conditions of the Commission's proposed order in that: (i) the size of the transactions for which the finder is engaged must not exceed a purchase price of $15 million; (ii) the finder may not conduct any due diligence for any party to the transaction; (iii) the finder must not participate in the transaction unless it is qualified by permit or exempt from qualification under California law; (iv) the finder must not make any disclosure to any potential purchaser of securities other than: (a) the name, address and contact information of the issuer; (b) the name, type, price and aggregate amount of the securities offered; (b) the issuer’s industry, location and years in business; (v) the finder must file, in advance of taking any finder’s fees, a statement of information with the finder’s name and address, together with a filing fee, with the California Bureau of Business Oversight, and thereafter file annual renewal statements with a filing fee and representations that the finder has complied with the exemption conditions; (vi) the finder must obtain a written agreement signed by the finder, the issuer and the person introduced by the finder, disclosing in addition to what the Commission's proposed order would require: (a) whether the finder is also an owner of the securities being sold; (b) that the parties have the right to pursue any available remedies for breach of the agreement; and (c) a representation by the investor that the investor consents to the payment of the finder’s fee; and (vii) the finder must preserve copies of the notice, the written agreement and all other records relating to the transactions for a period of five years.[16]

[12] Alternatively, find a blue-sky lawyer at law firm with a securities transaction practice, who already may have done this research.
[13] 2005 ABA Task Force Report *supra* n. 3 at pp. 7-8.
[14] Although I have not reviewed the current securities laws of all states, it has been my experience that when most states elect to regulate an activity via registration, they apply the registration obligation on a "from and within" basis, meaning that persons subject to registration include both persons resident in the state of registration who are engaged in the activity with respect to subjects resident in or out of state, and persons out of state engaged in the activity with respect to subjects resident in the state of registration.
[15] CA Corp Code §25206.1.
[16] I suggest that items (ii), (vi)(a), (b), and (c), and (vii) could be added or clarified in the Commission's proposed order.

Texas.[17] Texas permits finders to receive compensation if they register as a finder, which is different than broker-dealer registration; however, the fee received by the finder may not be a fee based on securities purchased or the investor's profits.

New York.[18] New York would require finders to comply with filing and examination requirements applicable to broker-dealers. A finder would be a person who "as part of a regular business'" would be deemed to be engaged in brokerage activity if the finder receives compensation for introducing a prospective investor or investors to any, broker, dealer or salesperson.[19]

While on the subject of state securities regulation, and as a preface to Comment 4 below, I wish to address the ACSEC recommendations that are referred to but not really explained at pp. 7-8 and in notes 15, 20, 21 and 22 of the proposed order. I do so because it is not clear from the order whether the Commission has any intention of taking up the ACSEC recommendations.

As best as I have been able to determine from the ACSEC letters and one report during the 2015-2017 period, ACSEC recommended in a September 23, 2015 letter to the Commission, cited in n. 21 of the proposed order, that:

1. "The Commission take steps to clarify the current ambiguity in broker-dealer regulation by determining that persons that receive transaction-based compensation solely for providing names of or introductions to prospective investors are not subject to registration as a broker under the Securities Exchange Act.
2. The Commission exempt intermediaries that are actively involved in the discussions, negotiations, and structuring, as well as the solicitation of prospective investors, for private financings on a regular basis from broker registration at the federal level, conditioned upon registration as a broker under State law.
3. The Commission spearhead a joint effort with the North American Securities Administrators Association and the Financial Industry Regulatory Authority to ensure coordinated State regulation and adoption of measured regulation that is transparent, responsive to the needs of small businesses for capital, proportional to the risks to which investors in such offerings are exposed, and capable of early implementation and ongoing enforcement.
4. The Commission should take immediate intermediary steps to begin to address issues regarding the regulation of intermediaries in small business capital formation transactions incrementally instead of waiting until development of a comprehensive solution."[20]

In my opinion, Recommendation No. 2 is very ill-advised for the following reasons:

---

[17] Rule 115.1(c)(2)(b)(v) of the Texas State Securities Board.
[18] Proposed addition to 13 NYCRR §10.10 "Definitions".
[19] *See* explanation in " Regulating Unregistered Finders: New York Dips Its Toe In the Murky Waters" Alert (Aug. 3, 2020) available at https://www.goodwinlaw.com/publications/2020/08/08_03-regulating-unregistered-finders.
[20] *See* https://www.sec.gov/info/smallbus/acsec/acsec-recommendations-regulation-of-finders.pdf.

i. If the Commission were to exempt finders who are natural persons from federal broker-dealer registration, it would mean that the finders also would not be subject to FINRA registration.
ii. What incentives would FINRA, who does the "heavy lifting" in federal-state broker-dealer and associated person registration and regulation, have to participate in the ACSEC Recommendation 3?
iii. As I explain above, in most states whose securities regulation is based on one of three uniform securities acts, finders would not be eligible to become state-registered agents of issuers because of their receipt of transaction-based compensation.
iv. NSMIA's amendments to the Exchange Act do not preempt states from defining who is a broker-dealer or adopting any form of broker-dealer regulation they choose when the persons to be regulated are not federally registered broker-dealers or associated persons.
v. It took many years and a tremendous amount of effort by the Commission staff, FINRA's predecessor, the NASD, NAASA and individual states to agree on the content of a uniform form for broker-dealer and associated person registration.

In summary, I suggest that ACSEC's recommendation of uniform regulatory regime outside of the current SEC, FINRA, States model is extremely unlikely to gain support. The consequences, which would leave individual finders faced with differing state broker-dealer registration problems, would be chaotic, costly, and time-consuming. Also, with respect to any broker-dealer lite regime, unless there is Commission and FINRA pressure on the states to convince them that a registration procedure forgiving past violations of law is preferable to the status quo, as recommended in the 2005 ABA Task Force Report. some finders are more likely to be the subjects of state enforcement actions barring them from registration.[21]

This is why I recommend in Comment No. 4 below that the best approach to legitimizing the activities of unregistered finders is the broker-dealer lite approach set forth in the 2005 ABA Task Force Report, much of which is already in place at FINRA. A broker-dealer lite approach, spearheaded by the Commission, FINRA and NAASA is the only alternative that is likely to encourage states to adopt coordinated broker- dealer lite requirements for finders.[22] Most importantly, it would impose affirmative registration and qualification requirements for finders, making it the only approach that would help

[21] Consider, for example, that even though finders should be subject to lighter state regulation if they are not handling investors' funds or securities, states may subject the finders seeking broker-dealer registration to separate examinations to qualify, separate restrictions on contacts with investors, different record keeping, reporting and supervisory requirements, different investor suitability requirements, and they may cause some of the individual finders to do business as a legal entity, either because the state requires it or the finders conclude that it is in their best interests to do so as a regulated person subject to examination.
[22] I also point out that one of the worst of all possible approaches would be a broker-dealer lite approach adopted at the federal level without participation of FINRA and coordination with the states. Over fifty years ago, the Commission attempted to administer a system (SECO) for registered broker-dealers who did not wish to become members of the NASD. Suffice to say, it did not work well and was abandoned in favor of a requirement of mandatory membership in a broker-dealer self-regulatory organization.

remove a significant minority of unqualified and/or dishonest finders from securities intermediation activity.

2.C. Applicability of Securities Act §17(b). The Commission and the drafters of the proposed order appear to have overlooked the specificity of the antifraud provisions of Securities Act §17(b), which would be violated if certain specific disclosures were not made by Tier II Finders, and also by Tier I Finders if the Commission were to permit them to communicate with investors. §17(b) provides:

> "(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof."

Query: Rather than emphasizing safeguards available to unregistered finders at p.17, p.23 n.77, and p.25 n.85 of the proposed order, shouldn't the Commission have stated what §17(b) requires and added the following warning:

> The Commission takes this opportunity to emphasize that any person engaged in finder activity that includes any of the activities set forth in §17(b) and is receiving transaction-based compensation or any other form of compensation from an issuer of the securities or any person who is an underwriter or dealer in the securities, is in violation of the antifraud provisions of §17(b) if the receipt of such compensation and the amount thereof, whether past or prospective, has not been disclosed in accordance with §17(b). The provisions of §17(b) apply to unregistered finders and to registered broker-dealers and their associated persons if they engage in any of the activities set forth therein.

Without seeing the specific wording of the Commission's proposal, it is not possible to determine whether the "description of the terms of such compensation arrangement" referred to on page 25 of the proposed order, would fulfill the requirements of Section 17(b). Shouldn't there be a more specific requirement to disclose of the amount or rate of compensation?

With respect to the content of a Finder's written agreements with an issuer and disclosure to prospective investors of all compensation that a Finder will receive, I recommend that the drafters of the proposed order accept many of the proposals in Release No. 5407 regarding disclosure of compensation paid to solicitors for investment advisory relationships, where the drafters of have done a magnificent job in describing the comparable issues that arise, and in proposing a rule with the proposed solutions.[23]

[23] See Release No. IA-5407, Proposed Rule §275.206(4)-3 (pp.475-80) and discussion at pp. 205-233.

Here are some (not all) of the key requirements regarding Finders' compensation that should be addressed in the proposed order, or preferably in a Commission rulemaking proposal:

- In Release No. IA-5407, p. 213 and 221-222. the disclosure requirement for solicitor's compensation would require disclosure per proposed Rule §275.206(4)-3(a)(1)(iii)(F) of any additional cost to the investment advisory client. The comparable disclosure requirement for Finders should be a statement of how much of the compensation paid by the issuer will be recovered from the proceeds of the offering. I recommend that the disclosure requirement apply to compensation received "directly or indirectly".
- Comparable to the requirements proposed in Release IA-5407, Finders and issuers should be subject to record keeping and retention requirements with respect to their written agreements with issuers, written compensation disclosures made to prospective investors, and written acknowledgements received from investors.[24]
- Considering both Release No. IA-5407's emphasis on disclosure of all forms of solicitor's compensation, and California's requirement, described in Comment 2.B above, that finders disclose any ownership of the issuer's securities being sold, Finders under the proposed order should be required to disclose any ownership of securities of the issuer they are serving because additional investment in the issuer's securities by others may enhance or preserve the value of the Finders' security holdings.[25]
- Separateness and timing requirements of Finders' disclosure to investors should be consistent with the requirements proposed in Release No. IA-5407.
- Subject to the above separateness and timing requirements, it would seem reasonable to permit either an issuer or a Finder to make the required disclosure, provided their written agreement specifies who is obligated to do so.
- Consider what additional requirements of obligations should apply if the Finder is a federal or state registered investment adviser.

2.D. <u>The requirements in the proposed order that a Tier II Finder must disclose any affiliation with the issuer and any conflicts of interest are insufficient without further specification of disclosure requirements</u>. There is a difference between owning a small amount of an issuer's shares and being a controlling shareholder. If a Finder owns or has the right to acquire 5% or more of an issuer's equity securities, disclosure of such holdings based upon the principles of Exchange Act §13(d) should be required. Even this may be insufficient? What if the Finder has recently acquired or been given the right to acquire securities at a price significantly below the price being offered to investors in the private offering? Disclosure of any material transactions between a Finder and the issuer or affiliates of the issuer also is necessary. For example, what if an unaffiliated Finder has loaned funds to the issuer and will be repaid from proceeds of the private offering?

---

[24] It appears that Release No. IA-5407 would not require written acknowledgements. Because of the greater risk of abuse with respect to unsupervised Finders, I would require such acknowledgements for Finders' compensation disclosure, which might be made in writing or electronically, .

2.E. <u>Reasonable Belief Regarding Accredited Investors</u>. Although it is not stated in Reg. D, the Commission's staff has indicated that if a registered broker-dealer is participating in a Rule 506 offering on behalf of an issuer, the issuer may rely on the broker-dealer: (i) to fulfill the issuer's obligations with respect to offers to accredited investors if, e.g., the broker-dealer has a pre-existing relationship with these offerees (required only under Rule 506(b)); and (ii) to fulfill the issuer's obligations under Rules 506(b) and 506(c) to have a reasonable basis for a reasonable belief that purchasers investing through the broker-dealer are accredited investors.

A question that arises under the proposed order is whether the Commission is now proposing that the reasonable belief that Tier I and Tier II Finders are required have regarding accredited investor status of investors they find may be relied upon by the issuer to fulfill the obligations described in the above paragraph.

I certainly hope that the Commission's answer is NO because unlike reliance by an issuer on a registered broker-dealer:

- There are no qualification requirements for Finders under the proposed order whereas associated persons of broker-dealers are subject to written examination and continuing professional education requirements.
- While Finders will be agents of their issuers, it is unrealistic to believe that issuers will be able to effectively supervise Finders and no "failure to supervise' doctrine applies to issuers..
- Regulation BI, the know your customer and investor suitability requirements do not apply to unregistered Finders' interactions with potential investors.
- Unregistered Finders would not be subject to Commission and FINRA broker-dealer examination requirements.

I believe my view is consistent with the Paul Anka letter. The issuer in Paul Anka would have been required to fulfill its own reasonable belief obligations. Nothing in the letter indicates a contrary result. In fact, it would have been impossible for Paul Anka to confirm at the time of purchase that the purchasers from his list of accredited investors provided earlier to the issuer were accredited investors at the date of their purchases because Anka had represented through his counsel that after referring them he would have no offering-related contacts with them.

2.F. <u>If the proposed order were issued, unsupervised activities of unqualified founders is likely to lead to increased court litigation and voidable transactions instead of arbitration that would apply if finders were subject to a broker-dealer lite regime.</u>

If adopted, the proposed order is likely to lead to increased litigation against issuers and finders seeking recission or damages, and in some cases, regardless of whether fraud occurred. The reason is that Exchange Act §29(b) provides that any contract made in violation of any provision of the Exchange Act or of any rule or regulation thereunder "-----shall be void (1) as regards the rights of any person who, in violation of such provision, rule or regulation, shall have engaged in violation of performance of such contract, -----".

The effect of §29(b) is that if a Finder acting on behalf of the issuer of securities engages in a violation of the terms and conditions of the proposed order and, therefore, is deemed an unregistered broker-dealer in violation of Exchange Act §15(a), an investor purchasing the issuer's securities may have a right to sue the issuer and the Finder for recission of the transaction, or for damages if the investor no longer owns the securities. This risk should be described in the proposed order.[26]

A closely related issue also not discussed in the proposed order is whether issuers and Finders in exempt offerings should be able to require investors to waive recourse to remedies under the federal securities laws and submit to binding arbitration of disputes. My view is No because the Finders status as unregistered persons does not provide the investor protections inherent in a Commission supervised broker-dealer context, which the U.S. Supreme Court has cited in decisions upholding arbitration.[27] The Commission's proposal to exempt finders from broker-dealer regulation also means the Commission would not have recourse to take action against unfair arbitration provisions pursuant to Exchange Act §15(o).

2.G. <u>How will the proposed order affect independence requirements applicable to accountants who may wish to act as finders</u>? When the Commission adopted a final rule regarding independence requirements for accountants in 2003,[28] it indicated " We are including unregistered broker-dealers within the rules because the nature of the threat to independence is unchanged whether the entity is or is not a registered broker-dealer." The Commission stated in n. 82:

> "Accountants and the companies that retain them should recognize that the key determination required here is a functional one (*i.e.*, Is the accounting firm or its employee acting as a broker-dealer?). The failure to register as a broker-dealer does not necessarily mean that the accounting firm is not a broker-dealer. In relevant part, the statutory definition of "broker" captures persons "engaged in the business of effecting transactions in securities for the account of others." Securities Exchange Act of 1934 §3(a)(4). Unregistered persons who provide services related to mergers and acquisitions or other securities-related transactions should limit their activities, so they remain outside of that statutory definition. A person may "effect transactions," among other ways, by assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions. A person may be "engaged in the business," among other ways, by receiving transaction-related compensation or by holding itself out as a broker-dealer. Involvement of

---

26 *See* James Boll, "Finders Are Not Always Keepers!" Brimage Law Group (Sep. 4, 2012) available at https://www.brimage.com/legal-articles/civil-litigation/finders-are-not-always-keepers/, which describes what happened to Neogenix, a public biotech company that used unregistered finders in late-stage financings.
27 *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) and Rodriquez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).
28 Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 33-8183, (Jan. 28, 2003) available at https://www.sec.gov/rules/final/33-8183 htm.

accounting personnel as unregistered broker-dealers not only can impair auditor independence, but also would violate Section 15(a) of the Exchange Act."[29]

2.H. The proposed order fails to discuss how it might be perceived under FINRA Rule 2040. Paragraph (a) of this Rule states:

"(a) No member or associated person shall, directly or indirectly, pay any compensation, fees, concessions, discounts, commissions or other allowances to:

(1) any person that is not registered as a broker-dealer under Section 15(a) of the Exchange Act but, by reason of receipt of any such payments and he activities related thereto, is required to be so registered under applicable federal securities laws and SEA rules and regulations; or

(2) any appropriately registered associated person unless such payment complies with all applicable federal securities laws, FINRA rules and SEA rules and regulations."[30]

Supplementary material under Rule 2040 indicates what might constitute "Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act" The Commission's proposed order permits payment of transaction-based compensation to unregistered finders under circumstances where there would be no oversight of compliance with the order by the Commission or FINRA. What is FINRA's position on this issue?

2.I. It should be stated explicitly in the terms and conditions applicable to both tiers of Finders that they will not have access to investor funds and securities. If there are Finders assisting issuers with respect to private securities offerings that are best efforts, Mini-Max or all or none offerings in which a registered broker-dealer is not participating, the written agreement between the unregistered Finder and the issuer should require the issuer to comply with the escrow requirements of Exchange Act Rule 15c2-4. This rule is an essential augmentation to Exchange Act antifraud Rule 10b-9, which applies to all best-efforts offerings of securities. Therefore, it is essential that there is some means of ensuring that all issuers in these offerings honor the requirements of Rule 15c2-4, notwithstanding that the rule as issued is a broker-dealer rule.[31]

At present, the proposed order states in two places on p. 28 that finders will not handle funds or securities, but this falls short of stating as a term and condition that they will not have access to funds and securities. And, even if properly stated as a term and condition,

---

[29] It is noteworthy that in denying the no-action request of a law firm, Brumberg, Mackey & Wall PLC proposing to engage in finder activities, the Commission's staff cited the fourth and fifth paragraphs of n. 82 as support for the following statement in its denial of no-action relief: "A person's receipt of transaction-based compensation in connection with these activities is a hallmark of broker-dealer activity". This statement is omitted from the description of this no-action letter in n. 52 of the proposed order.

[30] *See* https://www finra.org/rules-guidance/rulebooks/finra-rules/2040.

[31] Note that the 2005 ABA Task Force Report's terms and conditions for a broker-dealer lite regime, which are summarized in Comment 4.A below, considered it sufficiently important to refer specifically to Rule 15c2-4 escrow requirements notwithstanding the fact that the Rule applies automatically to offerings in which a registered broker-dealer is participating.

this provision does not ensure that an issuer will not prematurely pay transaction-based compensation to the Finder before it has been established that all conditions of the offering have been met.

If there were no requirement for an escrow account, and (i) the required amount of funds was not subscribed within a stated offering period and funds subscribed had to be returned to investors, or (ii) an issuer proposed an extension of the offering period to raise the required amount under circumstances where the Commission's staff has indicated that investors who have already subscribed must have a right to withdraw their funds if they do not consent to the extension, there would be no assurance that the funds subscribed will be available for return. For example, what if the issuer has already used them for other purposes, including payment of transaction-based compensation to the finder.

2.J. Question 25 in the proposed order, whether there should be limits on compensation payable to Finders under the proposed order is an excellent question. However, to enable interested persons to consider this question in the circumstances of Reg. D Rule 506 offerings it would have been helpful to add certain disclosures in the textual discussion, as would normally be done in a Commission rulemaking.

For example, in addition to the fact that the Commission has not proposed any limits on Finders' compensation under the proposed order, it would have been helpful to disclose that:

- FINRA has corporate financing rules that require review of public offerings of securities in which a FINRA member broker-dealer is participating that define and place limitations on the compensation members may receive, and that the rules are premised on the obligation of FINRA members to observe high standards of commercial honor and just and equitable principles of trade.[32]
- The above FINRA requirements do not apply to private offerings made pursuant to Rule 506 of Reg. D. However, they do apply to Reg. A offerings and to Rule 504 offerings if the securities in these offerings are not restricted securities
- A separate FINRA Rule 5122 addresses proprietary private offerings in which a FINRA member is the issuer (MPOs). Rule 5122(b)(3) requires that at least 85% of the offering proceeds for each MPO must be used for business purposes, and that business purposes do not include offering costs, discounts, commissions, or other cash or the value of non-cash incentives.[33]

The reason I suggest that these disclosures are relevant is that finder's transaction-based compensation is the functional equivalent of broker-dealers' offering compensation. Many small business advocates for a finder's exemption from broker-dealer registration claim it would be too costly and burdensome to require the finders to register as broker-dealers. Could it be that the real reason finders are averse to broker-dealer regulation is fear that FINRA might not look favorably on their receipt of say 20% of offering

---

[32] *See* FINRA Rules 5110, 5121 and 2310 in the FINRA Manual *supra* note 5.
[33] FINRA Manual *supra* n. 5.

proceeds coupled with tie-in agreements[34] that force issuers to use and pay for their services in future capital raising transactions?

Finally to provide interested persons with a better idea of problems arising from there being no limit on finders' compensation, it would have been helpful to cite one or two SEC enforcement actions. My suggestion is In the Matter of Steven Bailen, SEC File No. 3-18626, SEC Rel. No. 34-83801 (Aug. 8, 2018) (unregistered broker-dealer compensation of 30-40 percent of the amounts invested).

2.K. Proposed statutory disqualification provisions are inadequate and should be augmented by the "bad boy" provisions of Reg. D Rule 508. If a person connected with an issuer would cause the issuer to be prohibited from using Reg. D because of the "bad boy" provisions of Reg. D Rule 508, and the person now wishes to be an unregistered finder for an issuer eligible to use Reg. D, why would anyone consider it advisable to permit such person to be an unregistered finder who serves pursuant to written agreement as the issuer's agent?

3. Paul Anka: "Propping Up" a "dead letter" that should be withdrawn. The Paul Anka no-action letter issued in 1991 appears to serve as the Commission's rationale for Tier I Finders' activities under the proposed order. One of the most troubling aspects of the proposed order's references to this letter are the incorrect and flawed attempts of the drafters to engage in revisionist history suggesting that Paul Anka has remained a mainstream staff interpretive position supporting finders' receipt of transaction-based compensation ever since the unfortunate day the letter was issued more than twenty-nine years ago.

The reality, as I explain below, is that Paul Anka is a very limited, fact specific exception to the hallmark principle that any person receiving transaction-based compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer.[35] This hallmark principle (i) is reflected in subsequent no-action letters denying exemptive relief; (ii) is stated in the Commission's Guide to Broker-Dealer Registration; and (iii) serves as an underpinning of many Commission and state enforcement actions involving unregistered broker-dealer activity, which are discussed in the two documents cited in the next two paragraphs below.

In "What Is A Broker-Dealer?" [36] Robert L.D. Colby, Lanny A. Schwartz, and Zachary J. Zweihorn indicate in n. 77 to their text when and where "the SEC staff has indicated that it would not provide no-action relief under a comparable Paul Anka fact pattern regarding compensation arrangements today." They point out in n. 78 to their text that the

[34] *See* discussion of this problem in third paragraph under Section C at p. 12 of 2005 ABA Task Force Report *supra* n. 3.
[35] *Compare* what is stated in n. 29 *supra* with how the drafters of the proposed order describe the Brumberg, Mackey & Wall, P.L.C. no-action letter in n. 52 of the proposed order.
[36] Robert L.D. Colby, Lanny A. Schwartz, and Zachary J. Zweihorn, "What Is A Broker-Dealer?" current as of July 25, 2016 and available at https://www.davispolk.com/publications/what-broker-dealer. (hereinafter What's A Broker-Dealer?).

Commission has brought a number of successful enforcement cases (most of which are not cited in the proposed order) against persons whose receipt of transaction-based compensation caused them to be unregistered broker-dealers. Some at the Commission may be aware that Mr. Colby currently serves as the Executive Vice President and chief legal officer of FINRA and earlier served as Deputy Director and Chief Counsel of the Commission's Division of Market Regulation during the years that many of these no-action letters and enforcement actions were issued and undertaken, respectively.

Similarly, the 2005 ABA Task Force Report, issued five years before the Brumberg, Mackey, and Wall, PLC no-action letter was issued, states at p. 18:

> "The SEC staff may be reconsidering whether Mr. Anka's activities sufficiently removed him or others like him from having the ability to engage in abusive sales practices that registration is intended to regulate and prevent. Based on staff comments at a recent Business Law Section meeting, the SEC staff may also be reconsidering its position in the Paul Anka letter situation and might not issue such a letter today."[37]

I also find it very troubling that on p. 16 of the proposed order, the drafters state: "In some matters, the staff provided the no-action statement that was requested." (citing five letters in n. 50). In the context of a paragraph that purports to consider other no-action letters "in relation to broker status issues, similar to those in the Paul Anka letter", this "In some matters" sentence may mislead a reader to conclude that the five letters cited in n. 50. are further support for the Paul Anka letter. If anyone were to come to this conclusion, they would be mistaken. All five of these letters were issued before the Paul Anka letter and none of them include a Paul Anka fact pattern where a finder plans to be compensated for finding investors to invest in an offering of securities. The five letters cited in n. 50 all are within the category of M&A letters where the finder proposes to find companies a client might be interested in acquiring without involvement in soliciting investors as sources of funds for the client.[38] Paul Anka involves a finder finding

---

[37] The "may also be reconsidering" language refers to a March 7, 2000 decision by the Commission’s staff to withdraw a 1985 no action letter issued to Dominion Resources which preceded Paul Anka and permitted Dominion to receive transaction-based compensation even though it was providing a variety of offering-related services to issuers of securities. For other documentation indicating concerns about the viability of the Paul Anka letter as ongoing guidance and/or citing successful SEC enforcement actions for violations of Exchange Act §15(a) due to receipt of transaction-based compensation, which are not disclosed in the proposed order, see Joseph D. Edmondson, Jr., "A Look At SEC Enforcement Actions Against Unregistered Finders" (Aug. 31, 2018) available at https://www.foley.com/en/insights/publications/2018/08/a-look-at-sec-enforcement-against-unregistered-fin (5 cases); Stephen M. Goodman, "SEC Says Again: Transaction-based Compensation Triggers Registration Requirement" Pryor Cashman LLP Legal Update (June 2010) available at https://www.google.com/search?client=safari&rls=en&q=SEC+Says+Again:+Transaction-Bsed+Compensation+Triggers&ie=UTF-8&oe=UTF-8 (Paul Anka); and "SEC Proposes Exemption from Broker-Dealer Registration for 'Finders'", Sullivan & Cromwell LLP (Oct. 20, 2020) n.5 available at https://www.sullcrom.com/files/upload/SC-Publication-SEC-Proposes-Exemption-Finders-Requirements.pdf (Paul Anka).

[38] Indeed, the Garrett/Kushell/Assocs letter cited in n. 50 is discussed in What's A Broker-Dealer? at p.2-26 as an example of an M&A letter where no action relief was granted, at least in part because the finder was not receiving transaction-based compensation.

investors to write checks to purchase securities. The five M&A letters cited in n. 50 do not.

When one looks at the Commission's website at the indexed listing of Division of Trading and Markets No-Action, Exemptive, and Interpretive Letters issued after January 1, 2002 under the category "Broker-Dealer Registration - Finders"[39] (thus, excluding the 1991 Paul Anka letter), only three letters are listed. None of the three letters accept the applicant's position that its finder's activities do not require broker-dealer registration. Two of the letters, Brumberg, Mackey & Wall, P.L.C. and John Loofbourrow Associates Inc., are cited as denials in the proposed order. See n. 52. This observation further supports the points made by others, that the Commission's staff has distanced itself from the Paul Anka letter.

The Paul Anka facts involved a one-time activity where Anka was apparently wealthy enough to hire top-flite legal counsel to advise him. I have substantial concerns regarding the many persons who would be acting as Finders under the Commission's proposed order. Few are likely to be paying $1,000 per hour or more for the correct securities law advice regarding Tier I and Tier II activities, which are not clearly articulated in the proposed order. I also doubt that the imagined Chinese Wall between referring accredited investors and engaging in general solicitation or investment recommendations would be effective as an investor protection safeguard.

As Commissioner Allison Herren Lee has insightfully pointed out regarding Tier II Finders, in order to induce investors to purchase securities that are unsuitable investments, a finder would not even have to violate the terms and conditions of the proposed order by providing advice as to the valuation or advisability on an investment.

> "Imagine a discussion in which a finder, who stands to gain proportionately for every dollar invested, finds an investor, teams up with an issuer to present offering materials and analysis, and sings the praises of a proposed investment. All she needs to do to avoid registration is refrain from concluding the presentation with the words "you should invest." The issuer itself can handle that last step if it is even needed."[40]

Over twenty-nine years have passed since the Commission's staff issued the Paul Anka letter. During that time, the age of the Internet and other technological changes in the way we communicate have caused many Americans (and probably Canadians) to become increasingly concerned about cybersecurity risks and other consequences of their personal information being shared against their wishes and to their potential detriment. The public mood regarding privacy rights has become much more vocal and protective.

---

[39] *See* https://www.sec.gov/divisions/marketreg/mr-noaction.shtml.

[40] "Regulating in the Dark: What We Don't Know About Finders Can Hurt Us", Public Statement of SEC Commissioner Allison Herren Lee (Oct. 7, 2020), p.2 available at https://www.sec.gov/news/public-statement/lee-proposed-finders-exemption-2020-10-07. My comments recommending adoption of a "broker-dealer lite" regime for finders would appear to agree with Commissioner Lee's views in favor or scaled regulation.. (*See* Comment 5 below.)

Lawmakers are aware of this trend and have been responsive to it. See Comment No. 1 above.

I respectfully suggest that if the Commission were presented a letter including the facts of the Paul Anka request today and granted it, wholly apart changing interpretations of who is a broker-dealer, there would be a number of individual accredited investors, myself included, that would be offended that a regulatory agency whose paramount mandate is investor protection considered it in the public interest to disrespect the investors' privacy and permit the selling of access that exposes them to uninvited, unregulated persons "hawking" unregistered securities offerings by issuers with significant risks of failure.[41]

In my opinion, in today's environment, what the Commission's staff did in Paul Anka, and what the proposed order would do, are not in the best interests of investors. In addition to furthering disrespect for investor's rights to privacy, both actions facilitate indirectly the introduction of irrational, affinity-based behavioral factors, such as herd behavior and groupthink, into investors' decision making. Consider, for example, how many investors lost money in Bernie Madoff's massive Ponzi scheme because a good friend they respected at their country club or at a religious gathering raved about Bernie's investment skills. Man's a genius! Yeah, right![42]

4. <u>The proposed order should be withdrawn. Instead, the Commission should study the broker-dealer-lite proposal in the 2005 ABA Task Force Report and determine how best to implement and integrate its recommendations within the alternative broker-dealer lite initiatives now reflected in FINRA's rules, which are referred to in Comment 4.C below. This may require a rulemaking and/or a few changes in the FINRA rules. It definitely requires consultation with and "buy-in" by NAASA and FINRA. In the interim and without further delay, the Commission should instruct the Division of Enforcement in conjunction with FINRA and state regulators to commence a sweep of unregistered finders reported in recent Form D filings as recipients of finders' compensation and not having a CRD number that would indicate their being an associated person of a registered broker-dealer. This action is essential to send a message that unregistered finders receiving transaction-based compensation face a choice to cease and desist or to comply with broker-dealer lite registration alternatives, which are not unreasonable under FINRA's current rules.</u>[43]

---

[41] Although the Ottawa Senators are an NHL franchise today, it is unlikely that Paul Anka's investors, even those with fond memories of "Diana" and "Lonely Boy", have good feelings about their investment in the first Ottawa Senators partnership. The partnership in which Anka's referrals were asked to invest had two changes of ownership, one in 1993, and the second after the team filed for bankruptcy in 2003. *See* https://en.wikipedia.org/wiki/History_of_the_Ottawa_Senators_(1992–).

[42] Commission enforcement actions involving affinity-based fraud suggest that the proposed order, which would further an active secondary market in affinity-based lists of accredited investors, is not the best way to protect these investors from making irrational decisions to invest in offerings some of which will be fraudulent and many more inconsistent with such investors' investment risk tolerance. *See e.g.* cases discussed in Investor Alert: Affinity Fraud (June 18, 2014) available at https://www.sec.gov/oiea/investor-alerts-bulletins/ia_affinityfraud html.

[43] As explained in the 2005 ABA Task Force Report, this is matter of some delicacy and requires consensus among the three sets of regulators, so that an unregistered finder who may not even have been aware that what he was doing required broker-dealer registration and FINRA membership and whose activities do not

4.A. 2005 ABA Task Force Report. In 2005 a very responsible and talented group of lawyers, with first-hand experience regarding the investor protection problems that unregistered, unregulated finders present, published the 2005 ABA Task Force Report. This Report's comprehensive analysis and recommendations are by far the best proposal that I have seen for addressing the unregulated finders' problem. The Report sets forth the terms and conditions of its proposed broker-dealer lite recommendation as follows:

> "We believe that the SEC, NASD and State Administrators ("Regulators") should work to establish a simplified system for registration for PPBDs. [private placement broker-dealers] This system should recognize that PPBDs will be permitted to engage in only very limited activities.
>
> "Firms and principals of those firms eligible to participate in this limited category should meet certain minimum criteria including:
>
> - No participation in public offerings registered pursuant to the Securities Act of 1933, but with the ability to receive referral fees for introducing such offerings to full-service broker-dealers.
> - No statutory disqualifications of the firm or its principals.
> - Offerings by PPBDs could be made only to accredited investors and qualified purchasers when the SEC defines the term. Issuers however could separately offer to any investor qualified by the type of exemption.
> - The firm may not handle or take possession of funds or securities.
> - All offerings would be done on a best-efforts basis.
> - All funds from offerings will be placed in escrow in an unaffiliated financial institution and in accordance with escrow requirements in SEC Rule 15c2-4.
> - The firm must not engage in secondary market or trading activity, including assisting with maintenance of "desk drawer" markets at the issuer or the broker-dealer.
> - Principals and representatives shall have successfully completed NASD examinations appropriate to the scope of activities of the PPBD.
>
> The rules and procedures relating to membership in the NASD, record keeping and reporting, net capital, testing and continuing education should be modified to address only requirements which are logically applicable to the activities of the PPBD.
>
> We recommend that the PPBD be required to file an annual Statement of Activity with the NASD and applicable states which summarizes the transactions in which

appear to have caused any material damage to issuers or investors is given a reasonable grace period (e.g. six months) to register and qualify under one of FINRA's broker-dealer lite alternatives. 2005 ABA Task Force Report *supra* n.3, pp. 5-6 and pp. 46-47. On the other hand, if the unregistered finder's activities reveal fraud, such as in the Bailen case (Comment 2.J above), timely and robust enforcement action should be taken.

it has participated during the past calendar year and provides sufficient statistical information for regulators to analyze the effectiveness of the PPBD program or to conduct appropriate inspections."[44]

Other key parts of the 2005 ABA Task Force Report are:

- The Task Force's four objectives. p. 3
- What Problems does One Confront When Using an Unregistered Financial Intermediary? pp. 12-14
- Civil Liability under Federal Securities Laws. pp. 37-41
- Exemptions For Unregistered Broker Dealers, where the Task Force explains why an exemption approach will not succeed. pp. 47-49
- Problems in Compliance with the Present Regulatory System for Unregistered Financial Intermediaries, which would continue to have relevance to the extent the FINRA Capital Acquisition Broker Rules do not already address the Report's recommendations for reducing these compliance problems. pp.49-52

Unfortunately, a majority of the Commission ,and staff proponents of the proposed order either have not studied the 2005 ABA Task Force Report or they fail to appreciate why a broker-dealer lite regime is markedly preferable to an exemptive order for unregistered finders because:

- It would permit the Commission, with assistance from FINRA, to make certain basic components of broker-dealer regulation applicable to finders, such as written examination requirements limited to the scope of their activities, restrictions on cold calling, supervisory procedures, arbitration provisions, and regulatory inspection and disciplinary authority.
- It would facilitate exclusion of a significant minority of finders whose activity is in many cases fraudulent and in many others, pressures investors to purchase unsuitable investments. This activity is not in the best interests of investors or issuers and the proposed order, if adopted, would embolden this activity and lead to the presence of more unqualified, dishonest finders.
- It is the only regulatory policy toward finders that may be readily coordinated with FINRA and state securities regulators, an important step that would contribute positively to small business capital formation.
- It would be significantly more consistent with Commission interpretive precedent regarding what constitutes broker-dealer activity, and it would preserve current Commission litigation positions regarding broker-dealer activity.

No report is perfect,[45] but in my opinion the 2005 ABA Task Force Report "handed the Commission on a platter" a document, even containing first drafts of suggested

---

[44] 2005 ABA Task Force Report *supra* n. 3, p. 3.

[45] I believe that if I had read the Report in 2005, I would have endorsed it in its entirety. Fifteen years later, taking into consideration subsequent developments and the research I have undertaken in preparing these comments, (i) I would have rejected the view that there is a broad class of small business issuers deserving of special consideration in seeking investors; (ii) For reasons explained in Comment 7.B, I would limit the

registration forms, that could have quickly been turned into a rulemaking proposal. Unfortunately, the Commission has never done so with respect to the 2005 Report, or with respect to one earlier and one subsequent ABA/ broker-dealer lite proposals.[46] However, about twelve years later, the Commission approved a broker-dealer lite regime proposed by FINRA. This regime has been in effect since early 2017 and is set forth in FINRA's Capital Acquisition Broker Rules (CAB Rules) discussed in Comment 4.C below.

4.B. <u>The Commission majority approving the proposed order overlooks that a broker-dealer lite regime, imposing affirmative qualification requirements tailored to finder activities, is the only regulatory approach, augmented by Commission and state enforcement actions, that will reduce the size of the undesirable element that is currently a significant part of the finder universe, acting unlawfully and not promoting capital formation for anyone but themselves</u>. I am very concerned that fifteen years after the 2005 ABA Task Force Report, the unsavory element among the universe of unregistered finders may have grown significantly and could grow even more. Perhaps the greatest shortcoming of the Commission's proposed order is that it fails to address this problem.

FINRA statistical reports indicate that for 2019 there were 624,674 registered representatives registered with its 3,517 member firms.[47] In a universe of this size, it is not a statistical anomaly to expect that there will be bad actors. Brokerage firm terminations are likely to increase significantly due to Covid-19. A small minority of those terminated will be bad actors. If the Commission were to adopt the proposed order, let's hope that these bad actors decide not to continue participation in the securities industry, because if they do, there are no effective means to ensure their compliance with the proposed order's terms and conditions or to prevent them from engaging in fraud.

Unfortunately in processing termination requirements for associated persons of registered broker dealers, the Form U-5 Termination Notice system has its shortcomings. Consider the following hypothetical:

> Ben Quick recently lost his job as a registered representative at a registered broker-dealer firm when his branch manager found a draft letter on Ben's desk that Ben proposed to send to some of the firm's clients soliciting an investment in a limited partnership to be managed by Ben, and whose business would use drones to deliver gourmet meals and perform home security checks in affluent suburbs. Ben knows zero about the drone business, but he figured he could learn after the partnership is funded and he collects his 15% annual management

---

investors who may participate in offerings under a broker-dealer lite regime to the institutional investors currently defined by FINRA rules, which actually includes individual accredited investors that are also qualified purchasers; and (iii) I am uncertain whether subsequent M&A no-action letters require M&A finders to be part of a broker-dealer lite regime.

[46] The existence of earlier and later proposals during the 2002-2012 period are recited without further explanation in Stephen M. Honig, "'No-action letter': SEC relief for M&A finders", New England In-House (April 13, 2014) available at https://newenglandinhouse.com/2014/05/21/no-action-letter-sec-relief-for-ma-finders/.

[47] Available at https://www finra.org/media-center/statistics#key.

fee. Ben is disappointed that the firm did not embrace his proposal to pursue the Great American Dream with other peoples' money. However, he is pleased that before he was escorted out of their offices, he was able to use his thumb drive to secretly download the firm's client list, which identifies accredited investors, and its IPO list for even wealthier investors.

Ben Quick's brokerage firm has to file a Form U-5 regarding his termination. There are several possibilities among the boxes that might be checked to report his termination. After making it clear to Ben that he is history and not knowing of the stolen client list, his branch manager and compliance officer might convince him that in order to avoid future regulatory issues for both parties, he should submit a voluntary letter of resignation so the reason for termination on Form U-5 may be checked as Voluntary with no further explanation required.[48] Or, if the firm elects to check Permitted to Resign, Discharged, or Other on Form U-5, the required explanation might read "Prevented from engaging in proposed activity that might have violated FINRA rules regarding supervision of investor communications and private securities transactions. However, no such communications or transactions occurred."

Ben Quick also has a choice to make. Does he still want to become a crooked issuer or is it easier to become a crooked finder?

4.C. FINRA CAB Rules, not mentioned in the proposed order, are oriented primarily to a finder that would be a legal entity registered as a broker-dealer and FINRA member under a broker-dealer lite regime. Other FINRA rules, also not mentioned in the proposed order, provide two registration categories, Private Securities Offerings Representative and Private Securities Offerings Principal that would permit individual finders at very little cost to qualify via examinations for these categories, associate with any FINRA member firm that would have them and engage lawfully in a broader category of private offering activities than permitted under the proposed order.

I have reviewed the FINRA CAB Rules.[49] Insofar as they are oriented to a legal entity complying with them,[50] including a registered FINRA broker-dealer converting to them, I believe the CAB Rules are fundamentally sound. There are a few provisions that might be reconsidered. For example:

- Instead of requiring registration for advising a company regarding its purchase or sale of a business or assets or regarding its corporate restructuring, including a going-private transaction, divestiture or merger, or advising a company regarding its selection of an investment banker, I would make doing so a registration

---

[48] Most employers also prefer voluntary resignations because it reduces unemployment compensation costs

[49] *See* FINRA Regulatory Notice 16-37, "SEC Approves FINRA's Capital Acquisition Broker (CAB) Rules, which links to the FINRA website where the CAB Rules are included in the FINRA Manual available at https://www finra.org/rules-guidance/notices/16-37.

[50] Legally, I believe SEC and FINRA registration requirements would permit a sole proprietorship to register as a broker-dealer, although as a practical matter this is rarely done. That is why, in the case of finders who are natural persons, the FINRA qualification categories for private securities offerings representative and private securities offerings principal, described below, are more advantageous alternatives for registration as associated persons of already registered broker-dealers.

requirement only if there is no SEC rule, release, interpretation or no-action letter that permits a person to engage in such activities without having to register as a broker or dealer pursuant to Section 15(b) of the Exchange Act

- In determining capital and reporting rules under the Exchange Act that should apply to a capital acquisition broker, I would leave it up to the Commission to make adjustments so that the requirements are similar to the annual report and other requirements suggested in the 2005 ABA Task Force Report, and I would dispense with the requirement that a capital acquisition broker must have a FinOp principal.

Here are the provisions of FINRA Rule 1220 that would permit a finder who is a natural person to become associated with a FINRA member firm as a:

> **"(13) Private Securities Offerings Principal**
> **(A) Principals Engaged in Limited Activities**
> Each principal as defined in paragraph (a)(1) of this Rule may register with FINRA as a Private Securities Offerings Principal if his or her activities in the investment banking or securities business of a member are limited to the activities specified in paragraph (b)(9) of this Rule.
> **(B) Qualifications**
> Subject to the lapse of registration provisions in Rule 1210.08, each person registered with FINRA as a Private Securities Offerings Representative and a General Securities Principal on October 1, 2018 and each person who was registered with FINRA as a Private Securities Offerings Representative and a General Securities Principal within two years prior to October 1, 2018 shall be qualified to register as a Private Securities Offerings Principal without passing any additional qualification examinations.
> All other individuals registering as Private Securities Offerings Principals after October 1, 2018 shall, prior to or concurrent with such registration, become registered pursuant to paragraph (b)(9) of this Rule as a Private Securities Offerings Representative and pass the General Securities Principal qualification examination."

Here are the provisions of FINRA Rule 1220 that would permit a finder who is a natural person to become associated with a FINRA member firm as a:

> **"(9) Private Securities Offerings Representative**
> **(A) Representatives Engaged in Limited Activities**
> Each representative as defined in paragraph (b)(1) of this Rule may register with FINRA as a Private Securities Offerings Representative if his or her activities in the investment banking or securities business of a member are limited to effecting sales as part of a primary offering of securities not involving a public offering, pursuant to Sections 3(b), 4(2) or 4(6) of the Securities Act and the Securities Act rules and regulations, provided, however, that such person shall not effect sales of municipal or government securities, or equity interests in or the debt of direct participation programs as defined in paragraph (b)(8)(A) of this Rule.

(B) Qualifications
Subject to the lapse of registration provisions in Rule 1210.08, each person registered with FINRA as a Private Securities Offerings Representative on October 1, 2018 and each person who was registered with FINRA as a Private Securities Offerings Representative within two years prior to October 1, 2018 shall be qualified to register as a Private Securities Offerings Representative without passing any additional qualification examinations.
All other individuals registering as Private Securities Offerings Representatives after October 1, 2018 shall, prior to or concurrent with such registration, pass the SIE and the Private Securities Offerings Representative qualification examination. However, FINRA shall, upon such evidence as it determines to be appropriate, deem any person who while employed by a bank, engaged in effecting sales of private securities offerings as described in paragraph (b)(9) of this Rule, during the period from May 12, 1999 to November 12, 1999, as qualified to register as a Private Securities Offerings Representative without the need to pass the SIE and the Private Securities Offerings Representative qualification examination.

Some commenters have criticized FINRA's CAB Rules on the grounds of compliance costs and limitation of their applicability to private offerings to institutional investors.[51]

With respect to the costs issue, it should be noted that the 2014 ABA Letter actually appears to be commenting on minimum costs of becoming and annually remaining as a FINRA broker-dealer under FINRA's then current rules, not on costs of compliance with the proposed rules for Limited Corporate Financing Brokers, and certainly not on the costs of compliance with the FINRA CAB Rules as adopted in 2017. Also, there is no reference to the 2005 ABA Task Force Report's recommendation regarding how costs of a broker-dealer lite regime might be minimized.[52] Most importantly, however, the commenters overlook that the FINRA CAB Rules are oriented to how finders organized as a legal entity may become registered and operate as a CAB broker-dealer. This overlooks the opportunities described above that individual finders currently have under other FINRA rules to associate with a currently registered FINRA broker-dealer at virtually no upfront cost as a private securities offerings registered representative or a private securities offerings registered principal.

With respect to what is now FINRA Rule 016(i), Mr. Yadley took a stronger view than the 2014 ABA Letter in commenting that in limiting private offerings to institutional investors, the FINRA regime "does not go far enough to be meaningful to small business

---

[51] See Letter dated May 21, 2014 to FINRA Office of Corporate Secretary from Catherine T. Dixon, Chair, ABA Business Law Section Federal Regulation of Securities Committee commenting on FINRA Proposed Rules for Limited Corporate Financing Brokers, p. 6 (costs) and p. 9 (institutional account definition) (hereinafter 2014 ABA Letter) available at
https://www finra.org/sites/default/files/NoticeComment/p512735.pdf ; and Gregory C. Yadley, "Notable by Their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation," (June 3, 2015) p. 7 (institutional investors) *available at* https://www.sec.gov/info/smallbus/acsec/finders-and-other-financial- intermediaries-yadley.pdf
[52] 2005 ABA Task Force Report *supra* n.3 pp. 49-51.

issuers."[53] As currently in effect, however, Rule 016(i) permits offerings to institutional and individual qualified purchasers. The qualified purchaser inclusion was recommended in the 2014 ABA Letter. I explain in Comment 7.B below why I believe FINRA got this right.

It is very unusual that the Commission approved the above-cited FINRA rules and has now proposed to proceed in a different direction under the proposed order without any explanation for this change.

4. D. Concerns expressed about the costs and other burdens of a finder becoming a FINRA Capital Acquisition Broker do not take into consideration the alternative of individual finders associating with other currently registered broker-dealers. However the fact that not many finders have elected to register under either FINRA alternative suggests that there may be other undisclosed concerns on the part of both finders and registered broker-dealers that impede the process, rather than the publicly stated assertion of small business advocates that Reg. D financings are too small to be considered by registered broker-dealers.

One of the principal arguments of small business advocates is that unregistered finders are necessary to fill a gap in capital raising that is not being fulfilled by registered broker-dealers, and that it would be too costly and burdensome to require the finders to become registered broker-dealers. When I think of Merrill Lynch and Morgan Stanley, I am inclined to accept this argument. Even when I think of the top 100 broker-dealer firms who probably account for over 80-90% of all primary and secondary securities transactions the argument remains plausible.[54] However, as noted in Comment 4.B above, FINRA's 2019 statistics show that there are over 3500 registered broker-dealer firms. And, as pointed out in Comment 4.C above, in addition to its CAB Rules designed primarily for a broker-dealer lite entity, FINRA has already established registered representative and registered principal qualification categories that would permit finders who are natural persons to qualify at little upfront cost and associate with any broker-dealer firm that would have them.

Why is this not happening? FINRA data for 2018 regarding median registered representatives per member firm show that the median is approximately 11 representatives.[55] This means that many FINRA member firms are actually small businesses, and that they managed to overcome any costs and burdens of becoming registered broker dealers. In today's difficult economic environment why wouldn't one of these small member firms welcome the opportunity to take on an individual finder who is an experienced producer?

---

[53] Notable by Their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation *supra* n. 51.

[54] In shunning Reg. D offerings, many of the larger broker dealers are providing venture capital in more important ways, such as direct investment, asset management, investment in venture capital funds, and sponsorship of their own venture capital funds.

[55] Available at https://www finra.org/rules-guidance/guidance/reports-studies/2019-industry-snapshot/representative-data#repstwo.

I can identify two reasons and neither one of them is a good reason to exempt individual finders form broker-dealer regulation.

From the FINRA member firm's viewpoint, Suzanne Rothwell, an experienced former Associate General Counsel of FINRA, points out:

> "FINRA has stated in public meetings and in its Regulatory Letters, and its numerous enforcement actions reflect that in conducting its reviews of private placements FINRA staff are finding that a significant number of private placement filings made under Rule 5122 and Rule 5123 are problematic. In particular, FINRA has expressed concern that broker-dealers are not performing their reasonable suitability responsibilities as described in Notice 10-22. FINRA's enforcement actions have continued to involve violations of:"[56]

Her article strongly suggests that rather than avoiding smaller Reg. D offerings for cost reasons, smaller broker-dealer firms who might profit from participation in these offerings may have concluded that many of the offerings are unsuitable for their clients and participation might expose them to regulatory sanctions and reputational damage to the firm.

Perhaps the capital formation gap cited by small business advocates is really a securities law compliance gap. If some registered broker-dealer firms have encountered FINRA (and SEC) enforcement problems with Reg. D offerings, it frightens me to think of the problems unregistered finders are causing.[57]

From the individual, unregistered finder's viewpoint, the prospect of association with a registered broker-dealer may cause an honest finder to ask why do I want to share my compensation with someone else when no one is forcing me to do so? From the viewpoint of a finder who, for example, is earning very generous transaction-based compensation that is not being disclosed to investors, the reaction may be: "Oh no, not the Feds and FINRA." And, of course, as the 2005 ABA Task Force Report noted, there may be some finders who really don't know they are violating the law.[58]

The proposed order's advocacy of a broker-dealer exemption for finders because successive, annual small business forums have recommended some measure of relief for them is not necessarily sound reasoning that the proposal has merits. It fails to consider there may have good reasons why successive Commissions did not act on the proposal. Perhaps this would be a fruitful area for inquiry of past Commission Chairs. Off the record answers might range from "Good idea. We had so many priorities, we just never

---

[56] Ms. Rothwell goes on to describe a litany of over a dozen problems constituting fraud and failure to supervise violations. *See* Suzanne E. Rothwell, "FINRA Rules for Private Placements", Chapter 7 in Vol 1 of <u>Securities Law Techniques</u>, A.A. Sommer, Jr. ed. LexisNexis (updated through June 2019).

[57] *See* n. 79 below regarding one of the Commission's most recent enforcement actions against unregistered broker-dealers.

[58] 2005 ABA Task Force Report, *supra* n. 3, p. 2.

got around to taking it up" to "We didn't think a good case had been made that unregistered finders are essential for small business capital formation, especially in light of investor protection problems with unregistered intermediary activities" to "We thought we were being conned."

5. <u>The Commission's Office of Small Business Advocacy and annual small business forums seem to have shifted towards a populist view that the Commission's job is to ensure access to capital by all small businesses. However, what is a statutory mandate for the Office of Small Business Advocacy is not a statutory mandate for the Commission or other Commission divisions and offices.[59] The Commission's should consider competing viewpoints as to what is best in terms of investor protection and its more generally stated mandate to promote capital formation. That mandate does indicate that the Commission should decide who gets capital. I respectfully suggest that the Commissions' more general mandate is to ensure that there are federal securities laws and regulations in place that support a fair and efficient market infrastructure, which provides with full disclosure to investors and permits capital to be allocated to productive undertakings that may produce returns for investors consistent with their tolerance for risk</u>.

The philosophy underlying the federal securities laws relating to primary securities offerings is that any issuer, small or large, should have an opportunity to raise capital publicly or privately, provided the issuer is willing to play by the rules and make full disclosure of all information that a prudent investor would consider material to an investment decision.[60] If the issuer does so, it is not up to the Commission to allocate capital. This is a decision for the investors and private sector intermediaries they rely on for investment advice and investment management, including allocation of capital they manage. Many small business advocates and others fail to recognize that as "gatekeepers" these intermediaries are performing invaluable functions in "screening out" unworthy business proposals.

There are very sound reasons why many small businesses, particularly those that are inefficient, uncompetitive, poorly managed, failing financially, or simply do not wish to grow, should not expect to be able to raise capital from outside investors.

6.A <u>Debunking the Small Business Jobs Growth Myth</u>. It has become commonplace for advocates of U.S. small business initiatives to begin and premise their advocacy with a paean about how small businesses are the creators of most jobs' growth in the United States. Therefore, I am not surprised the that the second sentence under Introduction on page 3 of the proposed order reads:

---

[59] Now that I've read the SEC provisions of the Small Business Advocate Act of 2016 (15 U.S.C. §§ 78d and 78qq), I understand this difference.

[60] In some cases, where a prospectus or offering memorandum is not required, the antifraud provisions of federal and state securities laws still apply. The full disclosure obligation applies to oral offerings and requires truthful responses to any questions the issuer of its representatives may receive from prospective investors.

> "Our dynamic market and economy significantly benefit from a robust pipeline of new small businesses, which create the majority of net new jobs in the United States and generally contribute to innovation." (Authority cited is discussed below.)

A recent book[61] by Robert D. Atkinson and Michael Lind presents compelling evidence that despite assertions by Congress and every U.S. President since Gerald Ford[62] that U.S. small businesses are drivers of jobs growth, this assertion is not true with respect to most small businesses.

Here are a few paragraphs taken from the Preface of Atkinson & Lind, which summarizes their thesis:

> "Small business is the basis of American prosperity. Small businesses are overwhelmingly responsible for job creation and innovation. In addition, small businesses are more productive than big companies. As they power the American economy, small business owners are the basis of democracy in America, whose health depends on the existence of a large and growing number of self-employed citizens. Yet Washington, controlled by big business and engaged in "crony capitalism," systemically discriminates against small businesses.
>
> <u>Every word in the previous paragraph is false or misleading.</u> Small businesses create many jobs, but they also destroy many jobs because most small businesses fail. Virtually all big firms are more productive than small ones—that is why they got big and that is why they pay their workers more. <u>Only one particular kind of small firm contributes to technological innovation, the technology-based startup, and its success depends on scaling up, either on its own or in affiliation with large corporations, which are themselves extremely innovative because they can marshal the resources needed to invest in innovation." (Underling added.)</u>[63]
>
> *****
>
> "We conclude by calling for size neutrality in government policies toward business—including in taxation, financing and subsidies, procurement, and regulation—combined with a focus on new high-growth business, not small business, that is, on dynamic startups that can transform the economy, not on small businesses whose owners do not engage in innovation and do not seek growth.[64]

---

[61] Robert D. Atkinson and Michael Lind, <u>Big Is Beautiful: Debunking the Myth of Small Business</u>, (MIT Press, 2018). (Kindle Edition). 441pp. [(hereinafter cited as Atkinson & Lind).

[62] Atkinson & Lind, *supra* pp.10-11.

[63] *Id*. p.6.

[64] With respect to the motivation of small business owners, Atkinson & Lind point out at pp.135-36 that: (i) "Nearly three quarters of individuals who start a business want to keep their small businesses small." citing US Census Bureau, Business Dynamics Statistics (Longitudinal Business Database, Firm Characteristics Data Tables, Firm Age by Firm Size, 1977 to 2014, https://www.census.gov/ces/dataproducts/bds/data_firm html (accessed March 17, 2017);

> Our motive in writing Big Is Beautiful is not hostility toward small firms, some of which have vital functions to play in a dynamic economy that includes firms of all sizes as well as nonprofit research institutions and growth-promoting government agencies. Our intervention in this debate is motivated by our conviction that boosting America's economy-wide productivity makes all other public policies easier to achieve. The best way to boost productivity is to remove obstacles to the replacement of small-scale, labor-intensive, technologically stagnant mom-and-pop firms with dynamic, capital-intensive, technology-based businesses, which tend to be fewer and bigger. The current "small is beautiful" belief, held by both sides of the political aisle, represents a major barrier to that necessary and beneficial reallocation. But doing so will require debunking the small-is-beautiful myth while at the same time working to restore the reputation of large firms as engines of progress and prosperity."[65]

Robert D. Atkinson and Michael Lind are not "flakes". Atkinson is president of the Information Technology and Innovation Foundation, a public policy think tank based in Washington, D.C., that promotes policies based on innovation economics. Lind is a writer and academic with undergraduate and law degrees from the University of Texas and a master's degree from Yale University. He is currently a professor at the Lyndon B. Johnson School of Public Affairs at the University Texas at Austin. Their book is very well documented, citing numerous studies, some sponsored by U.S. Government agencies and others based on U.S. Government data, that support their thesis. At a minimum, I recommend reading the following parts of Atkinson & Lind:

- Full Preface, pp. 6-8.
- Chapter 1, Belittled: How Small Became Beautiful, pp. 10-32.
- Chapter 3, Understanding US Firm Size and Dynamics, pp. 58-94.
- Chapter 4, The Bigger the Better; The Advantages of Firm Size, pp. 95-103.
- Chapter 5, Small Business Job Creation: Myth vs. Reality, pp. 127-146.
- Chapter 12, Small Business Cronyism; Policies Favoring Small Business, pp. 328-55.

The book is available in electronic form as well as hardcover.

Atkinson & Lind also are not outliers in challenging the beliefs that a broader category of small businesses account for net jobs creation. In a 2009 article by Alan D. Viard and

---

(ii) Surveys show that the lion's share of people who start a small business do so not because they want to be a rich entrepreneur, something that takes enormous dedication and hard work to achieve; rather, most don't want to work for a boss. citing Hurst & Pugsley, "What Do Small Businesses Do?" available at https://www.brookings.edu/wp-content/uploads/2011/09/2011b_bpea_hurst.pdf; and
(iii) "One study of a representative sample of the founders of new businesses started in 1998 showed that 81 percent of them had no desire to grow their new businesses." citing Scott Andrew Shane, The Illusions of Entrepreneurship: The Costly Myths That Entrepreneurs, Investors, and Policy Makers Live By, Google Books, 2008, p.154.
[53] *Id*. p. 8.

Amy Roden of the American Enterprise Institute for Public Policy Research, the authors cite four studies that lend support to Atkinson & Lind's thesis.[66]

Atkinson & Lind's contention that technology-based startups are the only kind of small firm that contributes to technological innovation is not good news for small business advocates holding the populist view that all small businesses deserve access to outside capital because Atkinson & Lind also point out that

> "by the mid-2000s only about 7 percent of new company startups in the United States were in high-tech industries and only about 3 percent of business founders considered their new businesses to be 'technologically sophisticated'."[67]

6.B <u>Rather than supporting a broader small business jobs growth thesis, the article cited in n. 3 of the proposed order (hereinafter Akcigit & Kerr) actually supports Atkinson & Lind's thesis because the article's research model was limited to small firms that are technology-based startups</u>. More specifically, Akcigit & Kerr state:

> "First, our sample includes only innovative firms, which have a different firm size distribution than the economy as a whole. In our sample, for example, 14 percent of firms have more than 500 employees at some point in their life span (12 percent for all observations of the firm), while this share is about 0.3 percent for the whole economy. This tilt toward larger firms is not surprising, as the majority of small firms do not seek new innovations or to grow from their current size (Hurst and Pugsley 2011). This is often connected to nonpecuniary motivations for starting a business (e.g., to be one's own boss). We thus exclude large numbers of noninnovative firms from our sample (e.g., restaurants, beauty salons, grocery stores) to be in keeping with the model of innovative firms." (footnote omitted but discussed in next paragraph)[68]

In the last sentence of their n. 11 to the above paragraph, in describing the size of firms in the sample, Akcigit & Kerr state: "The mean employment level is about 1,805 workers."[69] The sample appears to have some large "small" businesses.

7.A. <u>SBA statistics regarding small businesses failure rates suggest that a stand-alone purchase of illiquid, restricted securities of a small business issuer under a Reg. D, Rule 506 offering, may exceed the risk tolerance of many individual accredited investors,</u>

---

[66] *See* Alan D. Viard and Amy Roden, "Big Business: The Other Engine of Economic Growth" AEI No. 1 (June 1, 2009) text and studies cited in notes 6, 14, 15 and 17 available athttps://www.aei.org/research-products/report/big-business-the-other-engine-of-economic-growth/

[67] Atkinson & Lind *supra* n. 61 at p. 161 citing Scott A. Shane, <u>The Illusions of Entrepreneurship: The Costly Myths That Entrepreneurs, Investors and Policy Makers Live By</u> (Yale Univ. Press, 2008) p. 30.

[68] Akcigit & Kerr, cited in the Commission's proposed order n. 3. p. 1381. Note also that both Atkinson and Lind (*supra* n. 52 (ii)) and Akcigit & Kerr cite to Hurst and Pugsley 2011). Akcigit & Kerr appears to be a well-prepared article. (I disclaim any ability to understand the higher-level mathematics.) While the article includes some references to small business growth and jobs, it appears that the main focus is to examine how the sample of firms best achieve innovation via internal or external means.

[69] Akcigit & Kerr, *supra*, 1st sentence.

particularly those close to the base income and net worth levels required for accredited investor status.

According to the SBA:

"Four out of five establishments that started in 2017 survived until 2018 (79.4%). This percentage was similar to the average one-year survival rate from 2008 to 2018 of 78.7%.

- About half of all establishments survive five years or longer. In the past decade, this ranged from a low of 45.4% for establishments started in 2006, and a high of 51.1% for those started in 2010.
- About a third of establishments survive at least 10 years. Although timely data is not available on firm survival rates, about two out of three establishment exits are firm closures. Note that an establishment is defined as a business location.[70] *Source: BED, BDS; Office of Advocacy calculations*"[71]

Given these statistics, a rational analysis, based on risk-reward relationships and modern portfolio theory would suggest that the Commission should be pursuing initiatives that permit certain individual accredited investors to participate in pooled investment vehicles that act as "gatekeepers" for screening small business startups and to diversify investment risk by investing in a portfolio of these enterprises that have innovative products and services that improve productivity, which make them the enterprises most likely to grow into larger enterprises that create jobs and shareholder value.

7.B. The Commission's proposed order would result in issuers and unregistered, unqualified finders encouraging accredited investors to invest in individual issuers' standalone Reg. D private offerings. However, the Commission's Reg. D usage statistics for 2009-2017[72] show that accredited investors, many of whom are actually qualified purchasers with not less than $5 million of investments, have chosen overwhelmingly to make more prudent Reg. D investments in private investment funds; presumably because the private funds offer diversification or risk and professional management in selecting investments. Given these circumstances, and without any empirical evidence that Reg. D issuers are even net creators of jobs, how is the proposed order consistent with the Commission's investor protection mandate?

[70] If a small business enterprise has more than one establishment, this means that the enterprise might have survived with one or more other establishments remaining open.

[71] https://cdn.advocacy.sba.gov/wp-content/uploads/2019/09/24153946/Frequently-Asked-Questions-Small-Business-2019-1.pdf.

[72] Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017" (Aug. 2018) (hereinafter 2018 Report) available at Rachttps://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf" I have also reviewed "Report to Congress on Regulation A / Regulation D Performance" As Directed by the House Committee on Appropriations in H.R. Rept. No. 116-22 (Aug. 2020). available at https://www.sec.gov/files/Report%20to%20Congress%20on%20Regulation%20A.pdf. However, I am using the 2018 Report because it provides a better breakdown of the data I needed to support this comment.

Applying some elementary math to the 2018 Report's data on p. 22 and in Table 11 on p. 34 reveals that of the \$10.32 trillion of new Reg. D capital raised during 2009-2017, \$8.9 trillion or 86.24% was raised by private investment funds (hedge funds, private equity funds, venture capital funds, and other funds), and that this \$8.9 trillion came investors in the private funds who represented 34.88% of total Reg. D investors[73]

If the authors of the 2018 Report had correlated the private investment funds data with one additional item on the private fund ' Form D filings, they could have determined how many of these funds checked that §3(c)(7) box, the §3(c)(1) box or both boxes to indicate the exemption or exemptions from Investment Company Act of 1940 (1940 Act) registration they were relying on.

Because of the substantial growth in private investment fund following §3(c)(7)'s addition to the 1940 Act in 1996, I believe that the §3(c)(7), which requires that all investors in these private funds must be qualified purchasers, is more commonly relied upon by private fund issuers, but the further analysis I suggest would be necessary to confirm this.

The requirements for being a qualified purchaser are defined in §2(a)(51)(A) of the 1940 Act. These qualified purchaser requirements for individual investors are substantially higher than the Reg. D requirements for individual accredited investors. §2(a)(51)(A) requires that an individual have investments of not less than \$5 million, as further defined in rules under the 1940 Act.

Before §3(c)(7) was added to the 1940 Act, private funds had to limit their investors to not more than 100 beneficial owners under the §3(c)(1) exemption from 1940 Act registration. It was also difficult to ensure ongoing compliance with §3(c)(1) because, e.g., an investor might die and leave his investment to more than one person or he might seek to transfer his investment to more than one person. §3(c)(1) is still available under the 1940 Act, and private funds who rely upon now would sell only to accredited investors to avoid general solicitation issues under Rule 506(b). (Only a relatively small percentage of Reg. D issuers are relying on Rule 506(c), which permits general solicitation but imposes more rigorous requirements for a reasonable belief that all investors are accredited.)

The important point is that all of these private fund investors are accredited investors and any institutional or individual accredited investors in the private funds relying upon the §3(c)(7) exemption must be qualified purchasers. Thus, the investors in these funds who accounted for 34.88% of total Reg. D investors and 86.24% of the funds invested in Reg. D offerings during 2009-2017 all met one or both of these investor thresholds. These investors overwhelmingly decided to make prudent Reg. D investments in private

[73] The 2018 Report indicates at p. 2 that Rule 506 offerings accounted for 99.9% of the amounts sold through Reg. D offerings. This percentage plus the dollar limits on Rule 504 offerings and Rule 505 offerings (Rule 505 is now withdrawn) are sufficient to conclude that all private fund issuers were Rule 506 issuers.

investment funds, presumably because the private funds offer diversification of risk and professional management in selecting investments.

If investors at these levels have prudently decided that private investment funds are the best way to have investment exposure to small startup enterprises, why is the Commission issuing a proposed order that would expose all of these investors to interaction with unregistered finders that have an incentive to promote higher risk standalone investments in illiquid securities of non-fund Reg. D issuers? How is the proposed order consistent with the Commission's investor protection mandate?

Should the Commission limit unregistered finders' actvities under the proposed order to private securities offerings made only to institutional investors as defined in the FINRA CAB Rules?

1. Wouldn't this be more consistent with the Commission's earlier decision to approve the FINRA rules?
2. Wouldn't it be more consistent with choices that investors are currently making regarding what types of Reg. D offerings are best for them?
3. Don't these investor driven choices show that capital is being allocated more efficiently now under Reg. D than would likely be the case if the Commission adopted the proposed order?
4. Why hasn't the Commission addressed these questions in the proposed order?

Of course, if there are some individual accredited investors who actually may wish to seek out investment opportunities among individual small business startups. Thanks to Congress and the Commission's efforts, these opportunities already exist and are likely to be enhanced via crowdfunding initiatives and use of a number of available angel investing funding portals.

7.C. <u>Before proceeding with an exemption that may do more harm than good, the Commission should direct its Division of Economic and Risk Analysis (DERA) to gather empirical evidence regarding how U.S. corporate issuers that are not Exchange Act reporting companies and have used Reg. D Rule 506 to raise equity capital during 2009-2019, have fared in terms of increasing employment, by running their names in other data bases that would show number of employees annually</u>.[74]

I note that Dun & Bradstreet reports include a company's employment data. It would not seem that difficult for DERA to take names of the Reg. D issuers I suggest above and see what Dun & Bradstreet data show is a company's reported employment for each year

[74] I have recommended focusing on equity securities offerings, which should pose greater risk to investors than most offerings of debt securities. I have excluded non-corporate issuers, some of which are limited duration entities, and many of which (e.g., tax shelters, are more likely to spend funds raised on activities where employment would be outside the non-corporate entity. I have excluded Exchange Act reporting companies because their offerings are excluded as a condition of finders' reliance on the proposed order, and I have excluded foreign issuers because some or all of their employment would be outside the United States. I defer to DERA's expertise regarding all of the above.

after the Reg. D offering. Perhaps there are other available data bases with employment data. I have not researched this.

If DERA finds that it is possible to obtain the annual employment data, it should be possible to accumulate it by year to show absolute growth and percentage growth data for this class of Reg. D issuers. The Commission and DERA might continue to accumulate this data on an ongoing basis for post-2019 Reg. D. Rule 506 issuers. Of course, due the force majeure effect of Covid-19, a new baseline for past and future issuers would likely be needed after the crisis is over.

The Commission also should consider adding one box to Form D, requiring non-private fund issuers to indicate their total employees on the date Form D is submitted. This would facilitate the ability of individual investors or other interested persons to use their own resources to track subsequent employment.

Finally, if Form D is used as an enforcement tool as I suggest in Comment 7.D below, perhaps it also could be used by DERA to provide the Commission and other interested persons more information about the size and characteristics of unregistered finders.

7.D. As pointed out in the underlined first paragraph of Comment 4 above, Form D is a useful tool that I understand is used by some states,[75] and should be used by Commission, to identify finders receiving compensation in Reg. D offerings who do not have CRD numbers indicative of association with a registered broker-dealer. This is an initiative that should be undertaken now to drive responsible, unregistered finders into FINRA registration and qualification categories that accommodate lawful participation in private securities offerings.

8. <u>The scope and potential effect of the proposed order as it relates to broker-dealer regulation and capital formation under federal and state securities laws is so broad that it should have been issued as a proposed rulemaking</u>. I am sure that the Commission's General Counsel has agreed that publication of the proposed order is legally permissible. That does not mean it is the best policy choice. The scope of the proposed order is probably as broad or broader than the scope of the Commission's proposed rulemaking under Release IA-5407 regarding a similar matter: the use of solicitors in investment advisory and investment management activities.

It would have been a better policy choice and considerably more helpful if the proposed order were issued as a rulemaking so that several federal procedural safeguards would be followed, including a cost/benefit analysis, a discussion of regulatory alternatives, a small business regulatory impact analysis, and setting forth the precise wording of the rule or rules on which comments are solicited. As reflected in many of my comments, there are

---

[75] *See* 2005 ABA Task Force Report *supra* n.3 p.11; and Charles Field, "The Unlicensed Securities Broker: Caveat Vendor" San Diego County Bar Assn. Business & Corporate Articles available at https://www.sdcba.org/index.cfm?pg=BusinessandCorporate-August-2015. SEC investigations are nonpublic. My apologies to the Commission's Division of Enforcement if they are already using Form D as I recommend.

provisions in laws, rules, releases, interpretations, and policies relating to broker-dealer regulation and capital formation that are administered by the Commission, FINRA and the states, many of which are not even mentioned in the proposed order. The proposed order does not inform interested persons how the order would affect or interact with these provisions.

9. The statutory basis for the proposed order cited in notes 54 and 55 thereof is Sections 15(a)(2) and 36(a)(1) of the Exchange Act, both of which require that an exemptive rule or order must be necessary or appropriate in the public interest and consistent with the protection of investors. For the reasons set forth in these comments, I respectfully submit that the proposed order fails substantially short of these statutory requirements. The alternative regulatory approach and initiatives I recommend would be consistent with the statutory requirements. Specifically, the regulation of Finders should be placed under a broker-dealer lite regulatory regime and the Commission's small business initiatives affecting individual accredited investors should focus on their ability to invest in pooled investment vehicles for technology-based startups, which are the small businesses most likely to create both jobs and shareholder value.

IV. Responses to 45 Questions

My primary recommendation in Comment 4 is that the proposed order be withdrawn.

Recognizing, however, that I am only one commenter among many. I have included in my comments below a number of comments that should be considered if the proposed order is adopted in any form. To avoid redundancy, I cross-reference as specifically as possible to my comments above.

1. Have we accurately and completely identified the legal uncertainties, if any, around the involvement by Finders in connecting investors with small firms in need of capital?

No, for reasons explained throughout my comments, especially Comment 2.A through 2.K and 4.C.

2. Have we appropriately defined Tier I Finders and Tier II Finders? Should there be two tiers of Finders or instead should there be multiple tiers of Finders? Should there be only one tier of Finders?

None of the above. Withdraw the proposed order and proceed as recommended in Comment 4.

3. Should the definition of Finder be limited to natural persons?

Probably yes. See discussion under Comments 2.B and 4.C.

If the definition were expanded to include legal persons, I respectfully suggest that the Commission would have to take into consideration the California Consumer Privacy Act of 2018, which, among other things, makes it unlawful for certain businesses defined in the Act (not just financial institutions) to sell a customer's private information protected by the Act without the customer's consent, and subject to certain exceptions, which do not appear to include sales to finders, issuers or other persons for purposes of unregistered public offerings of securities. I have not read this Act in its entirety and I do not know whether other jurisdictions have similar laws. However, from what I have read, the California Act is broader than privacy provisions of federal laws mostly applicable to financial institutions.

4. Should the definition of Finder be limited to a natural person resident in the U.S.?

Consent to service of process issues is a reason to limit it to U.S. persons, and the likelihood of foreign finders for U.S. accredited investors would not appear significant, I don't know how states have addressed foreign finders.

5. Have we appropriately identified the activities in which each tier of Finder should and should not be able to engage? Does the proposed exemption provide a workable path for Finders to be engaged in this activity?

No, for reasons explained throughout my comments, especially Comments 2.A through 2.K and all information under Comment 4.

6. Have we appropriately limited the types of investors whom a Finder can "find" or solicit? Instead of limiting potential investors to those the Finder reasonably believes are accredited investors, should investors identified by Finders be subject to investment limitations, regardless of the exemption being relied upon, such as a dollar limit on the size of the investment? If so, please specify.

No, I would limit it to the institutional investors defined in FINRA CAB Rule 016, which includes individual qualified purchasers who account for most of the dollars being invested in Reg. D, Rule 506 offerings. See Comments 4.C and 7.B.

7. Should the Finder be prohibited from engaging in general solicitation as proposed? Would this create practical problems for a Finder? For example, would a Finder be able to establish a pre-existing substantive relationship with investors in order to not engage in general solicitation?

This is a very confusing question about one of the most confusing issues under Reg. D, general solicitation, and general advertising.[76] Bear in mind also that Rule 506(c) does not prohibit general solicitation. My greatest concern in this area is stated in Comment 2.E

8. Should we limit the proposed exemption to offerings of a specific size threshold? If so, how should we define such threshold?

If, as appears, the principal objective is to find accredited investors to invest in Reg. D, Rule 506 offerings, I would not impose a dollar limit because Rule 506 does not have a dollar limit. However, see California's limit described in Comment 2.B.

9. Have we appropriately limited the number of offerings a Tier I Finder can participate in on an annual basis?

Yes.

10. Is the limitation that Tier I Finders do not have any contact with potential investors about the issuer workable? Should we instead permit Tier I Finders to have some contact with potential investors?

---

[76] Because Rule 503(c) of Reg. D refers to a limitation on general solicitation and general advertising in the manner of offering, it should be clarified that the proposed order's references to general solicitation are intended to encompass general advertising.

No contact. However, the prohibition really won't be honored and there is no supervisory framework to enforce the requirement. See Comments 2.A and 4.B.

11. Should we define "capital raising transaction" for purposes of Tier 1? If so, how?

Not necessary.

12. Have we appropriately defined the conditions that should apply to the proposed exemption for each tier of Finder? Is more clarity, specificity or flexibility required with respect to the proposed conditions? Are there other or different conditions that should apply to the proposed exemption?

Definitely not. For starters, the requirements that are applicable should be stated in their entirety with any applicable guidance, just as done in a rulemaking (Comment 8). Substantially more specificity and several additional conditions are necessary. I address these in Comments 2.A, 2.C 2.E, 2.G, 2.I and 2.J.

13. Should Finders be able to "find" or solicit investors only for exempt offerings, as proposed? Should Finders be able to "find" or solicit investors only for offerings under certain exemptions from registration? If so, which ones?

Finders under the proposed order should have **zero** involvement with registered public offerings and exempt public offerings, such as Regulation A, Rule 504, and crowdfunding offerings. I would be reluctant to permit issuers who rely upon the Section 4(a)(2) exemption without complying with Reg. D Rule 506 to use Finders. Bottom line, Finders' activity should be limited to finding accredited investors for Rule 506 offerings.

14. Should Finders be able to "find" or solicit for all non-Exchange Act reporting companies or should they be able to solicit for a narrower or wider range of companies?

There should be a much narrower range of non-Exchange Act Reporting companies. The following should be excluded:

a) An issuer that is a subsidiary or other affiliate of an Exchange Act reporting company;
b) An issuer that is:
   i) in bankruptcy or receivership,
   ii) a blank check company as defined in Rule 419(a)(2) of the Securities Act, iii) a blind pool, or iv) a shell company as defined in Rule 405 of the Securities Act, including a company that has no specific business plan or purpose or has indicated that the issuer's primary business plan is to engage in a merger or combination of the business with, or an acquisition of, an unidentified person;
c) An issuer in an offering of penny stock as defined in Rule 3a51-1 of the Exchange Act
d) A foreign issuer, including a foreign private issuer, as these terms are defined in Rule 405 of the Securities Act and Rule 3b-4 of the Exchange Act;
e) An issuer of depository receipts for which the underlying are securities of a foreign issuer;
f) An asset-backed issuer as defined in Item 1101(b) of Regulation AB of the Securities Act;
g) A partnership, including a finite-life limited partnership or other finite-life entity, as these terms are defined in item 901(b) of Regulation S-K.

In addition, the Division of Investment Management should be consulted regarding any unregistered collective investment funds that they believe should be excluded or included as exceptions to g) above..

The basis for the above exclusions may be summarized briefly: a) because of the affiliation with an Exchange Act reporting company; b) and c) because these companies have historically and continually presented unique and substantial investor protection and enforcement problems for the Commission and state securities regulators; d) and e) because the proposed order arises from recommendations to help U.S. small businesses raise capital rather than promoting investment in foreign issuers; f) because of unique disclosure requirements applicable to asset-backed issuers; and g) which is intended to cover tax-sheltered investments, which FINRA euphemistically refers to as direct participation programs, because these issuers also present substantial enforcement problems. Even those that are operating lawfully have rarely provided positive after-tax returns for investors.

15. Should Finders only be able to "find" or solicit for primary offerings? Should we expand the scope of the proposed exemption to secondary offerings, such as transactions facilitating the sale of equity by employees holding options or warrants?

Only for primary offerings. I agree with the following recommendation of the 2005 ABA Task Force Report *supra* n.3, p. 3,

> "The firm must not engage in secondary market or trading activity, including assisting with maintenance of "desk drawer" markets at the issuer or the broker-dealer."

16. Should the proposed exemption include limitations on the types of securities for which a Finder can "find" or solicit investors?

I think the best approach is to limit eligible issuers as I propose under Question 14 above. If this is done, it follows that the securities of these issuers would be excluded. However, some thought needs to be given to whether an exclusion for derivative securities also is necessary.

17. Is more clarity or specificity required with respect to the specific written disclosures that are a condition of the proposed exemption for Tier II Finders? Should we provide more guidance about any of the specific written disclosures?

More clarity required. See Comments 2.A, 2.C and 2.D.

18. Are there any specific written disclosures to investors that should be required, beyond those that are a condition of the proposed exemption for Tier II Finders? Should the disclosures be required to be written or should the Finder be permitted to provide them orally? Should the written disclosures be required at all?

Definitely. In writing, including email. See Comments 2.A, 2.C and 2.D.

19. Should we adopt comparable disclosure requirements with disclosures required under the proposed changes to Rule 206(4)-3 under the Advisers Ac for solicitations of investors in private funds, if adopted? Should the disclosures required by Tier II Finders be deemed to satisfy the disclosure requirements under the proposed changes to Rule 206(4)-3 under the Advisers Act for solicitations of investors in private funds, if adopted?

The Release No. IA-5407 approach is very good. See Comments 2.A and 2.C

20. Should Tier II Finders be required to receive an acknowledgment of receipt of the required disclosure from the investor? If so, are there methods other than an acknowledgment, for example, a read receipt for e-mail, that could serve to validate that investors received the required disclosure?

See Comment 2.A. Only in writing and email.

21. Should Tier I Finders be subject to a disclosure and acknowledgment requirement?

No, as long as there activities are limited as currently proposed. However, it should be made clear that the issuer has an obligation to disclose the compensation being paid to the Tier I Finders. I would make this a written requirement for issuers. See also Comment 2.C.

22. Should Tier II Finders be required to enter into a written agreement with the issuer where the issuer, without affecting the Finder's obligations, also assumes liability with respect to investors for the Finder's misstatements in the course of his or her engagement by the issuer?

I would like to say you should do this to increase issuer responsibility for the Finder. I'm not sure you can use the proposed order to trump state law regarding principals and agents, and I'm not sure what that law or the Restatement of Agency says about this. Maybe if it's a consensual agreement it works.

23. Should the proposed exemption be conditioned on a Finder filing a notice with the Commission of reliance on the exemption from registration? Why or why not? If so, when should Finders be required to file the notice? What, if any, disclosures should be required in the notice?

If the proposed order is not withdrawn, I would definitely favor a notice requirement, some of which is already built into Form D.

24. Should there be any limitations on the amount of fee a Finder can receive?

There probably should considering that Commission two Commission enforcement cases I cite involved 30-40% commissions. But how to implement is difficult. See Comment 2.J.

25. Should we impose limitations on the form of compensation Finders can receive? Should Finders be prohibited in certain circumstances from receiving transaction-based compensation, and instead be required to receive compensation that is not tied to the success of the transaction (that is a fixed fee or other arrangement)? If so, under what circumstances and how should Finders then be compensated?

See Comments 2.D and 2.J and note that in Comment 2.B I point out that Texas does not permit transaction- based compensation. Generally, transaction-based compensation will prevent most finders from registering as agents of an issuer under state securities laws.

26. Should a Finder be able to receive a financial interest in an issuer as compensation for its services? Why or why not?

Probably yes. But see Comment 2.D re conflicts of interest and disclosure obligations.

27. Are the explicit limitations on the activities in which Finders can or cannot engage appropriate for each tier of Finder? What other activities should be expressly permitted or prohibited for each class of Finder?

Not completely appropriate. See Comments 2.A, 2.D, 2.I and 2.K and compare FINRA CAB Rules requirements discussed under Comment 4.C.

It should also be stated that unregistered employees of a bank that has a networking arrangement with a registered broker-dealer may not rely on the exemptive order to receive incentive compensation. Currently, Exchange Act Section 3[a][4](B)(i)(VI) provides that unregistered bank employees may not receive "incentive compensation" for brokerage transactions, except that such employees may receive a nominal one-time cash referral fee of a fixed dollar amount that is not contingent on whether the referral results in a transaction.

28. Should we provide guidance on how a Finder can establish that he or she did not know and, in the exercise of reasonable care, could not have known, that the issuer had failed to comply with the conditions of an exemption?

No. Too complicated. I'd leave it to the facts and circumstances.

29. Should we provide further guidance on the solicitation-related activities in which Tier II Finders can engage on behalf of an issuer, for example, guidance surrounding a Tier II Finder's discussion of issuer information and arrangement and participation in meetings with issuers and investors?

From my perspective, which would prohibit most of this activity unless the Finders were registered under a broker-dealer lite regime, I'd say less specificity is better.

30. Should we provide guidance regarding activities of private fund advisers, M&A Brokers as defined in the *M&A Broker* Letter, or real estate brokers that may require registration under Section 15(a) of the Exchange Act? Should we consider codifying the *M&A Broker* Letter?

Codify. In my opinion M&A finders' activities are different from the finders' activities that would be covered by the proposed order. The M&A finders generally do not cause investors to write checks. The private offering finders do. An unregistered M&A finder may bring together companies interested in an M&A transaction, but in doing so, if the unregistered finder has no involvement in in soliciting or affecting the investment/voting decisions of the companies' shareholders, the finder is not raising investor protection concerns. Of course if a registered broker-dealer is an M&A finder, then it may affect shareholders' investment/voting decisions, e.g. via negotiation of the terms of the M&A transaction and/or rendering a fairness opinion.

31. Are there other areas in which the Commission should provide guidance regarding the registration requirements of Section 15(a) of the Exchange Act to other types of limited- purpose broker-dealers?

Not in the proposed order. Ok by no action letter.

32. If the proposed exemption is adopted, which staff letters, if any, should or should not be withdrawn, and why?

For reasons explained in Major Comment 3 above, I would not issue the proposed order in its current form and I would withdraw the Paul Anka letter.

33. Have we appropriately defined the disqualification condition for Finders?

Definitely not. See Comment 2.K.

34. Have we appropriately limited the proposed exemption to individuals who are not associated persons of a broker-dealer?

This is another very difficult issue. *See* my hypothetical in under Comment 4.B. Again, this is why I prefer a broker-dealer lite regime. Only a broker-dealer lite regime as I recommend under Comment 4 will help address this type of problem and drive the bad finders out of the business.

35. Should the proposed exemption include a limitation such that it would not be available to individuals who were associated persons of a broker-dealer within the previous 12 months?

That might work to reduce the bad guys, but it would hurt good guys like retirees or RIF victims.

36. Should the proposed exemption be limited to individuals who are not associated persons of a municipal advisor or investment adviser representatives of an investment adviser?

Not sure. I defer to the Division of Investment Management. See my Comment 4.D that addresses why registered broker-dealers shy away from Reg. D. deals.

37. Should the proposed exemption be limited to individuals who are not associated persons of an issuer? Why or why not?

Doesn't the written agreement make any finder the issuer's agent which by itself might constitute association? See Comment 2.D.

38. Would the proposed exemption provide sufficient investor protections while promoting capital formation for small businesses?

Absolutely not. See all of my Comments 1, 2, 4, and 7.

39. Would the proposed exemption have a competitive impact on registered brokers?

Probably not an adverse one. I think less than 20% of Rule 506 offerings involve a broker-dealer. If responsible finders were required to associate with broker-dealers it might provide more revenue. See Comments 4.C and 4.D

40. With respect to the activities permitted for Tier I Finders, what are the practical implications of the requirements if they were subject to broker registration? What about for Tier II Finders?

Please see all of my text under Comment 4, including 4.A through 4.D and read the 2005 ABA Task Force Report.

41. Should we instead take an alternative approach for either class of Finders?

Absolutely. Withdraw the proposed order, withdraw Paul Anka, and proceed as I recommend under Comment 4.

42. Are there areas related to the proposed Finders framework for which the Commission should provide guidance?

See Comments 2.A through 2.K.

43. Should we coordinate with other regulators to provide clarity and consistency on what types of activities Finders and other limited purpose brokers may engage in?

Yes. Coordination with NAASA and FINRA is essential. See Comment 2.B and everything under Comment 4.

44. Are there any other sources of data or information that could assist the Commission in analyzing the consequences of the proposed exemption? We request that commenters provide any relevant data or information.

Yes. See Comments 7.B and 7.C and more generally Comments 5 and 6.

45. Other than the possible obligation of a Finder to register as a broker-dealer, the proposed exemption is not intended to affect the rights of the Commission or any other party to enforce

compliance with applicable law, or the available remedies for violations of the law. This includes, in the case of the Commission, the ability to impose a broker-dealer registration bar on a person for misconduct that would warrant a bar. Are there any other considerations in this regard that the Commission should take into account as it considers the exemptive relief?

See Comment 4.F

V. Conclusion

The damage caused by securities fraud can occur in different ways. In some cases, it only takes one undetected Ponzi scheme (Madoff) to cause millions of dollars of investor losses.[77] In others, numerous smaller frauds may cause cumulative losses that are substantial. What impresses me most about the 2005 ABA Task Force Report is the courage and dedication that the lawyers on the Task Force displayed in pointing out to the Commission and others that unregistered finders were violating federal and state securities laws and their activity posed significant risks for investors and issuers. Here we are fifteen years later, when the problem has only gotten worse. Unfortunately, we will never know the amount of investor losses that have been incurred in Reg. D offerings since 2005 (or 1982) because unregistered finders committed fraud or recommended unsuitable investments. My guess is that it's less than the Madoff scheme, but easily many millions of dollars.

The Commission's mandates to promote investor protection and capital formation require that it implement laws and regulations that enable a market infrastructure that permits capital to be allocated to productive undertakings that may produce returns for investors consistent with their tolerance for risk. It is an unfortunate reality that today and in years past, many of the small business offerings made to investors, including individual accredited investors, have been unsuitable investments, and a good number have been fraudulent. Instead of now promoting individual access to these investors through unregulated, possible unqualified and dishonest finders, the Commission should be focusing on how more individual investors may diversify risk and provide capital for deserving small businesses through crowdfunding and professionally managed, private investment funds whose managers are in the best position to distinguish the good from the bad among small business undertakings.

The Commission should take pride in the many small business initiatives it has adopted (see p.1) and in a number of other initiatives it has proposed in "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets".[78] Unfortunately, issuance of the proposed order is not a proud moment for the Commission. It's adoption would further open a "can of worms" that needs to be closed.[79] For the reasons explained in these comments, the proposed order should be withdrawn.

---

[77] *Cf.* Harry Markopolos, <u>No One Would Listen</u> (John Wiley & Sons, 2010).

[78] Cited in n. 3 of the proposed order.

[79] It is refreshing to learn from the *SEC News Digest* that on November 9th, the same day that two Commisioners who voted for the proposed order for unregistered finders were espousing its benefits at an SEC Small Business Advisory Committee Meeting, the Commission announced a settlement subject to

Respectfully submitted,

/s/ Robert D. Strahota

Robert D. Strahota

ccs via email:
Honorable Jay Clayton, Chairman
Honorable Hester M. Peirce, Commissioner
Honorable Elad L. Roisman, Commissioner
Honorable Allison Herren Lee, Commissioner
Honorable Caroline A. Crenshaw, Commissioner

---

court approval in *Securities and Exchange Commission v. Hughe Duwayne Graham, Donald Lee Howard, Larry Louis Matyas*, No. 1:20-cv-02505 (N.D. Ohio filed Nov, 6, 2020). Lit. Rel. No. 24958 (Nov. 9, 2020) (three unregistered brokers charging commissions of approximately 40 percent). Eradicating a problem is better than proposing the wrong solution to make it worse.