Chapman and Cutler LLP

Chapman Client Alert

November 6, 2020 Current Issues Relevant to Our Clients

SEC Proposes Additional Small Business Capital-Raising Opportunities outside of Traditional Broker-Dealer Channels

This fall, the U.S. Securities and Exchange Commission (the *"Commission"*) has proposed additional avenues for businesses to raise capital away from the use of registered broker-dealers. These avenues, in the first instance permitting the use of "finders," override the Commission Staff's recent position in a number of No-Action Letters that focused on the receipt of "transaction-based compensation" to require the finder to be a registered broker-dealer; in the second instance, the avenues codify and detail the requirements of the Staff's interpretation since 2015 with respect to whether "demo days" constitute a general solicitation in violation of the safe harbor provisions of Rule 506(b) promulgated under the Securities Act of 1933, as amended (the *"Securities Act"*). In announcing these provisions, the Commission has stated that its mission includes facilitating capital formation, not only for public companies, but also for the small businesses that are active participants in the private markets.

During 2020, the Commission has, among other things, expanded the definition of "accredited investors" under Regulation D; increased offering limits in Regulation A, Regulation Crowdfunding and Rule 504 offerings; and allowed closed-end funds and business development companies the ability to use registration, offering and communications rules that were currently available to publicly registered operating companies. However, like the June 2020 grant of temporary relief from broker-dealer registration to municipal advisors for certain direct placement activities, these new proposals greatly expand an issuer's use of individuals and entities to perform and receive payment for activities that had been historically reserved for registered broker-dealers.

Finders

On October 7, 2020, the Commission announced a proposal to grant a conditional exemption from the broker registration requirements of Section 15(a) of the Securities Exchange Act of 1934, as amended (the *"Exchange Act"*), to permit natural persons to engage in certain limited capital-raising activities involving "accredited investors." Under the exemption, the Commission would create two classes of exempt "finders," Tier I Finders and Tier II Finders, both being permitted to accept transaction-based compensation under the terms of the proposed exemption despite the Commission's and the Staff's long-held view that the "receipt of transaction-based compensation is a hallmark of being a broker."

In both instances, the finder must be a natural person, not an entity, including a pass-through entity wholly owned by a natural person.

Tier I Finders

A Tier I Finder would be limited to providing contact information of potential investors in connection with only a single capital-raising transaction by a single issuer in a twelve-month period. A Tier I Finder could not have any contact with a potential investor about the issuer. The Tier I Finder is similar in scope covered by the Paul Anka No Action Letter where the Staff stated that it would not recommend enforcement action to the Commission against an individual who, without registering with the Commission as a broker-dealer: (a) entered into an agreement with an issuer to provide to the issuer a list of names and telephone numbers of potential investors he reasonably believed to be accredited investors and with whom he had a pre-existing business or personal relationship, (b) had no further contact with potential investors concerning the issuer, and (c) received a finder's fee for doing so.[1]

Tier II Finders

The Commission is proposing to allow Tier II Finders to solicit investors on behalf of an issuer, but their activities would be limited to: (w) identifying, screening and contacting potential investors; (x) distributing issuer offering materials to investors; (y) discussing issuer information included in any offering materials, *provided* that the Tier II Finder does not give advice as to the valuation or advisability of the investment; and (z) arranging or participating in meetings with the issuer and investor.

Conditions for Both Tier I and Tier II Finders

The proposed exemption for both Tier I and Tier II Finders would be available only where the:

- Issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;

- Issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act;
- Finder does not engage in general solicitation;
- Finder has a reasonable belief that the potential investor is an "accredited investor" under Rule 501 of Regulation D or the potential investor is, in fact, an "accredited investor";
- Finder's services and compensation are memorialized by a written agreement with the issuer;
- Finder is not an associated person of a broker-dealer; and
- Finder is not subject to "statutory disqualification," as that term is defined under the Exchange Act.

Proposed limitations placed upon a finder's services include that the finder may not (i) be involved in structuring or negotiating the terms of the offering; (ii) handle customer funds or securities; (iii) bind either the issuer or any investor; (iv) participate in the preparation of any sales materials; (v) perform any independent analysis of the sale or engage in any "due diligence" activities; (vi) assist or provide financing for such purchases; or (vii) provide advice as to the valuation or financial advisability of the investment.

Additional Disclosure Obligations for Tier II Finders

A Tier II Finder wishing to rely on the proposed exemption also must (a) satisfy certain disclosure requirements prior to or at the time of the solicitation as to the Tier II Finder's role and compensation and (b) obtain from the investor, prior to or at the time of any investment in the issuer's securities, a dated written acknowledgment of receipt of the required disclosures.

The proposed exemption is currently within the Commission's comment period but the adoption as proposed or only slightly modified will allow issuers to use its contacts outside of the broker-dealer network to solicit potential investors for its securities and pay the individuals compensation based upon the success of the solicitation or referral.

Demo Days

A Commission interpretation from August 6, 2015,[2] has been reviewed by counsel and relied upon by certain start-up companies and private funds with respect to presentations at a "demo day" event. In the interpretation, the Commission stated that "[w]hether a demo day or venture fair constitutes a general solicitation for purposes of Rule 502(c) is a facts and circumstances determination."

On November 2, 2020, as part of the Commission's amendment of its rules in order to harmonize, simplify and improve the multilayered and overly complex exempt offering framework, the Commission provided additional guidance with respect to the "facts and circumstances" whereby a communication regarding a securities offering will not be deemed a "general solicitation" under Regulation D should the conditions of new Rule 148 be met.

Qualification as a Demo Day Sponsor

An issuer would not be deemed to have engaged in general solicitation if the communications are made in connection with a seminar or meeting sponsored by (a) a college, university or other institution of higher education, (b) a state or local government or instrumentality of a state or local government, (c) a nonprofit organization, or (d) an angel investor group, incubator or accelerator. The Commission stated that it believes the exclusion of brokers, dealers and investment advisers from the scope of the new exemption will help to limit the application of Rule 148 to events sponsored by organizations less likely to have a profit motive for their involvement in the event or whose sole or primary purpose is to attract investors to private issuers.

To qualify as an "angel investor group," the group is required to (a) consist of accredited investors, (b) hold regular meetings and (c) have "defined processes and procedures" for investment decisions. The Commission refrained from requiring written processes and procedures as initially proposed so as to "not disrupt existing angel investor group practices by requiring them to formally memorialize their established processes and procedures." Although angel investor groups may not include groups associated or affiliated with brokers, dealers or investment advisers, the fact that an angel investor group may include registered representatives or employees of brokers, dealers or investment advisers will not, by itself, result in the angel investor group being deemed to be associated or affiliated with brokers, dealers or investment advisers for the purpose of Rule 148.

Demo Day Requirements

- More than one issuer must participate in the seminar or meeting to help to prevent an organization from attempting to hold an event that is, in essence, a sales pitch for the securities of one issuer, while characterizing the event as a demo day.
- The sponsor may not: (a) advertise for the demo day by referencing any specific offering of securities by the issuer; (b) make investment recommendations or provide investment advice to attendees of the event; (c) engage in any investment negotiations between the issuer and

investors attending the event; (d) charge attendees of the event any fees, other than reasonable administrative fees; (e) receive any compensation for making introductions between event attendees and issuers, or for investment negotiations between the parties; or (f) receive any compensation with respect to the event that would require it to register as a broker or dealer under the Exchange Act, or as an investment adviser under the Investment Advisers Act of 1940, as amended.

- The only information conveyed at the demo day regarding the offering of securities by or on behalf of the issuer will be: (a) notification that the issuer is in the process of offering or planning to offer securities; (b) the type and amount of securities being offered; (c) the intended use of the proceeds of the offering; and (d) the unsubscribed amount in an offering.

- Any online participation in the demo day event is limited to: (a) individuals who are members of, or otherwise associated with, the sponsor organization; (b) individuals that the sponsor reasonably believes are accredited investors; or (c) individuals who have been invited to the event by the sponsor based on industry or investment-related experience and are reasonably selected by the sponsor in good faith and disclosed in the public communications about the event.

Like the proposed finders' exemption from broker-dealer registration under the Exchange Act, Rule 148 is structured for the use of demo days to promote an issuer's securities offering away from traditional broker-dealer channels as the demo day may not be sponsored by brokers, dealers, their affiliates or their respective registered representatives and any angel investor group participation needs to be separate and apart from a representative's activities on behalf of its firm.

For More Information

If you would like further information concerning the matters discussed in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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1 *Paul Anka*, SEC Staff No-Action Letter (July 24, 1991).

2 SEC Compliance and Disclosure Interpretations of the rules adopted under the Securities Act - Question 256.33.

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