Private M&A Brokers Receive Relief from Broker-Dealer Registration and Restriction on Transaction-Based Compensation

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Representing welcome news to private company M&A advisors and business brokers (individually an "M&A Broker," and collectively, "M&A Brokers") and a substantial departure from prior interpretive guidance, on January 31, 2014, the Division of Trading and Markets of the U.S. Securities and Exchange Commission (the "SEC") issued a no-action letter[1] (the "No-Action Letter") that would permit them to receive transaction-based compensation under certain conditions without having to register as a broker-dealer under Section 15(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

M&A Brokers have historically navigated through a murky regulatory environment with little guidance as to whether their services trigger broker-dealer registration and regulation. M&A Brokers advising on smaller, privately-held company transactions in particular have been impacted by the lack of regulatory clarity in this area. Legislation was introduced last year by the U.S. House of Representatives to create a new category of transaction intermediary to be known as a "Merger and Acquisition Broker." The objective of the proposed legislation was to establish a regulatory scheme designed to address the limited scope of intermediary activity in connection with small, privately-held company transactions.

While the future of this legislation is unclear, the No-Action Letter expands the types of services that the SEC staff permits M&A Brokers to provide without requiring registration as a broker-dealer.

M&A Broker or Broker-Dealer?

The SEC's longstanding position had been that M&A advisors and business brokers that provide advice concerning corporate acquisitions involving the sale of securities and that receive transaction-based compensation - traditionally deemed a "hallmark" of broker-dealer activity - were generally required to register as broker-dealers under the Exchange Act. Registration involves a lengthy and costly application process and membership with FINRA. More importantly, registration also subjects them to a complex web of Exchange Act and FINRA rules that had only an attenuated relationship, at best, to their business models.

The SEC's position was supported by judicial precedent. In 1985, the U.S. Supreme Court in *Landreth Timber Co. v. Landreth*,[2] and in a companion case, *Gould v. Reufenacht*,[3] held that the federal securities laws apply to M&A transactions structured as stock sales, even though they were not capital raising transactions and would not have applied to the same deal if structured as an asset sale. For the Court the statutes defined a "security" to include "stock," and there was no basis not to

give literal effect to the statutory definition.

The holding immediately impacted M&A advisors and business brokers acting as intermediaries or brokers in mergers or acquisitions involving stock sales or securities received as consideration. Under Section 3(a)(4) of the Exchange Act, a securities "broker" is broadly defined as any person "engaged in the business of effecting transactions in securities for the account of others." It is unlawful for any broker to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless the broker or dealer is registered with the SEC under the Exchange Act. The penalties for failing to register as a broker-dealer where so required are onerous, including, most notably, the imposition of monetary fines and rescission of securities transactions.

In the past, the SEC granted no-action relief from broker-dealer registration for those providing advice relating to corporate acquisitions, but those instances involved what are commonly referred to as "finders," and the scope of the relief granted was very limited.[4] For instance, intermediaries could not participate in negotiations between sellers and purchasers. Further, intermediaries were prohibited from advising a party whether to issue securities as well as how to transfer the business by means of a securities transaction. Intermediaries were also prohibited from advising on or assessing the value of any securities involved in a merger and acquisition transaction.

Further problematic was the fact that the SEC staff's grant of relief from broker-dealer registration applied only to transactions in which the selling company met size standards for a "small business," and only assets could be advertised or otherwise offered for sale by the intermediary. Transaction-based compensation for intermediaries was permitted under very limited conditions which, as a practical matter, precluded most finders from benefiting from it, including the requirement that compensation be determined prior to any decision as to how to structure or effect the sale of the business.

No-Action Relief Granted

The No-Action Letter provides that M&A Brokers facilitating mergers, acquisitions, business sales, and business combinations (individually, an "M&A Transaction" and collectively, "M&A Transactions") between sellers and buyers of privately-held companies, without regard to the size of the privately-held companies, may engage in such activities, including advertising a privately-held company for sale, with information concerning a potential transaction, such as the description of the business, general location, and price range, and receive transaction-based compensation without being required to register as broker-dealers under the Exchange Act, provided that certain terms and conditions are satisfied.

"M&A Broker" Defined

An "M&A Broker" for purposes of the No-Action Letter is a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company.

No-Action Letter Terms and Conditions

The conditions to the relief in the No-Action Letter consist of the following:

1. The M&A Broker may not have the ability to bind a party to an M&A Transaction.
2. The M&A Broker may not directly, or indirectly through any of its affiliates, provide financing for an M&A Transaction. An M&A Broker that assists purchasers to obtain financing from third

parties must comply with all applicable legal requirements, including, as applicable, Regulation T (12 CFR 220 *et seq.*), and must disclose any compensation in writing to the client.

3. The M&A Broker may not have custody, control, or possession of or otherwise handle funds or securities issued or exchanged in connection with an M&A Transaction or other securities transactions for the accounts of others.

4. The M&A Transaction may not involve a public offering of securities. Any offering or sale of securities must be conducted in compliance with an applicable exemption from registration under the Securities Act of 1933. No party to any M&A Transaction may be a shell company,[5] other than a "business combination related shell company."[6]

5. To the extent that an M&A Broker represents both buyers and sellers, it must provide clear written disclosure as to the parties it represents and obtain written consent from both parties to the joint representation.

6. The M&A Broker may facilitate an M&A Transaction with a group of buyers only if the group is formed without the assistance of the M&A Broker.

7. The buyer, or group of buyers, in any M&A Transaction must, upon completion of the M&A Transaction, control and actively operate the company or the business conducted with the assets of the business. A buyer, or group of buyers collectively, would have the necessary control if it has the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise.[7] In addition, the buyer, or group of buyers, must actively operate the company or the business conducted with the assets of the company.

8. No M&A Transaction may result in the transfer of interests to a passive buyer or group of passive buyers.

9. Any securities received by the buyer or M&A Broker in an M&A Transaction will be restricted securities within the meaning of Rule 144(a)(3) under the Securities Act because the securities would have been issued in a transaction not involving a public offering.

10. The M&A Broker (and, if the M&A Broker is an entity, each officer, director or employee of the M&A Broker): (i) must not have been barred from association with a broker-dealer by the SEC, any state or any self-regulatory organization; and (ii) must not be suspended from association with a broker-dealer.

What This Means

The SEC staff's guidance in the No-Action Letter represents a significant shift in the SEC's longstanding position that the receipt of transaction-based compensation in connection with effecting a securities transaction requires broker-dealer registration, including transactions involving a merger and acquisition. Going forward, those providing M&A advice in connection with the purchase or sale of a privately-held company within the "four corners" of the No-Action Letter can take a high degree of comfort that they will not have to register as a broker-dealer in order to receive transaction-based compensation for their mergers and acquisitions advisory services.[8]

[1] The No-Action Letter, issued to six lawyers who have represented clients in connection with mergers and acquisitions and similar brokerage transactions, is available at http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[2] 471 U.S. 681 (1985).

[3] 471 U.S. 701 (1985).

[4] *See, e.g. Country Business, Inc.,* SEC No-Action Letter (Nov. 8, 2006) and *International Business Exchange Corporation,* SEC No-Action Letter (Dec. 12, 1986).

[5] A "shell company" is defined in the No-Action Letter as a company that: (1) has no or nominal operations; and (2) has: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets. In this context, a "going concern" need not be profitable, and could even be emerging from bankruptcy, so long as it has actually been conducting business, including soliciting or effecting business transactions or engaging in research and development activities.

[6] The term "business combination related shell company" means a shell company (as defined in Rule 405 under the Securities Act) that is: (1) formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity solely within the United States; or (2) formed by an entity defined in Securities Act Rule 165(f) among one or more entities other than the shell company, none of which is a shell company.

[7] The necessary control will be presumed to exist if, upon completion of the transaction, the buyer or group of buyers has the right to vote 25% or more of a class of voting securities; has the power to sell or direct the sale of 25% or more of a class of voting securities; or in the case of a partnership or limited liability company, has the right to receive upon dissolution or has contributed 25% or more of the capital.

[8] While the No-Action Letter is a welcome development for those contending with the status of finders, it is important that the effect of the letter be kept in perspective. First, a no-action letter means that the Division of Trading and Markets will not recommend enforcement action. It does not mean that the SEC (*i.e.,* the Commissioners) has adopted the staff's position, nor does it mean that the courts must adopt the same interpretation. Further, the relief granted in the letter is limited to the transactions described in the letter requesting no-action relief. In relevant part, the letter identifies ten different representations that were made in the requesting letter. Different facts may yield different action by the staff. Finally, the letter does not interpret or apply state laws and regulations governing brokers. Of course other provisions of the federal securities laws, including the anti-fraud provisions, will continue to apply.