SEC No-Action Letter Allows Certain Kinds of "M&A Brokers" to Avoid Broker-Dealer Registration Under the Exchange Act

Written by Paul Bork

February 24, 2014

On January 31, 2014, the SEC's Division of Trading and Markets issued a significant no-action letter permitting the involvement of "M&A Brokers" in business acquisition transactions involving privately-held companies. The no-action letter means that the SEC Staff will not seek enforcement action against the type of "broker" activity described in the letter. By adhering to the conditions specified in the no-action letter, an M&A Broker may advertise a privately-held company of any size for sale, with information such as the description of the business, its general location, and a price range, without fear of violating federal laws that require broker-dealer registration. State laws will still apply.

Subject to numerous limitations on the M&A Broker's activities, the letter effectively exempts certain intermediaries from the considerable burdens of registration as a broker-dealer under Section 15(a) of the Securities Exchange Act of 1934 when involved in the sale of privately-held companies. The no-action letter, in a limited revival of the "sale of business doctrine," provides a welcome source of clarity for these intermediaries involved in brokering the sale of private companies.

The Problem

The involvement of intermediaries in private company stock transactions has traditionally created uncertainty, because an individual or entity involved in soliciting the sale or purchase of any security is generally required to register as a broker. The failure of such an intermediary to comply with law could give other parties a right of rescission. The SEC has historically taken an expansive view of this requirement, and individuals involved in effecting the sale of private companies have typically been required to register where they are involved in bringing together the purchaser and seller, negotiating the sale or otherwise integrally involved in the process. The SEC has required broker registration of "finders" or "business brokers" that (i) were involved in the solicitation, negotiation or execution of the transaction; (ii) received transaction-related compensation; or (iii) handled the securities or funds in connection with the transaction.

What Is An "M&A Broker"?

The January 31 no-action letter provides relief on behalf of "M&A Brokers" without regard to the size of the transaction. The letter defines "M&A Broker" as:

> a person [or entity] 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.

Thus the no-action relief is only available where the buyer *both controls and operates* the target company.

A buyer will be deemed to operate the company if, among other actions, the buyer elects executive officers, approves the annual budget or serves as an executive or other executive manager of the company. Further, control will be presumed 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.

How Are the Activities of M&A Brokers Limited?

To avail themselves of the no-action relief, M&A Brokers must limit their activities to those set forth in the no-action letter. An "M&A Transaction" is a merger, acquisition, business sale or business combination. Thus:

- An M&A Broker cannot have the ability to bind a party to the M&A Transaction;
- An M&A Broker cannot directly or indirectly provide financing for the M&A Transaction and, where the M&A broker assists the parties in securing financing from unaffiliated third party lenders, must follow all applicable laws and *disclose any compensation in writing to the client*;
- An M&A Broker can never have custody, control, or possession of or otherwise handle funds or securities issued or exchanged in connection with the M&A Transaction or other securities transaction for the account of others;
- The M&A Transaction must not involve a public offering, must be conducted under an applicable exemption from registration under the Securities Act of 1933, and may not involve a "shell company" except for a "business combination shell company" defined under Rule 405 of the Securities Act;
- If and to the extent the M&A Broker represents both buyers and sellers, the M&A Broker must provide *clear written disclosure* as to the parties it represents and *obtain written consent* from both parties to the joint representation;
- The M&A Broker will facilitate the M&A Transaction with a group of buyers only if the group if formed without assistance from the M&A Broker;
- The buyer(s) in the M&A Transaction will, upon completion of the Transaction, control and actively operate the target company as described above in this Alert;
- No M&A Transaction will result in the transfer of interests to a passive buyer or group of passive buyers, including the use of non-business combination shell companies;
- Any securities received by the buyer or the M&A Broker will be restricted securities as defined in SEC Rule 144(a)(3) (because the M&A Transaction cannot involve a public offering);
- The M&A Broker (and, if the M&A Broker is an entity, any officer, director or employee of the M&A Broker) (i) must not be 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.

Limited Application to Each Separate M&A Transaction

The January 31 no-action letter provides important and helpful clarification for non-registered individuals in connection with the sale of privately-held companies. Still, M&A Brokers should be mindful of the limited scope of the letter.

The relief offered will be applied on a transactional basis and does not apply broadly to exempt M&A Brokers from the more general requirements of registration when engaged in activities requiring registration under Section 15 of the Exchange Act. Accordingly, M&A Brokers should not rely on the no-action position without independent legal analysis of the facts and circumstances of a particular transaction. The conditions set forth in the letter will require additional due diligence efforts by M&A Brokers. Among other things, no-action relief is limited to the purchase or sale of companies with no securities registered or required to be registered under Section 12 of the Exchange Act, and prior failure of such a company to comply with those registration requirements would foreclose availability of the exemption.

Further, the no-action relief requires that the buyer control and actively operate the target. M&A Brokers should accordingly undertake due diligence to verify that control will be transferred and that the M&A Transaction structure will permit the buyer to "actively operate" the company after closing.

State Law Not Addressed

The January 31 no-action letter does not affect state law requirements and accordingly individuals, whether or not they are "M&A Brokers." must still comply with any applicable state laws requiring registration of "finders" or "brokers." The SEC specifically notes this in its guidance and, while the SEC's analysis may be persuasive to many state authorities, a state securities regulator has no obligation to adopt the SEC's views in applying state law. Proceed with caution.

RELATED PRACTICES

- Capital Markets
- Business Counseling