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M&A Brokers Exempted from SEC Broker-Dealer Registration

In what appears to be a noteworthy departure from the Securities and Exchange Commission's ("SEC") long-held view that persons receiving transaction-based compensation in connection with facilitating the acquisition and or sale of a company must register with the SEC as a broker-dealer, the SEC issued a No-Action Letter on January 31, 2014, that was revised February 4, 2014 ("No Action Letter"), that stated that "the SEC would not recommend enforcement action … if an M&A Broker were to effect securities transactions in connection with the transfer of ownership of a privately-held company … without registering as a broker-dealer pursuant to Section 15(b) of the Exchange Act." This represents the most significant guidance to small business brokers and M&A Brokers engaged in mergers and acquisition activities since the SEC issued the Country Business, Inc. No-Action Letter dated November 8, 2006.

The SEC No-Action Letter addresses a long-standing issue in the area of broker-dealer regulations that stems from the historical requirement of an intermediary to register as a broker-dealer for facilitating the sale of an operating business. The issue was driven in part by the question as to whether a sale of all, or a controlling interest in, a business was a securities transaction or effectively a sale of the assets of the company (and not a securities transaction). This issue was also driven in part by the fact that broker-dealer registration imposes significant costs on intermediaries, as well as a regulatory model that is not structured to accommodate the particular role played by these intermediaries. To that end, the No-Action Letter does provide the basis for long term relief to M&A Brokers. The need for this regulatory relief has been discussed in-depth by various professionals for the past decade, including the American Bar Association Report and Recommendation of the Task Force on Private Placement Broker-Dealers, which was issued in June, 2005.

While this is not a resolution of all the regulatory issues faced by M&A Brokers, the No-Action Letter represents a major shift in the regulatory position of the SEC as to what financial intermediary activities require registration as a broker-dealer with the SEC. However, for now, financial intermediaries and the activities of M & A Brokers continue to be subject to state law, and as such M&A Brokers will still have to comply with those state securities' law statutes with respect to registration requirements. It is anticipated that in the near future, state law will catch up, as the M&A Broker exemption is supported by the North American Securities Administrators Administration, and approximately 14 states are considering rule making and or legislation that would exempt certain M&A Brokers from broker-dealer registration in their respective jurisdictions. Notwithstanding that, to date no state jurisdictions have passed legislation providing relief from registration as a broker-dealer in conformity with the No-Action Letter.

Also, it is unclear at this time of what the implications of the No-Action Letter are with respect to the rule modifications the Financial Industry Regulatory Authority ("FINRA") is anticipated to

propose for “limited corporate financing brokers”, and or H.R. 2274, the Small Business Mergers, Acquisition, Sales, and Brokerage Simplification Act of 2013, which passed the House of Representatives on January 14, 2014 and was forwarded to the Senate for consideration.

Important Definitions

For the purposes of applying the No-Action Letter, the following definitions are important to note:

- "M&A Broker" is defined as 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.
- A "privately-held company" is defined as a company that does not have any class of securities registered, or is required to be registered, with the Commission under Section 12 of the Exchange Act, or with respect to which the company files, or is required to file, periodic information, documents, or reports under Section 15(d) of the Exchange Act. Additionally, for purposes of the No-Action Letter, any privately-held company would also be required to be an operating company that is a going concern, and not a "shell" company.
- "M&A Transactions" are mergers, acquisitions, business sales, and business combinations between sellers and buyers of privately-held companies, without regard to the size of the privately-held companies that are facilitated by M&A Brokers.

Conditions to Relief

In order to be able to rely on the relief from registration as a broker-dealer, the M&A Broker must comply with 10 specific conditions set forth in the No-Action Letter. Those conditions include:

1. The M&A Broker will not have the ability to bind a party to an M&A Transaction.
2. An M&A Broker will 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 unaffiliated 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. Under no circumstances will an M&A Broker 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 transaction for the account of others.
4. No M&A Transaction will involve a public offering. Any offering or sale of securities will be conducted in compliance with an applicable exemption from registration under the Securities Act of 1933 ("Securities Act"). No party to any M&A Transaction will be a shell company, other than a business combination related shell company.

5. To the extent an M&A Broker represents both buyers and sellers, the M&A Broker will provide clear written disclosure as to the parties it represents and obtain written consent from both parties to the joint representation.
6. An M&A Broker will 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. In any M&A Transaction, the buyer, or group of buyers will 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. 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. 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 will 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) has not been barred from association with a broker-dealer by the Commission, any state or any self-regulatory organization; and (ii) is not suspended from association with a broker-dealer.

Challenges for Compliance

The majority of the conditions set out in the No-Action Letter are not an issue in most M&A Transactions; however condition 2 (assists purchasers to obtain financing), condition 7 (active management and control) and condition 8 (no passive buyers or group of passive buyers) are exceptions which necessitate caution. With respect to financing, most M&A Brokers do not directly provide financing, so that will not generally be an issue. However, where the M&A Broker assists the buyer in obtaining third party financing, care will need to be given to make sure that the financing obtained does not have attributes that could result in the financing being deemed a security (for example, warrants issued to lenders), as that would potentially expose the transaction to not being a M&A Transaction as described in the No-Action Letter.

Condition 7 & 8 are problematic in that the SEC did not clarify who a passive buyer is for purposes of the M&A Transaction. While a fund or partnership could clearly be active in management and control, the reference to a "group of passive buyers" could be read to imply that to the extent a fund or partnership had passive investors, the M&A Transaction may not qualify as result of the passive investors in the fund or partnership. In the alternative, an argument can be made that the No-Action Letter speaks to direct buyers, and not the beneficial owners of a buyer. In any event, until "passive buyer" is clarified as it pertains to pooled investments, this will be problematic for

all M&A Transactions which have partnerships or funds participating as a Buyer. Buy side M&A Brokers will benefit most from the No-Action Letter in that they will have more control over any M&A Transaction that is completed, while the sell side M&A Broker will not generally know what the transaction and or "buyer" looks like until fairly far into a transaction. Once it is determined that the buyers don't conform to the conditions set out in the No-Action Letter, and the seller elects to go forward, the M&A Broker will again be exposed to broker-dealer registration and or the seller refusing to pay the commission.

Regulatory Framework

It is unclear at this time of what the implications of the No-Action Letter are with respect to H.R. 2274 and or the rule modifications proposed by FINRA. It has been observed that both the No-Action Letter and the FINRA rule making are directed at putting rules in place to address the issue, prior to the passage of H.R. 2274.

The Small Business Mergers, Acquisition, Sales, and Brokerage Simplification Act of 2013 (H.R. 2274), is intended to amend the Securities Exchange Act of 1934 to exempt from registration brokers performing services in connection with the transfer of ownership of smaller privately held companies. The bill has been received in the Senate, read twice and referred to the Committee on Banking, Housing, and Urban Affairs for further discussion. While the passage of H.R. 2274 is unclear, should it become law as submitted, it will have an impact on the No-Action Letter. While both have some elements in common, there are significant differences that impact the No-Action Letter. The No-Action letter speaks to no passive buyers and the actual exercise of control by a buyer, H.R. 2274 doesn't address passive buyers at all, and speaks to the M&A Broker having a "reasonable belief" that the buyer will have control and be active in management upon the completion of the transaction. Additionally, the No-Action Letter speaks to any M&A Transaction that satisfies the conditions stipulated, while H.R. 2274 defines an Eligible Privately Held Company to be both privately held (no class of registered securities) and with annual gross revenues of less than $250,000,000, or EBITA of less than $25,000,000.

With respect to FINRA rulemaking, at the December 2013 FINRA Board of Governors meeting, the Board authorized FINRA to publish a Regulatory Notice seeking comment on a set of modified FINRA rules that will govern a new category of FINRA registration, that being a "limited corporate financing brokers." It is anticipated that the proposed rule changes would create a set of modified rules for firms whose activities are limited to advising an issuer about its securities offerings, corporate restructuring and merger where the customers are institutional clients. While the modified rules are anticipated to ease some of the regulatory burden on the limited corporate financing brokers, it is unclear at this time whether the No-Action Letter has or will impact the FINRA proposed rule changes since FINRA has yet to publish the proposed rule changes.

Summary

Between the No-Action Letter, proposed state law changes, H.R. 2274 and proposed FINRA rulemaking, it is clear that the regulation of the M&A Broker is rapidly evolving. We anticipate that in the next 12 to 18 months M&A professionals will see more regulatory changes than have occurred since the early 1990's, when the regulators first focused directly on the registration issues related to M&A activities. With that caveat, should you desire to utilize the No-Action Letter for regulatory relief, it is recommended that (i) you contact an attorney or consultant who is familiar with the laws of the states you are engaging in your M&A activities to determine if your activities are impacted by state securities laws and regulations; and (ii) monitor H.R. 2274. In the alternative,

if you are currently a FINRA member firm, monitor the website for the release of the Regulatory Notice related to the proposed rules for limited corporate financing brokers so as to understand its implication on your corporate finance activities, and respond to the request for comments.

We hope that this information has been helpful to you. Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail or phone, at 281-367-2454, or consult with your legal counsel or compliance consultant. This legal update has been provided to you courtesy of The LeGaye Law Firm, P.C., 2002 Timberloch Drive, Suite 200, The Woodlands, Texas 77380. Visit our web site at www.legayelaw.com.