



## Private Company M&A Brokers Don't Need to Register With the SEC as Broker-Dealers

On January 31, 2014, the SEC issued a ground-breaking no-action letter, taking the position that a financial intermediary that limits its business activity to advising privately held companies in M&A transactions need not register as a broker-dealer. The no-action letter, as revised on February 4, 2014, may be found here: <http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf>.

This no-action letter departs from the SEC's long-standing position that treated M&A brokers in the same manner as more traditional broker-dealers. It also opens the door for brokers who only represent private companies in M&A transactions to withdraw their broker-dealer registration with the SEC. Before doing so, however, they should consider both the limitations in the no-action letter and the implications under state law should they cease to be an SEC-registered broker-dealer.

### Background

Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires broker-dealers engaged in interstate commerce to register with the SEC. "Broker" is defined in Section 3(a)(4) of the Exchange Act as anyone engaged in the business of effecting transactions in securities on behalf of others.

The SEC has traditionally interpreted the definition of "broker" very broadly to reach persons who participate in important parts of a securities transaction, including solicitation, negotiation and execution of the transaction. The presence of transaction-based compensation has often led to a presumption that the recipient must register as a broker-dealer.

Financial intermediaries advising on private company M&A transactions and compensated through success fees fall squarely within this definition if the transaction takes the form of a sale of the target company's stock to the acquirer. However, such intermediaries would not be required to register as broker-dealers if the transaction was structured as an asset sale. In many cases, the parties do not know at the outset how the transaction will ultimately be structured. As a result, intermediaries advising private companies on M&A transactions have been required to register as broker-dealers in order to accommodate the possibility that the resulting transaction would be structured as a stock purchase by the acquirer.

The application of the broker-dealer regulatory framework to private company M&A advisers has always been somewhat awkward. Much of that framework is designed to protect customers against abusive sales or trading practices and to ensure that customer funds and securities are safeguarded. However, in the typical private company M&A transaction, the terms of the deal are negotiated directly by the principals with assistance from their financial and legal advisers. Unlike the customer who buys or sells stock based on a brief conversation with his broker, the owners of a private business are generally very involved in the negotiation process, which may take

place over a period of weeks or months. Moreover, the financial intermediary never touches the customer's funds or securities. The "broker" in private company M&A transactions functions essentially as an adviser to its client and its role bears little resemblance to more traditional broker-dealers.

While the SEC had provided some limited no-action relief in the past, such no-action letters did not really go to the heart of the problem and left private company M&A brokers with all the burdens of compliance with a regulatory regime that was ill-suited to their business.

### **The No-Action Letter**

The no-action letter states that the SEC's Division of Trading and Markets will not recommend enforcement action to compel registration by brokers who limit their securities activity to assisting in transactions which result in the transfer of ownership of privately-held companies ("M&A Brokers"). The transfer of ownership may be accomplished by any number of means, including a stock sale, merger, issuance of new shares or other business combination. However, the transaction must result in the acquirer obtaining control and actively operating the target company. There is no limitation on the size of the transactions or the target companies.

The no-action letter sets forth a number of important criteria which M&A Brokers should consider in determining if they would qualify for relief from SEC registration requirements.

1. The M&A Broker must not have the authority to bind the principals in the M&A transaction.
2. The M&A Broker should not provide financing for the transaction.
3. The M&A Broker must never have possession of customer funds or securities.
4. The M&A transactions must not involve a public offering.
5. If the M&A Broker represents both the target and the acquirer, it must obtain written consents from both parties.
6. If the target company is to be sold to a group of buyers (e.g., a club bid by private equity firms), the M&A Broker must not have assisted in the formation of the group.
7. Upon completion of the M&A transaction, the buyer must have control of the target and it must actively operate the business.
8. The target company may not be sold to a passive buyer.
9. Any securities sold to the acquirer (or the M&A Broker) will be restricted securities.
10. The M&A Broker must not have been barred or suspended from association with a registered broker-dealer.

### **Considerations for Private Company M&A Brokers**

Based on this no-action letter, brokers who focus their business on handling M&A transactions for private companies may give serious consideration to not applying for SEC registration or, if already registered, withdrawing their broker-dealer registration with the SEC in order to escape the rather burdensome regulatory requirements. However, before doing so, they should bear in mind some of the limitations they may encounter if they are not SEC-registered.

First, and most obviously, they will foreclose the possibility of advising public companies that are contemplating a sale of control. Second, they must refrain from assembling groups of buyers, which may constrain their ability to work on larger private company M&A transactions.

In addition, they should consider the consequences under state law if they are no longer SEC-registered broker-dealers. Some states such as California have an exemption for M&A specialists. However, many states do not have a parallel exemption and state registration will have to be maintained. Moreover, failure to obtain a license as a securities broker-dealer may force brokers in some states to obtain a real estate broker's license or a business broker's license in order to sell businesses in that state. Many states predicate their exemption for out-of-state broker-dealers on SEC registration as well as certain limitations on in-state business. If an M&A Broker withdraws from SEC registration, it may no longer qualify for such exemptions for out-of-state brokers, resulting in an increase in their state registration requirements. It is not clear what actions, if any, the states will take to harmonize their regulatory requirements with the position set forth in the no-action letter.

## Conclusion

The no-action letter is a significant development which has the potential to relieve the regulatory burden for M&A Brokers. Prior to taking advantage of such relief, brokers should carefully weigh their ability to comply with all of the criteria set forth in the no-action letter as well as the implications at the state level of conducting an M&A business without an SEC license.

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