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A More Practical Approach to Broker-Dealer Registration

Recent SEC no-action letter provides business brokers relief from federal broker-dealer registration requirement.

On January 31, 2014, the Division of Trading and Markets of the U.S. Securities and Exchange Commission (SEC) issued a no-action letter (Letter) permitting certain "M&A Brokers" (defined below) to facilitate securities transactions in connection with the purchase and sale of privately-held companies and receive transaction-based compensation without registering as broker-dealers under Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act).[1]

While the Letter is focused on the activities of so-called "business brokers," it is noteworthy beyond this limited context. First, the Letter follows the trend begun in no-action letters issued last year to AngelList[2] and FundersClub[3] that indicates a certain thawing of the Trading and Markets staff's views on what constitutes broker-dealer activity for purposes of the registration requirements of Section 15(a) of the Exchange Act. In those letters, however, the critical element upon which relief was granted was that no compensation received by the investment advisers could be deemed "transaction-based." The Letter marks one of the very few times the staff has permitted transaction-based compensation to be received by persons who arguably fall within the definition of "broker" under the Exchange Act, but are not registered as such.[4]

Second, the Letter follows last year's public comments by David Blass, Chief Counsel of the SEC's Division of Trading and Markets, in which Blass highlighted issues related to payments in connection with private placements and investment banking transactions that implicate the broker-dealer requirements.[5] (For a more detailed summary of Blass's speech, see our previous *Client Alert* entitled *"Finders" and the "Issuer Exemption": The SEC Sheds New Light on an Old Subject.*) While the Letter does not provide any direct answers to the issues cited by Blass, the private fund industry and members of the American Bar Association have undertaken a continuing dialogue with the Trading and Markets staff to address the issues, and the Letter may portend developments in this area.

Finally, however, a word of caution. Although some industry participants appear to have read more into the relief granted in the Letter, it remains narrowly tailored and focused on the "business broker" constituency. Importantly, the Letter does not address the capital raising and investment banking activities identified by Blass as problematic in the private funds space. As described below, the Letter is also subject to a number of specific conditions. Accordingly, market participants who intend to rely on the Letter should carefully review its terms to fully ascertain its scope, and should consider applicable state broker-dealer registration requirements, which continue to apply even if the proposed activities might otherwise fall within the parameters of the relief from federal broker-dealer registration requirements.

Scope of the No-action Relief

Since at least the formation of the ABA Task Force on Private Placement Broker-Dealers in the mid-2000s,[6] there has been a concerted effort by practitioners in this area to convince the SEC to provide relief for business brokers and others involved in the purchase and sale of small businesses. The Letter represents the fruit of these efforts, and grants relief to M&A Brokers facilitating mergers, acquisitions, business sales, and business combinations between buyers and sellers of "privately-held companies." For purposes of the Letter, the term "privately-held company" is defined as a company that does not have any class of securities registered, or required to be registered, with the SEC 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, the company must be an "operating company" that is a going concern and not merely a "shell company" with no or nominal operations and assets or assets consisting only of cash or cash equivalents.[7]

Among other things, the transactions covered by the Letter must satisfy the following criteria:

- The transaction must not involve a public offering of securities, and any offer and sale of securities in the transaction must be conducted in compliance with an applicable exemption from registration under the Securities Act of 1933 (Securities Act) and any securities received by the buyer or M&A Broker in connection with the transaction must be "restricted securities," as defined in Rule 144(a)(3) under the Securities Act.

- The transaction must involve a sale to a buyer (or group of buyers) that will "control"[8] the company and actively operate it at the conclusion of the transaction (passive buyers are expressly excluded). A buyer may actively operate the company through the power to elect executive officers and approve the annual budget or by service as an executive or other executive manager, among other things.

The "actively operate" requirement will limit the utility of the Letter for many situations, such as for private funds that take a minority stake in a company. Nonetheless, in transactions where control of the board of directors of the target is obtained, it would appear the active operation requirement would be satisfied.

Specified Activities

To the extent the conditions cited in the Letter are satisfied, M&A Brokers are permitted to engage in the following types of activities, among others, without having to register as a broker-dealer:

- Receive transaction-based compensation
- Participate in negotiations (without the ability to bind either party to a transaction)
- Advertise the company for sale with information such as the description of the business, general location, and price range
- Advise the parties to issue securities or otherwise to effect the transfer of the business by means of securities (as opposed to an asset purchase/sale), or assess the value of any securities sold

The Letter also makes clear that an M&A Broker may not provide financing for a transaction (either directly or indirectly), and that to the extent the M&A Broker assists purchasers in obtaining financing from an unaffiliated third party the M&A Broker must comply with all applicable legal requirements and any compensation received by the M&A Broker must be disclosed to the client in writing. We note that to the extent securities-related financing is obtained for the transaction, the Letter would not relieve an M&A Broker from the broker-dealer registration requirements to the extent its activities in connection with such financing would otherwise be captured under the Exchange Act.

Conclusion

The Letter appears to signal a new and potentially more reasonable approach by the SEC staff to the many broker-dealer registration issues faced by financial markets participants. While limited in scope, the Letter provides meaningful relief to M&A Brokers and provides a potential framework for addressing related issues more broadly in the future.

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Endnotes

1 *See* SEC No-Action Letter, dated January 31, 2014 [Revised February, 4, 2014], available at: http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

2 *See* SEC No-Action Letter, dated March 28, 2013, available at: http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf.

3 *See* SEC No-Action Letter, dated March 26, 2013, available at: http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf

4 *See* SEC No-Action Letter, dated November 8, 2006, available at: http://www.sec.gov/divisions/marketreg/mr-noaction/cbi110806.htm. Note that in this no-action letter the activities of the ostensible broker (Country Business, Inc.) were curtailed in the context of a securities transaction, which appeared to justify the payment of what would otherwise have been prohibited transaction-based compensation.

5 *See* David W. Blass, A Few Observations in the Private Fund Space (April 5, 2013), available at: http://www.sec.gov/news/speech/2013/spch040513dwg.htm; *see also* Private Fund Sales and Marketing: A Conversation with Senior Staff from the SEC Division of Trading and Markets (September 26, 2013), available at: http://www.pli.edu/Content/Seminar/Private_Fund_Sales_and_Marketing_A_Conversation/_/N-4kZ1z12eeq?ID=190064&t=KFG3_8AM35&utm_source=8AM35&utm_medium=EMAIL&utm_campaign=KFG3

6 *See* Report and Recommendations of the ABA Section of Business Law Task Force on Private Placement Broker-Dealers (June 7, 2005).

[7] The SEC staff specifically noted, however, that 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.

[8] The Letter defines "control" as 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 percent or more of a class of voting securities; has the power to sell or direct the sale of 25 percent 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 percent or more of the capital.