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Practice Update

M&A Brokers for Private Companies Need Not Register with the SEC

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The staff of the SEC recently issued a no-action letter permitting an "M&A Broker" to advise on and be compensated in connection with the purchase and sale of a privately held company without registering as a broker-dealer under the Securities Exchange Act of 1934 (the Exchange Act), even where the transaction is structured as a sale of securities. The no-action letter may be found here.

Historically, broker-dealer registration issues have made it difficult to structure engagements with unregistered advisors in the context of a stock sale even though the disposition of the same business in an asset transaction would not raise broker-dealer concerns. The no-action letter significantly expands the scope of the advisory arrangements that may lawfully be entered into between unregistered advisers and their clients and, in doing so, will facilitate greater choices in selecting advisers in business combination transactions involving privately held companies.

An "M&A Broker" is defined in the no-action letter 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

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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. The regulatory relief granted in the no-action letter applies to the purchase and sale of companies that do not have any class of securities registered with the SEC under Section 12 of the Exchange Act or publicly report under Section 15(d) of the Exchange Act and that are not "shell" companies.

Although SEC no-action letters are in terms applicable to the specific facts and parties requesting relief from the staff, the M&A Broker no-action letter addresses broker-dealer registration issues conceptually, and transaction participants should be comfortable proceeding with advisory engagements that meet the following conditions set forth in the no-action letter:

- The M&A Broker will not have the ability to bind a party to the transaction.
- The M&A Broker will not directly, or indirectly through any of its affiliates, provide financing for the transaction. An M&A Broker that assists purchasers in obtaining 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.
- The M&A Broker will not have custody, control, or possession of or otherwise handle funds or securities issued or exchanged in connection with the transaction.
- The transaction will not involve a public offering of securities. Any offering or sale of securities will be conducted in compliance with an applicable exemption from registration under the Securities Act of 1933. No party to the transaction can be a shell company other than a business combination related shell company (e.g., a merger subsidiary formed for the purpose of completing a business

combination transaction among other entities that are not shell companies).

- To the extent the M&A Broker represents both buyers and sellers, it will 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 a transaction with a group of buyers only if the group is formed without the assistance of the M&A Broker.
- The buyer in the transaction must control and actively operate the target (or the business conducted with its assets) upon completion of the transaction. Importantly, under the no-action letter, the necessary "control" will be presumed to exist if, upon completion of the transaction, the buyer 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. However, the requirement that the buyer actively operate the target (or the business conducted with its assets) upon the completion of the transaction is distinct and must also be satisfied.
- The transaction will not transfer interests in the target to a passive buyer or group of passive buyers.
- Securities issued to a buyer or an M&A Broker in the transaction will be restricted securities within the meaning of Rule 144(a)(3) of the Securities Act.
- The M&A Broker and, if the M&A Broker is an entity, its officers, directors and employees may not have been (i) barred from association with a broker-dealer by the SEC, any state or any self-regulatory organization or (ii) suspended from association with a broker-dealer.

Based on the factual predicates contained the no-action request letter, an M&A Broker that complies

with the above conditions should be able to perform any of the following in connection with a private company transaction engagement without invoking federal broker-dealer registration requirements, irrespective of the size of the transaction:

- Advertise a company for sale with information such as the description of the business, general location, and price range.
- Advise a party to issue securities, or otherwise to effect the transfer of the business by means of securities, or assess the value of any securities sold.
- Facilitate due diligence, and participate in the structuring and negotiation of the transaction.
- Receive transaction-based or other compensation, as agreed by the parties, in connection with transaction.

Provisions of the federal securities laws other than federal broker-dealer registration requirements are not addressed by the no-action letter. Anti-fraud provisions, among others, continue to apply.

The staff did not express any opinion on the applicability of state laws to the operation of M&A Brokers. Many states exempt from state registration an out-of-state broker-dealer who is registered with the SEC as a broker-dealer. As a result, M&A Brokers are cautioned to check on the need for state registration, either as a business broker or a real estate broker, in states where they will provide services.
