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The Ever-Changing Registration Landscape for Private Company Brokers

Two recent developments may impact when certain financial intermediaries should register as broker-dealers under federal law: (1) a significant no-action letter issued by the SEC, and (2) legislation passed by the U.S. House of Representatives.

1. No-Action Relief:

In the so-called "Six Lawyers Letter," the SEC's Division of Trading and Markets departed from its decades-long stance and now will permit certain mergers and acquisitions intermediaries that effect transactions in securities (M&A Brokers) to do so without registering as brokers under the Securities Exchange Act of 1934 (1934 Act). Traditionally, M&A Brokers compensated for effecting the sale of securities in an M&A transaction have been required to register as brokers under the 1934 Act, unless they fell within very limited exemptions.

The no-action relief applies to M&A Brokers solely engaged in the transfer of ownership and control of "privately held" companies through certain transactions the company's assets or securities with a buyer that will "actively operate" the company or the business. "Privately held" companies for these purposes are companies (regardless of size or revenues) that do not have any class of securities registered or required to be registered under section 12 of the 1934 Act or with respect to which the company files or is required to file periodic reports under section 15(d) of the 1934 Act. Further, "privately held" companies must be "going concerns" and not "shell" companies.

What is permitted. The no-action relief permits M&A Brokers, regardless of the manner in which they are compensated, to effect mergers, acquisitions,

business sales or combinations between buyers and sellers of privately held companies involving the sale of securities and to publicly advertise the company to be sold without registering as a broker under section 15 of the 1934 Act.

Conditions to relief. The SEC included several restrictions to such M&A Brokers' activities in connection with permitted M&A transactions involving the sale of securities, all of which should be scrupulously followed by any M&A Broker seeking to rely on the relief:

i. the M&A Broker may not have the ability to bind a party to the M&A transaction;

ii. the M&A Broker may not (directly or indirectly) provide financing for the M&A transaction;

iii. M&A Brokers assisting buyers with financing from unaffiliated third parties must comply with "all applicable legal requirements" and disclose any compensation in writing to the client;

iv. M&A Brokers may not have custody or possession of or otherwise handle funds or securities issued or exchanged in an M&A transaction or other securities transaction for the account of others;

v. the M&A transaction may not involve any public offering of securities, and any offer or sale of securities must be exempt under the Securities Act of 1933 (1933 Act);

vi. other than a "business combination related shell company," no party to the M&A transaction may be a shell company;

vii. M&A Brokers representing both buyers and sellers must provide clear written disclosure about who they represent and obtain the parties' written consent for the joint representation;

viii. an M&A Broker may not facilitate an M&A transaction with a group of buyers unless the group is formed without the M&A Broker's assistance;

ix. after completion of the M&A transaction, the buyer (or permitted group of buyers) must control and actively operate the company or the business conducted with the assets of the business — the transaction may not result in the transfer to a passive buyer or group of passive

buyers;

x. securities received by either the buyer or the M&A Broker are restricted securities within the meaning of 1933 Act Rule 144(a)(3);

xi. neither the M&A Broker nor (if it is an entity) its officers, directors or employees may have been barred from associating with a broker-dealer by the SEC, any state or self-regulatory organization, or suspended from associating with a broker-dealer; and

xii. other than section 15(a), the rest of the 1934 Act, including its anti-fraud provisions, as well as other federal securities laws (such as the 1933 Act), apply.

What the relief does not do. The Six Lawyers Letter only means that the SEC's Division of Trading and Markets will not recommend enforcement action to the SEC in the circumstances detailed in the letter. M&A Brokers contemplating relying on the Six Lawyers Letter should carefully evaluate its limitations and consider what the letter does *not* do:

While the letter excuses registration, it has no bearing on who, in the first place, is considered to be a broker under the 1934 Act or any state law. It instead appears to start with the Staff's long-held position that an M&A Broker described in the letter is likely going to meet the definition of "broker" under the 1934 Act.

While the letter may or may not be persuasive to state securities regulators in the future, it in no way binds any state securities regulator or otherwise exempts an M&A Broker from having to register in one or several states for conducting an M&A transaction of the type described in the letter.

The letter does not excuse M&A Brokers from registering under the 1934 Act if their deal financing activities otherwise trigger registration requirements.

It remains to be seen how the letter may impact what some see as the greatest risk faced by M&A Brokers who should be registered but are not: the voiding of their engagement letters. Under section 29(b) of the 1934 Act, any contract made in violation of the 1934 Act is void, and many clients of

unregistered M&A Brokers have used that provision to avoid paying contractually agreed upon success fees, and in some cases even clawed back progress payments previously made. In the future, the Six Lawyers Letter may be used to persuade a court to conclude that an unregistered M&A Broker effecting a securities transaction does not violate section 15 of the 1934 Act, but because that determination will have to be made on a jurisdiction-by-jurisdiction basis, the letter leaves open some uncertainty on a very important issue.

Companies issuing securities in M&A transactions should keep in mind that the letter does not necessarily address the issues that can arise with the use of an unregistered broker, such as the availability of state exemptions or the relief available to purchasers.

Questions remaining. While the relief in the Six Lawyers Letter is significant, some additional clarity may be needed on issues, such as (i) whether its relief is unavailable if the M&A Broker is involved in any other types of securities transactions; (ii) what constitutes "active" operation of an acquired company by the buyer(s); (iii) what rights a class of securities transferred must have to meet the threshold of securities that must be transferred; and (iv) how much information about a company to be sold may be publicly advertised.

2. H.R. 2274:

Initially introduced in the U.S. House of Representatives in a form contemplating registration with a limited scope compliance burden for M&A brokers, house bill H.R. 2274 was unanimously passed in January 2014, after undergoing changes in the process. The bill would statutorily exempt "M&A Brokers" from registering under the 1934 Act as a broker if they effect securities transactions in connection with the "transfer of ownership" of an "eligible privately held company," regardless of whether securities transactions are involved, so long as the M&A Broker "reasonably believes that" the acquirer(s) will "control" the acquired company and will be directly or indirectly "active in the management" of the company or the business conducted with the company's assets, and further so long as the M&A Broker reasonably believes that buyers of securities have access to the target's financial information.

Similar to the Six Lawyers Letter, "eligible privately held companies" (EPHCs) may not have a class of securities registered under section 12 of the 1934 Act or file periodic reports under "subsection (d)."[1] Unlike the Six Lawyers Letter, legislation provides that the EPHCs must have (in the fiscal year preceding the engagement of the M&A Broker) either earnings before interest, taxes, depreciation and amortization of less than $25,000,000 or gross revenues of less than $250,000,000 (both numbers to be adjusted for inflation over time).

An "M&A Broker" is defined in a manner similar to the Six Lawyers Letter, except that the broker must reasonably believe that upon consummation of the transaction, acquirer(s) will control and be active in the management of the EPHC or the business conducted with the EPHC's assets; and acquirers of securities receive specified financial information before being bound.

Key differences. The statute differs from the Six Lawyers Letter in an important way in defining an M&A Broker: the statute defines an M&A Broker as a person effecting securities transactions "solely in connection with the transfer of ownership" of an EPHC; whereas the Six Lawyers Letter defines M&A Brokers as persons effecting securities transactions "solely in connection with the transfer of ownership *and control*" of a company. Further, H.R. 2274 only requires that the M&A Broker "reasonably believe" that after the deal, the acquirer(s) will control and actively manage the EPHC; whereas the Six Lawyers Letter requires similar control and management to in fact occur. Due to these definitional differences and the use of different conditions, the relief afforded under H.R. 2274 appears to be broader than that provided under the Six Lawyers Letter.

While similar, H.R. 2274's definition of "control" also differs from that used in the Six Lawyers Letter. The statute would define "control" as the power to direct the company's management or policies, and "control" is presumed to be had for any person who (i) is a director, general partner, member or manager of an LLC, or officer exercising executive responsibility or similar functions, (ii) has the right to vote 20 percent or more of a class of voting securities or the power to sell or direct the sale of 20 percent or more of a class of voting securities, or (iii) has contributed or has the right to receive 20 percent or more of a partnership's or LLC's capital. Not only is the security ownership threshold lower in H.R. 2274, the Six Lawyers Letter requires the acquirer(s) to "actively operate" the company — whereas the statute would merely require that the broker believe that an acquirer will become a member of an LLC and be active in its management.

While it may not be the drafters' intent, because of the way H.R. 2274 defines an M&A Broker and control, it could be read to permit an M&A Broker to conduct any sale of securities exempt under the 1933 Act, so long as the broker merely believes that after the transaction, the buyers will be members of an LLC and participate in its management.[2]

What the legislation does and does not do. Similar to the Six Lawyers Letter, H.R. 2274 has no bearing on any state requirement to register as a broker. However, unlike the Six Lawyers Letter, H.R. 2274 would reach beyond the limits of the relief granted to M&A Brokers exempted from registration under the 1934 Act, and would eliminate related section 29(b) claims of the 1934 Act to void M&A engagement letters. Further, H.R. 2274 appears to permit more activities than does the Six Lawyers Letter. For example, while it would be a challenge to stretch the relief granted under the Six Lawyers Letter to raising capital in non-M&A deals, H.R. 2274 may permit such activity.

Room for interpretation. H.R. 2274, in its present form, appears to leave a significant number of issues open for judicial or administrative interpretation. As noted above, it would appear to permit an intermediary to generally solicit the sale of securities in the capital raising (in addition to the M&A) context, so long as its conditions are met. Similar to the Six Lawyers Letter, it is not clear if an M&A Broker must restrict its securities activities to only those permitted in the relief; what constitutes "control" and "active" management may engender varied interpretations; and one could see the standard for establishing the M&A Broker's "reasonable belief" being subject to differing interpretations.

[1] Presumably the statutory reference is intended to refer to section 15(d) of the 1934 Act and not section 12(d).

[2] In addition to the statute's other limitations of EPHC size and other conditions.

What This Means to You

The foregoing developments may end up providing clarity, and likely further nuance, when financial intermediaries seek to effect securities transactions without registering as brokers under the 1934 Act. Those intermediaries should continue to track these developments and consider the limitations afforded under any available relief.

Contact Us

For more information, please contact your Husch Blackwell attorney.