Westlaw Today
powered by Reuters

New exemption from federal broker-dealer registration for M&A brokers

By Daryl Robertson, Esq., Hunton Andrews Kurth LLP*

JANUARY 23, 2023

The Consolidated Appropriations Act, 2023, H.R. 2617 (the "2023 Act"), was passed by Congress and signed into law by President Biden on December 29, 2022, and contained new amendments (the "Amendments") to §15 of the Securities Exchange Act of 1934, as amended (the "1934 Act").[1]

The Amendments are effective 90 days after enactment of the 2023 Act. The Amendments will allow an "M&A broker" to engage in securities transactions in connection with the purchase and sale of an "eligible privately held company" without registering as a broker-dealer under §15 of the 1934 Act.

Background

Because the US Supreme Court has held that sale of all of the outstanding shares of a privately held company involves the sale of a security,[2] there has been for many years a concern that business brokers should register as securities brokers and become members of FINRA. Many of these business brokers have simply chosen to ignore this requirement.

If the broker assisted in the sale of the assets of the business instead of the stock of the company, and no related securities were sold, these registration requirements would not be triggered. In case of both an asset sale or stock sale, the broker tends to perform similar services and earn similar fees, leading to the somewhat anomalous result that its activities could trigger extensive and costly regulation as a broker-dealer in one case and no such regulation in the other case.

There has been for many years a concern that business brokers should register as securities brokers and become members of FINRA.

In an attempt to address some of these concerns without engaging in any rule-making, in early 2014, the Securities & Exchange Commission (SEC) issued a significant no-action letter in response to a request from a group of individual lawyers (the "SEC M&A Broker Letter").[3]

The SEC M&A Broker Letter stated that the Division of Trading and Markets of the SEC (the "Division") would not recommend enforcement action against an "M&A Broker" whose activities satisfied certain conditions.

Following the issuance of the SEC M&A Broker Letter, the North American Securities Administrators Association (NASAA) followed suit and adopted its Model Rule Exempting Certain Merger & Acquisition Brokers from Registration (the "NASAA Model Rule") on September 29, 2015. While many of the conditions set forth in the SEC M&A Broker Letter were similar to the requirements contained in the Amendments, the new Amendments are clearly derived in large part from the NASAA Model Rule.

The Amendments impose a size limitation on the eligible privately held company.

Since 2014, business brokers and mergers and acquisitions lawyers have continued to push for further clarity on these matters because they recognize that the SEC M&A Broker Letter merely states the no-action position of the Division and is not binding precedent on the SEC in any legal proceedings with respect to the same issues.

Key definitions

M&A broker. In the Amendments, "M&A broker" is defined to be a broker, and any associated person, engaged in the business of effecting securities transactions solely in connection with the transfer of ownership of an eligible privately held company, regardless of whether the broker acts on behalf of the seller or buyer, through the purchase, sale, exchange, issuance, repurchase or redemption of, or a business combination involving, securities or assets of the eligible privately held company.

The broker must reasonably believe that, upon consummation of the transaction, any person acquiring securities or assets, acting alone or in concert, (1) will control the eligible privately held company (or the business conducted with the assets of such company) *and* (2) directly or indirectly, will be active in the management of the eligible privately held company (or the business conducted with its assets).

The Amendments contain the following examples of how a buyer could be deemed to be active in the management of the eligible privately held company: (1) electing executive officers; (2) approving the annual budget; (3) serving as an executive or other executive manager; or (4) carrying out such other activities as the SEC, by rule, may determine to be in the public interest.

If any person is offered securities in exchange for securities or assets of the eligible privately held company, such person must, prior to becoming legally bound to consummate the transaction, receive (or have reasonable access to):

(1) the most recent year-end financial statements of the issuer as customarily prepared by its management in the normal course of operations (and any related statement by the independent accountant if the financials are audited, reviewed or compiled);

(2) a balance sheet dated not more than 120 days before the date of the offer; and

(3) information pertaining to the management, business, results of operations for the period covered by the foregoing financial statements, and material loss contingencies of the issuer.

Eligible privately held company. The phrase "eligible privately held company" is defined to mean a privately held company that does not have any class of securities registered (or required to be registered) with the SEC under §12 of the 1934 Act or does not file (or is not required to file) periodic reports under §15(d) of the 1934 Act.

The exemption provided by the Amendments is limited to broker-dealer registration with the SEC and does not provide an exemption from broker-dealer registration under applicable state securities laws.

Unlike the SEC M&A Broker Letter, but similar to the NASAA Model Rule, the Amendments impose a size limitation on the eligible privately held company.

In the fiscal year immediately prior to the fiscal year in which the M&A broker is initially engaged with respect to the securities transaction, the privately held company must meet either or both of the following conditions: (1) earnings before interest, taxes, depreciation and amortization are less than $25 million or (2) the gross revenues are less than $250 million. These dollar amounts are required to be adjusted for inflation every five years and may be modified by SEC regulation.

Control. "Control" is defined, in a familiar fashion, to mean the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise.

Control of the eligible publicly held company is presumed if, upon consummation of the transaction, the buyer or group of buyers has the right to vote, sell or direct the sale of at least 25% of a class of voting securities of the company or, in the case of a partnership or limited liability company, has the right to receive upon dissolution, or has contributed, at least 25% of the capital of the entity.

Excluded activities

The Amendments provide that the M&A broker is not exempt from registration if the broker engages in any of the following activities:

(1) Directly or indirectly, receives, holds, transmits or has custody of funds or securities to be exchanged by the parties to the transaction.

(2) Engages on behalf of an issuer in a public offering of any class of securities registered (or required to be registered) under §12 of the 1934 Act or for which the issuer files (or is required to file) periodic reports under §15(d) of 1934 Act.

(3) Engages in a transaction involving a "shell company" (which is a defined phrase), other than a "business combination shell company" (which is defined to be a shell company formed by a non-shell company solely for the purposes of a redomestication or a business combination transaction).

(4) Directly or indirectly through any of its affiliates provides financing related to the transfer of ownership of an eligible privately held company.

(5) Assists in obtaining financing from an unaffiliated third party without complying with all other applicable laws and disclosing any compensation in writing to the assisted party.

(6) Represents both buyer and seller in the same transaction without providing clear written disclosures and obtaining written consent from both parties to the joint representation.

(7) Facilitates a transaction with a group of buyers formed with the assistance of the M&A broker to acquire the eligible privately held company.

(8) Engages in a transaction involving transfer of ownership of an eligible privately held company to a passive buyer or group of passive buyers.

(9) Binds a party to a transfer of ownership of an eligible privately held company.

Disqualification

The Amendments also provide that an M&A broker is not exempt from registration if the broker (including any officer, director, member, manager, partner or employee thereof) has been barred from association with a broker or dealer by the SEC, any state or any self-regulatory organization or has been suspended from association with a broker or dealer.

Some observations

The Amendments legitimize the wide-spread practice of business brokers who have chosen not to register as broker-dealers. It

remains to be seen whether further material conditions will be included in any SEC rule-making based on the Amendments.

The exemption provided by the Amendments is limited to broker-dealer registration with the SEC and does not provide an exemption from broker-dealer registration under applicable state securities laws.

There could be an uneven playing field going forward, from a regulatory cost standpoint, with some business brokers remaining registered as brokers with the SEC while other business brokers continue not to be registered with the SEC or otherwise determine to deregister with the SEC to avoid the ongoing regulation and related costs.

The anti-fraud prohibitions of the 1934 Act will also continue to apply to any securities transactions and to any M&A brokers who aid and abet fraudulent activities with respect to securities transactions.

There is no clear restriction on advertising by the M&A broker for the sale of the eligible privately held company but, of course, the broker must avoid any transaction that might result in a public offering of registered securities.

Although not stated in the Amendments, any securities received by the buyer or M&A broker in the securities transaction will probably be treated as "restricted securities" under SEC Rule 144.

Notes

[1] Public Law No. 117-328; H.R. 2617, Consolidated Appropriations Act, 2023, Division AA, Title V- Small Business Mergers, Sales, and Brokerage Simplification, Sec. 501. Registration Exemption for Merger and Acquisition Brokers.

[2] *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

[3] *Faith Colish, Esq., Arter Ledyard & Milburn LLP, et al* (SEC No-Action Letter, January 31, 2014).

About the author

Daryl Robertson, a partner in **Hunton Andrews Kurth LLP**'s mergers and acquisitions group, focuses on business and finance transactions, entity formation and securities law. He is based in Dallas and can be reached at (214) 468-3371 or drobertson@HuntonAK.com. This article was originally published Jan. 17, 2023, on the firm's website. Republished with permission.

This article was published on Westlaw Today on January 23, 2023.