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NEW EXEMPTION FROM FEDERAL BROKER-DEALER REGISTRATION FOR M&A BROKERS

A new Federal law has created an exemption from broker-dealer registration for an M&A broker who effects securities transactions in connection with the transfer of ownership of an eligible privately held company, which is a company with EBITDA of less than $25 million and gross revenues of less than $250 million for its last fiscal year and that satisfies certain other criteria. The transaction must be with a buyer (or buyers) that, after the transaction, will control, and, directly or indirectly, will be active in the management of, the target company. In this article, the author summarizes (1) the background and policy reasons for the new law, (2) key definitions in the new law, including "M&A broker," "eligible privately held company," and "control," (3) excluded activities in which the broker cannot engage while remaining eligible for the exemption, (4) broker disqualifications, and (5) various interpretative issues, questions, and observations. The new Federal law does not preempt state law in this area.

By Daryl B. Robertson *

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 Section 15 of the Securities Exchange Act of 1934, as amended (the "1934 Act").[1] The Amendments became effective March 29, 2023. The Amendments 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 Section 15 of the 1934 Act.

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

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BACKGROUND AND REASONS

A "broker" is defined by the 1934 Act to be any person engaged in the business of effecting transactions in securities for another person's account.[2] Because the US Supreme Court has held that the sale of all of the outstanding shares of a privately held company involves the sale of a security,[3] there has been for many years a concern that business brokers should register as securities brokers and become members of FINRA. Compliance with the broker-dealer registration requirements is costly and involves substantial time and effort. SEC no-action letters on the topic of exempting

[2] 1934 Act §3(a)(4)(A).

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

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small business brokers began in 1986.[4] Underlying policy considerations and related recommendations were summarized in the 2005 Report of the ABA Task Force on Private Placement Broker-Dealers.[5]

Because of the large costs and regulatory hassles, many business brokers have simply chosen to ignore the broker-dealer registration requirements. If the business 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.

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").[6] 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. On March 29, 2023, upon effectiveness of the Amendments, the SEC announced the formal withdrawal of the SEC M&A Broker Letter.

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, for state security regulators to consider adopting. 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.

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. Privately negotiated M&A transactions involving sellers and buyers who are actively managing and acquiring those businesses rarely involve public policy concerns that underpin securities law protection of public securities markets and passive investors. Parties to these transactions commonly engage lawyers, accountants, tax advisors, commercial lenders, and other advisors to assist in structuring, negotiating, performing due diligence, and closing these transactions. Parties and their legal counsel contractually protect their own rights, interests, and remedies, including for example earnest money deposits, extensive representations from sellers, representations and warranties insurance, post-closing escrows and indemnities from sellers, breakup fees, and guaranties from affiliated entities. Parties rarely rely upon federal or state securities laws or turn to securities regulators for protection or enforcement of their rights. Federal legislation providing an exemption from broker-dealer registration with the SEC for M&A brokers has been introduced from time to time since 2014 and finally came to fruition with the passage of the Amendments late in 2022.

KEY DEFINITIONS IN AMENDMENTS

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

[4] E.g., *International Business Exchange Corporation* (SEC Staff No-Action Letter, December 12, 1986).

[5] 60 *Business Lawyer* 959-1028 (2005).

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

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):

(a) 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);

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

(c) 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 Section 12 of the 1934 Act or does not file (or is not required to file) periodic reports under Section 15(d) of the 1934 Act. 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 limitations are required to be adjusted for inflation every five years and may be modified by SEC regulation. Presumably, the policy justification for including these dollar limitations is that larger companies can more easily afford to engage regulated investment bankers to assist in their M&A transactions.

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:

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

(b) Engages on behalf of an issuer in a public offering of any class of securities registered (or required to be registered) under Section 12 of the 1934 Act or for which the issuer files (or is required to file) periodic reports under Section 15(d) of 1934 Act. By negative inference, it would seem that a private offering of securities would be permissible.

(c) 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). A "shell company" means a company that has no or nominal operations and has (1) no or nominal assets, (2) assets consisting solely of cash and cash equivalents, or (3) assets consisting of cash and cash equivalents and nominal other assets. The shell-company definition appears to include the typical SPAC (or "special purpose acquisition company"). This exclusion effectively means that any broker involved in an SPAC's initial acquisition transaction will be unable to rely on the new M&A broker exemption.

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

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

(f) 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.

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

(h) Engages in a transaction involving the transfer of ownership of an eligible privately held company to a passive buyer or group of passive buyers. A "passive buyer" is not defined by the Amendments, but perhaps a future SEC regulation will clarify its meaning. One interpretation of that phrase could be a buyer who will not, directly or indirectly, be active in the management of the company or its business.

(i) Binds a party to a transfer of ownership of an eligible privately held company. Accordingly, the M&A broker cannot act as an agent for a party in signing the purchase agreement or the closing transfer documents.

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. This provision seems similar to the "bad boy" disqualifications contained in the SEC's Regulation D. It would be advisable as a best practice for the M&A broker to obtain appropriate questionnaires from the broker's employees as part of its diligence and retain them in its records.

SOME INTERPRETATIVE ISSUES, QUESTIONS, AND OBSERVATIONS

The Amendments legitimize the widespread 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. More than 20 states have adopted some form of exemption from broker registration requirements for business brokers. There is a great deal of variety in these state exemptions. A summary of the state exemptions is beyond the scope of this paper.

There are some key differences between the NASAA Model Rule and the M&A brokers exemption established by the Amendments. First, the threshold for the presumption of control in the NASAA Model Rule is a 20% ownership level as compared to a 25% ownership level in the Amendments. The NASAA Model Rule contains fewer excluded activities (e.g., financing conditions, disclosure obligations for representing both parties, or assisting a group of buyers).

Although the SEC No-Action Letter from 2014 has been officially withdrawn by the SEC, will the SEC No-Action Letter continue to be relied upon by M&A brokers who do not meet all of the new conditions in the Amendments (e.g., size limits on eligible privately held company)? The key differences between the SEC No-Action Letter and the new federal M&A broker exemption are: (1) the SEC No-Action Letter contained no restriction on the size of companies for whom M&A brokers could facilitate acquisition transactions; (2) the SEC No-Action Letter did not require that if any person is offered securities in exchange for securities or assets of the target company, such person must receive or have access to recent financial statements of the issuer; and (3) the SEC No-Action Letter contemplated that the M&A broker could advertise the privately held company for sale with information such as a description of its business, general location and price range.

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 de-register with the SEC to avoid the ongoing regulation and related costs. Will exempt M&A brokers make an adequate living out of only engaging in transactions that fit within the parameters of the new exemption?

The anti-fraud prohibitions of the 1934 Act will apply to any securities transactions and should apply to any M&A brokers who aid and abet fraudulent activities with respect to securities transactions, regardless of the new exemption is available.

Does the standard "*solely* in connection with the transfer of ownership of an eligible privately held company" mean that this is a "one-time-only" exemption, with the word "solely" being given independent meaning and effect? Can the M&A broker engage in business with respect to multiple eligible privately held companies at the same time or successively over time? The phrase "engage in the business" supports an interpretation that multiple transactions are allowed, and this author believes such would be the better interpretation. Otherwise, the new exemption would have limited practical benefits.

Some excluded activities in the Amendments do not appear to be tied to the M&A transaction at issue. For example, does engagement in any shell company transaction preclude a broker from being exempt with respect to a subsequent M&A transaction involving an eligible privately held company? Does a broker representing both a buyer and seller in any kind of purchase transaction without obtaining proper written consent prevent the broker from thereafter being eligible for the exemption? The better interpretation of these provisions in the Amendments is that all of the excluded activities should relate to the particular M&A transaction at issue in determining whether the broker qualifies for the new M&A broker exemption.

How can a person be "indirectly" active in the management of the eligible privately held company or its business and assets? The indirect standard may be intended to contemplate, among other situations, the role of a director on a board of directors. It remains to be seen how indirect a buyer's involvement with the company can be after the transaction.

How broad will "indirectly" be interpreted with respect to the exclusion of transmitting or having custody of funds or securities? Can a regulated bank or trust company affiliated with the broker undertake those activities?

To be eligible for the exemption, the broker must "reasonably believe" that the standards are satisfied. Presumably, the broker should conduct appropriate diligence regarding the terms of the proposed transaction and the size of the target company, including reviewing financial information of the company. This is a standard that may be ripe for clarification by SEC rule.

The Amendments contain a certain amount of circularity because they state that the new exemption only applies to a "broker." To be eligible for the new exemption, does a person have to be engaged in the business of effecting transactions in securities for another person? The Amendments could have avoided this circular result by referring to a "person" instead of a "broker."

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. Also, if there is a private offering of securities as part of the M&A transaction, any related public advertising could jeopardize the availability of the Regulation D exemption from registration of the offering with the SEC. If the broker is certain that the M&A transaction will take the form of an asset sale, the broker will have greater latitude to advertise the business for sale. Of course, the broker needs to consider potential state law restrictions and other state licensing requirements (for example, real estate broker license) that could be implicated.

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. This result was clearly stated in the SEC No-Action Letter. Presumably, the SEC would consider any securities sold in the M&A transaction to be offered and sold in an exempt private offering. ■