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CORPORATE, SECURITIES AND FINANCIAL SERVICES ALERT

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Business Brokers Get "No-Action" Relief from SEC

Business intermediaries who facilitate the purchase or sale of privately-held businesses for a success fee based on the size of the completed acquisition may no longer have to be concerned about registering as broker-dealers with the Securities and Exchange Commission (SEC). On January 31, 2014, the SEC issued a no-action letter allowing an M&A Broker (defined here as a person engaged in the business of facilitating transactions in which control and ownership of a privately-held company are transferred to a buyer who will actively operate the acquired business) to avoid registering with the SEC as a broker-dealer.

Adjusting a Long-standing Practice

Under federal securities law, a person engaged in the business of effecting transactions in securities for the account of others is a "broker" who must register with the SEC. A key factor in determining whether a person is acting as a "broker" is whether he or she is receiving compensation based on the size of a successful transaction. Compensating a business intermediary based on a percentage of the value of a completed acquisition is a long-standing common practice. As a technical matter, a business intermediary who is not registered with the SEC as a broker would not be able to enforce any contractual right to receive transaction-based compensation, and perhaps more importantly, a completed acquisition transaction may be subject to rescission.

Since 1985, when the U.S. Supreme Court, in *Landreth Timber Co. v. Landreth*, decided that the sale of a privately-held business structured as a stock sale was a securities transaction subject to federal securities law, an intermediary facilitating the sale of a privately-held business structured as a stock transaction was subject to broker-dealer regulation, while the sale of the same business structured as an asset sale was not. As such, a fee based on the size of a completed acquisition, a common feature for merger and acquisition advisory intermediaries, technically could be paid only if the transaction were structured as an asset sale or the intermediary were registered with the SEC as a broker. In practice, however, the decision of whether to structure an acquisition as a stock or asset sale is beyond the control of the intermediary and is decided by the buyer and the seller based on tax and other business concerns. The SEC's "no-action" relief announced on January 31 will provide certainty to business brokers receiving a success fee regardless of how the acquisition is ultimately structured.

Key Requirements for M&A Brokers

A business broker engaged in the business of facilitating the purchase or sale of privately-held businesses does not have to qualify with the SEC as an M&A Broker. M&A Brokers may facilitate the sale of privately-held businesses by way of mergers, acquisitions, business sales, and combinations, without regard to the size of the transaction, as long as the transaction does not involve a public offering (M&A Transactions). Key requirements to take advantage of this SEC relief include:

a. Upon completion of the M&A Transaction, the buyer will control and actively operate the acquired business. Control will be presumed to exist at the 25 percent ownership level. Accordingly, an M&A Transaction need not involve the sale of all or even a majority of the equity of a privately-held business; however, in all cases the buyer must actively operate the business.

b. The M&A Broker must not (1) have the power to bind his or her client, whether through a power of attorney or proxy; (2) have custody, control, or possession of funds or securities in connection with the M&A Transaction; (3) directly or indirectly provide financing for the M&A Transaction; (4) have assisted in the formation of a buyer group in the case of an M&A Transaction involving a group of buyers; or (5) have been barred or suspended from association with a broker-dealer with the SEC or with any state or self-regulatory organization (a restriction that applies to officers, directors, and employees of an M&A Broker that is an entity).

Navigating the New Parameters

An M&A Broker can represent the buyer or the seller in an M&A Transaction or both the buyer and the seller in an M&A Transaction if both parties consent in writing to the joint representation. While an M&A Broker may not provide financing for the M&A Transaction, he or she can introduce the buyer to unaffiliated third party sources and receive compensation from the funding source if such compensation is fully disclosed to the client.

In navigating the parameters of this "no-action" relief, it is important to contrast a retail customer who buys and sells securities on the open market, often in reliance on the advice of a broker, from a buyer in M&A Transactions, such as a private equity firm, which performs its own extensive due diligence, does not give an M&A Broker custody or control of its assets, and upon completion of the acquisition will actively operate the acquired business.

The timing of the SEC's action is somewhat curious since Congress is currently considering legislation to address M&A Brokers. Perhaps this action will be the first of other SEC initiatives designed to improve the broker-dealer regulatory regime and facilitate capital formation and business activities for privately-held businesses. For an interesting perspective on the current state of the broker-dealer regulatory regime, click here to see the ABA's "Report and Recommendations of the Task Force on Private Placement Broker-Dealers" (2006).

To discuss this issue further, please contact Howard M. Berkower at 212.609.6824 or hberkower@mccarter.com, or any of his McCarter & English colleagues listed below:

George W. Arnett, III
973.849.4014
garnett@mccarter.com

Joseph W. Bartlett
212.609.6920
jbartlett@mccarter.com

Howard M. Berkower
212.609.6824
hberkower@mccarter.com

David F. Broderick
973.639.2031
dbroderick@mccarter.com

Theodore M. Grannatt
617.449.6599
tgrannatt@mccarter.com

Jonathan Guest
617.449.6598
jguest@mccarter.com