PRYOR CASHMAN LLP

LEGAL UPDATE

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SEC CLARIFIES AND EXPANDS BUSINESS BROKER EXEMPTION

No-Action Letter Allows Percentage-Based Compensation Regardless of Business Size for Sales of "Privately-Held Companies"

In response to a request by several experienced securities attorneys who represent clients in connection with mergers and acquisitions ("M&A") and similar business brokerage transactions, the Securities and Exchange Commission ("SEC" or the "Commission) has finally agreed, in its *M&A Brokers* no-action letter,[1] that intermediaries in such transactions may accept percentage-based compensation if their activities adhere to the detailed guidelines set forth in the SEC's response. As a result, such "business brokers" will no longer be required to register as brokers[2] under Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act")[3] or with the Financial Industry Regulatory Association ("FINRA").

The SEC's willingness to modify and clarify an exemption for what it regards as "true" business brokers represents a small break from its general hostility toward any unregistered intermediary in a securities transaction who accepts percentage-based compensation.[4] In almost every case where such compensation has been present, the SEC has refused to grant no-action relief, no matter how limited the finder's activities might be or how questionable the relationship between the broker's actual activities and those of a typical retail securities broker.[5]

The difficulties created by the SEC's position in this matter have seemed particularly counterintuitive in the case of business brokers. Before the decision by the United States Supreme Court in *Landreth TimberCo. v. Landreth*,[6] sales and purchases of entire businesses were generally not regarded as securities transactions, even if structured as a sale of the equity in the company. However, in *Landreth*, the Supreme Court held that if such a

[1] Issued January 31, 2014. Available at http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[2] Section 3(a)(4) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), defines "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others."

[3] Section 15(a)(1) of the 1934 Act states: "It shall be unlawful for any broker . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section."

[4] The corporate bar has been trying for many years without success to get the SEC to create a "broker light" registration for brokers who engage solely in private placements. *See, e.g.*, the American Bar Association's Report and Recommendations of the Task Force on Private Placement Broker- Dealers (June 20, 2005), available at http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf.

[5] *See* Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf. For an extensive discussion of the issues raised by this no-action letter, see Stephen M. Goodman, *Vanishing Breed: The Narrowing Opportunities for Unregistered Finders*, 42 SEC. REG. & L. REP. 1911, Oct. 11, 2010. See also, Pryor Cashman Legal Update, Potential Broker-Dealer Pitfalls For Private Investment Funds And Their Managers (April 2013), available at http://www.pryorcashman.com/assets/attachments/946.pdf.

[6] 471 U.S. 681 (1985).

sale was structured as a sale of 100% of the stock of a company, it would be regarded as a sale of securities subject to the Securities Act of 1933 (the "Securities Act"), despite the parties' understanding that they were engaged in the sale of an operating business. Stressing that the plain language defining "security" in Section 2(1) of the Securities Act specifically included "stock," the court in *Landreth* held that when an instrument is both called "stock" and bears stock's usual characteristics, "a purchaser justifiably may assume that the federal securities laws apply."

Unfortunately for business brokers, the logical implication of *Landreth* was that if a sale of the stock of a company was a sale of stock for securities law purposes, then intermediaries who assisted in such sales of stock could be considered brokers "engaged in the business of effecting transactions in securities" and thus required to register under the Exchange Act.

There was at least some recognition of this anomaly by the SEC immediately following the decision in *Landreth* in a no-action letter issued in 1986. In *International Business Exchange Corp.* ("*IBEC*"),[7] the SEC acknowledged that it would refrain from taking any enforcement action for failure to register if business brokers limited themselves to a very restrictive set of specified activities. Twenty years later, a second no-action letter, *Country Business, Inc.* ("*Country Business*"),[8] addressed the same set of issues regarding a business broker and again agreed to take no enforcement action. However, the criteria articulated this time for the broker's permissible activities were equally limited, but in slightly different ways. Because of the inconsistencies between the two letters and the very limited scope of activities in which the broker is permitted to engage, the letters do not offer meaningful relief for the majority of situations in which a business broker's services might be desirable. As described by the authors of the request in *M&A Brokers*, "A person seeking to rely on the [earlier] letters cannot engage in negotiations on behalf of a client, advise the client whether to issue securities, or assess the value of any securities sold." Furthermore, the letters only allow intermediaries to assist in transactions where 100% of the equity of the company is being disposed of. The intermediary could not assist in a sale of a controlling stake in a company.

Equally significantly, *IBEC* and *Country Business* created uncertainty about an intermediary's permissible compensation arrangements. *Country Business* allowed for percentage-based compensation as well as other arrangements, such as fixed or hourly fees, but limited the size of the transaction. *IBEC* expressly permitted only commission arrangements, without addressing any other type of compensation arrangement.

With *M&A Brokers*, the staff has provided business brokers with criteria for avoiding registration which nevertheless encompass most aspects of the broker's role in a true M&A transaction. To begin with, the transaction must involve a "privately-held company" – an operating company that is a going concern[9] and that does not have any class of securities registered (or required to be registered) under Section 12 of the Exchange Act or with respect to which periodic reports must be filed under Section 15(d) of the Exchange Act. According to the letter, a person who meets the definition of an "M&A Broker" will not be required to register under Section 15(a) of the Exchange Act if it facilitates mergers, acquisitions, business sales, and business combinations (collectively defined as "M&A Transactions") between sellers and buyers of privately held companies, without regard to the size of the privately-held companies.

[7] SEC No-Action Letter, LEXIS 3065 (Dec. 12, 1986).

[8] SEC No-Action Letter, LEXIS 669 (Nov. 8, 2006).

[9] According to footnote 1 of the letter, as long as the company is not a "shell company" as defined in Rule 405 under the Securities Act, a "going concern" need not be profitable and could even be emerging from bankruptcy, so long as it has actually been conducting business, including soliciting or effecting business transactions or engaging in research and development activities.

An "M&A Broker" is defined for purposes of the 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 [as defined above] through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a 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." (Emphasis added.) In other words, as long as the transaction involves an active privately-held business being transferred to a new operator, and not a passive investor, the broker does not need to be concerned that the transfer may be effected through the issuance or transfer of securities and not assets.

The letter stresses that, after completing the purchase, the buyer, or group of buyers, must both control and actively operate the company, or if assets are transferred, actively operate the business previously conducted with those assets. Control is defined in the same terms as in Rule 405 under the Securites Act.[10] However, the letter states that control will be presumed to exist if, upon completion of the transaction, the buyer or group of buyers has the right to vote, sell or direct the sale of 25% of the voting equity.[11] In addition, a buyer may be considered to actively operate the business through the power to elect executive officers and approve the annual budget or by service as an executive or other executive manager, among other things. Thus, an M&A Broker would not be at risk if the transaction involved the transfer of as little as 25% of the equity, provided that the buyers obtain the required control and exercise that control to appoint officers to run the business following the closing.

Other helpful aspects of the *M&A Brokers* letter include an acknowledgement by the staff that the M&A Broker may advertise the privately-held company for sale with information such as the description of the business, general location and price range.

The M&A Brokers letter does contain a number of specific restrictions on the activities of an M&A Broker and the characteristics of permitted M&A Transactions. The M&A Broker cannot have discretion to bind a party to an M&A Transaction. If it represents both buyers and sellers, it must provide clear written disclosure as to the parties it represents and must obtain written consent from both parties to the joint representation. The M&A Broker cannot assist in the formation of a group of buyers to participate in the transaction. It cannot provide financing for the transaction and, if it arranges financing from third parties, it must comply with Regulation T[12] and other legal requirements, and disclose any compensation for its assistance in writing to the client. The M&A Broker cannot have custody, control or possession of, or otherwise handle funds of any party or securities issued or exchanged in connection with the M&A Transaction.

Any securities transaction involved in the M&A Transaction must comply with an available exemption from registration under the Securities Act. No public offering is permitted in connection with an M&A Transaction. Any securities received by the buyer or M&A Broker in an M&A Transaction will be "restricted securities" within the meaning of Rule 144(a)(3) under the Securities Act.[13] No shell company, other than a "business combination related shell

[10] "The term ***control*** (including the terms ***controlling***, ***controlled by*** and ***under common control with***) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." Rule 405, 17 C.F.R. §230.405.

[11] In the case of a partnership or limited liability company, control is presumed to exist if the buyer or group of buyers has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the entity.

[12] 12 C.F.R. 220 *et seq.* Regulation T governs the extension of credit by securities brokers and dealers in the United States.

[13] Because the seller company must be a privately-held company and no public offering is permitted in an M&A Transaction as defined, the securities necessarily would have been issued in a transaction not involving any public offering.

company"[14] can be a party to the M&A Transaction.

Finally, the M&A Broker (and, if the M&A Broker is an entity, each officer, director or employee of the M&A Broker): (i) must not have been barred from association with a broker-dealer by the Commission, any state or any self-regulatory organization; and (ii) must not have been suspended from association with a broker-dealer.

It is important to remember that the no-action letter provides M&A Brokers relief only from the obligation to register as a broker-dealer under Section 15(a) of the Exchange Act. As the staff points out, other provisions of the federal securities laws, including the anti-fraud provisions, still apply. Furthermore, the letter does not address any applicable state laws or regulations which may apply to broker activities or any other federal laws, all of which should be reviewed before engaging in brokerage activity. However, it seems clear that the *M&A Brokers* letter removes a significant risk to business brokers and thus should facilitate purchases and sales of privately-held companies.[15]

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[14] The term *business combination related shell company* means a shell company (as defined in §230.405) that is:

(1) Formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity solely within the United States; or

(2) Formed by an entity that is not a shell company solely for the purpose of completing a business combination transaction (as defined in §230.165(f)) among one or more entities other than the shell company, none of which is a shell company.

[15] It is unclear what impact the *M&A Brokers* letter will have on certain other initiatives intended to accomplish a similar goal. *See* H.R. 2274, *Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013*, passed by the House of Representatives on January 14, 2014. Companion bill S. 1923 referred to Committee on Banking, Housing, and Urban Affairs on January 14, 2014. *See also*, FINRA Regulatory Notice 14-09, *Limited Corporaate Financing Brokers* (February 2014), a proposal for a streamlined set of rules for firms that engage in a limited range of activities, essentially advising companies and private equity funds on capital raising and corporate restructuring.

If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen M. Goodman at sgoodman@pryorcashman.com.

ABOUT THE AUTHOR

Stephen M. Goodman is co-head of the Mergers and Acquisitions Practice at Pryor Cashman LLP. He has extensive experience representing technology-based companies in public offerings; private placements; limited liability company, partnership and joint venture agreements; and complex arrangements for the acquisition, sale, development and commercialization of patents, copyrights and trademarks, in particular for drug compounds and formulations, software and technology.

Mr. Goodman has written on topics ranging from export controls relating to biotechnology research to raising seed capital for entrepreneurial companies. He has also lectured on various aspects of pharmaceutical/biotech collaboration agreements.

Mr. Goodman has negotiated and documented the following representative transactions:

- On behalf of a multi-national professional publishing company, acquisitions of the stock or assets of more than thirty targets, in transactions ranging in value up to $1 billion, including acquisitions involving counsel in multiple jurisdictions, auction transactions and several involving friendly tender offers for the stock of publicly-traded companies
- On behalf of a development stage biotechnology company, a private financing of $8.4 million to advance a client's two lead drug programs and a "double-dummy" reverse merger a second biotechnology company, creating a single company with multiple drug programs which has been purchased by a public pharmaceutical company for more than $100 million
- On behalf of an early pioneer in internet music delivery, two private preferred equity financings, the second led by a major hedge fund
- On behalf of a company developing compounds believed to have wound-healing and other regenerative properties, acquisition of a portfolio of patents for certain compounds together with clinical trial data filed with regulatory agencies related to these compounds
- On behalf of a public company in the field of monoclonal antibody research, an initial and a secondary public offering
- On behalf of a company in the field of RNAi therapeutics, acquisition of an entire division of a company engaged in RNAi research for influenza
- On behalf of a warehousing logistics software company, a set of master documents for licensing and maintaining the company's software
- On behalf of a company offering menu-driven iPod applications for foreign language translation, a license to utilize voice recognition software to enhance the utility of its programs
- Multiple licenses for the use of university or research institute technology, including a license for exclusive worldwide rights to patents and patent applications covering a naturally occurring peptide and its derivatives in the fields of obesity, appetite suppression, reducing food intake, inducing weight loss and inducing satiety and another for a compound with potential for treating various conditions of the central nervous system, including addiction
- A Feasibility Study, Option and License Agreement for the development of a client's lead drug candidate for moderate-to-severe pain
- Agreements with major textbook publishers for conversion of print or electronic textbooks into interactive formats utilizing client's proprietary software and coding