CLIENT ALERT

New Federal Registration Exemption for M&A Brokers

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Title V of the Consolidated Appropriations Act, 2023, entitled "Small Business Mergers, Acquisitions, Sales and Brokerage Simplification," added a new subsection 15(b)(13) to the Securities Exchange Act of 1934 (the "Exchange Act") that codified a statutory exemption from federal securities broker-dealer registration for firms and individuals engaged in the transfer of ownership of eligible small privately held companies, effective March 29, 2023.

Previously, persons engaged in the business of facilitating acquisition or merger transactions that wished to avoid broker-dealer registration with the U.S. Securities and Exchange Commission ("SEC") generally relied on a 2014 SEC no-action letter (the "M&A Brokers No-Action Letter")[1] that outlined specific circumstances under which a person or firm could receive compensation based on the size or success of a securities transaction ("transaction-based compensation") in connection with the transfer of ownership and control of a privately held company.[2] Except in very limited circumstances,[3] the SEC

[1] Letter from David Blass, Chief Counsel, Division of Trading and Markets, SEC to Faith Colish Esq., Carter Ledyard & Milburn LLP, et al. re: M&A Brokers (dated Jan. 31, 2014, rev. Feb. 4, 2014).

[2] Section 3(a)(4) of the Exchange Act states that the term "broker" means any person engaged in the business of effecting transactions in securities for the account of others. The Exchange Act does not provide a definition of "engaged in the business". However, the SEC staff through no-action letters and other actions has provided guidance as to what factors are important in making a determination whether the Exchange Act's broker-dealer registration provisions are applicable to specific securities related activities.

[3] *See* Country Business, Inc. (SEC No-Action letter, Nov. 8, 2006) and International Business Exchange Corporation (SEC No-Action letter, Dec. 12, 1986).

staff considers the receipt of transaction-based compensation as one of the most important indicia of acting as a securities broker-dealer.[4]

While the requirements for the new federal exemption from broker-dealer registration largely track the previous M&A Brokers No-Action letter, subsection 15(b)(13) introduces a new size-based test for the target company. Under the new federal standard, an M&A broker will only qualify for the exemption from registration if the target company has, in the fiscal year ending immediately before the fiscal year in which the services of the M&A broker are initially engaged with respect to the securities transaction, either (i) earnings before interest, taxes, depreciation and amortization of less than $25 million or (ii) gross revenues of less than $250 million.[5] Subsection 15(b)(13) also requires that the M&A broker provide, or provide reasonable access to, persons being offered securities in the transaction the most recent fiscal year-end financial statements prior to such person becoming legally bound.[6] In response to the new federal exemption, the SEC rescinded the M&A Brokers No-Action Letter upon the effectiveness of new subsection 15(b)(13).

Although subsection 15(b)(13) provides relief from the SEC's broker-dealer registration requirements, it is important to remember that such persons or firms would still be subject to state registration requirements. Similar to the federal requirements, violation of state registration requirements can result in sanctions and parties being able to rescind a particular transaction. Since the issuance of the M&A Brokers No-Action Letter, a number of states have adopted by regulation or order exemptions that tracked the requirements of the M&A Brokers No-Action Letter. In response to this new federal standard, state securities regulators may in the future update their regulations to track the requirements of new subsection 15(b)(13).[7] Parties should continue to evaluate state level broker-dealer requirements when entering into securities-related transactions.

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4 *See* In the Matter of Blackstreet Capital Management, LLC and Murray N. Gunty, SEC Releases 34-77959, IA-4411, Administrative Proceeding File No. 3-17267 (June 1, 2016) where a private equity fund advisory firm and its owner agreed to pay more than $3.1 million to settle charges that they engaged in brokerage activity and charged fees without registering as a broker-dealer. *See also* Speech, *A Few Observations in Private Fund Space*, David W. Blass, Chief Counsel, SEC Division of Trading and Markets, (April 5, 2013) available here.

5 Subsection 15(b)(13)(E)(iii)(II) in the definition of "Eligible privately held company".

6 Subsection 15(b)(13)(E)(iv)(II) definition of M&A broker provides: if any person is offered securities in exchange for securities or assets of the eligible privately held company, such person will, prior to becoming legally bound to consummate the transaction, receive or have reasonable access to the most recent fiscal year-end financial statements of the issuer of the securities as customarily prepared by the management of the issuer in the normal course of operations and, if the financial statements of the issuer are audited, reviewed, or compiled, any related statement by the independent accountant, a balance sheet dated not more than 120 days before the date of the offer, and 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.

7 Additionally, in some states individuals and firms may be able to conduct their activities so as to rely on exemptions from state securities broker-dealer registration for firms doing business only with certain institutions in the state. However, the entities considered "institutions" for this purpose vary from state to state and in many states the exemption is not available if a firm has a place of business in the state.

Impact on Private Equity

Private equity firms who routinely have relied on the rescinded M&A Brokers No-Action Letter to compensate operating partners or other consultants for sourcing and facilitating transactions should evaluate their existing arrangements in light of this new federal exemption. Accordingly, internal policies and procedures on payments (and any agreements with or required representations from unregistered brokers) should be updated. In particular, before making any payments of transaction-based compensation to an unregistered broker-dealer, sponsors should explicitly confirm that the transaction qualifies under this new size-based test. If a transaction does not qualify for the new federal exemption or qualifies for the federal exemption but is not eligible for an exemption under state law, private equity sponsors may have resulting liability, either secondarily, for aiding and abetting a separate entity that is paid by the sponsor but engages in registrable activity[8] or primarily for engaging in investment banking and other brokerage-related activities.[9] Violation of broker-dealer licensing requirements may also allow other parties to rescind the contracts under both federal and state law.[10]

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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8 *See* In the Matter of Ranieri Partners LLC and Donald W. Phillips, Respondents, SEC Releases 34-69091, IA-3563, Administrative Proceeding File No. 3-15234 (March 8, 2013).

9 *See*, e.g., SEC Order against Blackstreet Capital Management, LLC (June 1, 2016).

10 *See,* e.g., Section 29(b) of the Exchange Act.