Burns Figa & Will P.C.

HERRICK K. LIDSTONE, JR.
(720) 493-3195
hklidstone@bfwlaw.com

Federal Broker-Dealer Exemption for M&A Brokers

By: Herrick K. Lidstone, Jr.
Burns, Figa & Will, P.C.

The Securities and Exchange Commission and the Colorado Securities Commissioner have historically taken a very broad view towards the broker-dealer registration requirements under federal law (Securities Exchange Act of 1934, § 15(a)) and state law (C.R.S. § 11-51-401). Effectively they have held that when involved in the offer and sale of securities, the person selling must be appropriately registered or licensed unless there is a specific exemption from the registration or licensing requirements available. Registration and licensing under both federal and state law involves meeting the testing and educational requirements of the Financial Industry Regulatory Authority, net capital requirements, and other onerous requirements.

These requirements apply as well to business brokers and others who receive fees for selling companies in stock acquisitions. Narrow registration exemptions have been available, and now the SEC has broadened the exemption in a recent no action letter.

The Colorado Securities Commissioner has not followed suit. [READ ARTICLE]

1991 - *Paul Anka* No Action Letter

Once upon a time there was the possibility that an occasional participant in a securities transaction could meet the role of a "finder" - a person who earns a fee for doing nothing more than making an introduction between an investor and a company needing the investment. Under the standard established by the SEC in the 1991 *Paul Anka* no action letter, the finder could not be involved in negotiations, could not lend his name to the enterprise, and generally must make the introduction and leave the scene. The *Paul Anka* letter also suggested that this was an exemption for a person who had never previously acted as a finder and did not intend to do so again. Since 2008, the SEC staff has taken steps away from its *Paul Anka* position, and in November 2008, the chief counsel of the SEC's Division of Trading and Markets said "the way we look at broker-dealer regulation today, I'm not even sure that we would issue the *Paul Anka* letter again."

Exemptions from Broker-Dealer Registration

The SEC has adopted Rule 3a4-1 under the Securities Exchange Act of 1934 which provides an exemption from the broker-dealer registration requirements for certain persons who are working for the issuer of the securities (and expect to continue to do so after the

offering), who are not receiving any transaction-based compensation for the sale of securities for the issuer, and who do not have a recent broker-dealer past. Similarly Colorado, in its definition of "broker-dealer" in § 11-51-201(2), exempts "an issuer with respect to purchasing and selling the issuer's own securities," and in § 11-51-201(14), exempts individuals acting for an issuer under circumstances similar to Rule 3a4-1 from the definition of "sales representative."

Neither federal nor Colorado law distinguishes between people who act for an issuer when selling securities for cash or in a business acquisition/sale transaction. Unlike federal law, though, Colorado (in C.R.S. § 12-61-101(2)(a)(IX)) does have a provision that includes business brokers within the definition of the term "real estate broker" and allows them to be involved in the negotiation and sale of a business "when such act or transaction involves, directly or indirectly, any change in the ownership or interest in real estate, or in a leasehold interest or estate, or in a business or business opportunity which owns an interest in real estate or in a leasehold." These business brokers have to be licensed real estate agents, but can receive transaction-based compensation for the sale of a business, even when it involves the sale of a security.

2014 - *M&A Brokers* No Action Letter

The staff of the SEC's Division of Trading and Markets took a major step forward when it issued a no action letter entitled "M&A Brokers" on January 31, 2014, in response to a request from a group of New York lawyers (www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf). The no action letter permits an "M&A Broker" to facilitate mergers, acquisitions, business sales, and business combinations ("M&A transactions") between buyers of privately held companies when (among other conditions) following the M&A transaction the buyer will both control and actively operate the purchased company or business.

M&A Brokers following the guidance set forth in the no action letter are exempt from the 1934 Act registration requirements for broker-dealers in Section 15(a) and may accept transaction-based compensation. For the purposes of the no action letter, an "M&A Broker" is 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 . . . 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" following the transaction. A "privately-held company" is one that does not have a class of securities registered under the 1934 Act, Section 12, is not subject to the reporting requirements of Section 15(d) of the 1934 Act, and is not a shell company.

For the exemption from broker-dealer registration to be available, the M&A Broker may not have the power to bind any of the parties to the M&A transaction, may not provide or arrange for financing for the M&A transaction through an affiliate, may not "hold,

control, possess or handle" any funds or securities related to the M&A transaction, may not facilitate an M&A transaction for a group of buyers where the M&A Broker assisted in organizing the group, and may not be under certain legal disabilities. The M&A Broker may assist in arranging financing for the transaction through an unaffiliated third party.

The no action letter makes it clear that no party to the M&A transaction may be a shell company, and the securities offered in the M&A transaction may not constitute a "public offering." As a result, the securities involved in the M&A transaction must be "restricted securities" in the hands of the buyer and the M&A Broker (where the M&A Broker's compensation is paid in securities of the deal).

Importantly, the no action letter makes it clear that there are no advertising restrictions. The M&A Broker will be permitted to advertise the sale of the target business and, among other things, the targeted price range.

The no action letter only provides relief to M&A Brokers from the registration requirements of Section 15(a) of the 1934 Act. It does not provide any relief from the anti-fraud rules, the requirement to register securities offered for sale unless exempt from registration, investment adviser registration requirements, or state law.

Colorado Rules - More Restrictive

State law remains important for persons intending to act as M&A Brokers. As discussed above, the M&A Broker relief will be helpful to licensed Colorado real estate brokers who can now be M&A Brokers exempt from the 1934 Act's broker-dealer registration requirements while in compliance with Colorado law. 1934 Act registered broker-dealers who are also registered in Colorado can also participate in Colorado M&A transactions without the restrictions applicable to M&A Brokers. For others, however, Colorado law and the rules published by the Division of Securities strictly regulate persons who can offer and sell securities in Colorado - whether in M&A transactions or for any other purpose.

Colorado Rule 51-2.1.1B (adopted in 2013) provides very limited relief for what it refers to as a "business broker." It provides:

> A person who acts as a business broker with respect to a transaction involving the offer or sale of all of the stock or other equity interests in any closely held corporation or limited liability company [is exempt from the definition of the term "broker-dealer" in C.R.S. § 11-51-201(2)] provided that such stock or other equity interest is sold to no more than one person, as that term is defined in the [Colorado Securities] Act.

This provides extremely limited relief as compared to the federal requirements set forth in the M&A Broker no action letter. The principal difference is that there can be no

more than a single purchaser. The definition of the term "person" in C.R.S. § 11-51-201(12) does provide some flexibility, defining the term as meaning: "an individual, a corporation, a partnership, an association . . . or any other legal entity." Whether the Division will take a more restrictive view of the term where it involves (say) an LLC of investors who join in a single entity for the sole purpose of purchasing the defined business remains to be seen. This issue may become even more difficult when the entity purchaser distributes the equity interests to the owners shortly after the purchase occurs.

The Colorado rule also requires that the transaction include "all of the stock or other equity interests", whereas the M&A Broker no action letter only requires sale of "control."

On the other hand, note that the Colorado rule does not require that the buyer actually operate the business after the M&A transaction. One would think that with 100% ownership they would want to operate, but that may not be true in some cases, such as where some members of the entity purchaser intend to be passive investors and others more active.

The other point not covered in the Colorado rule is whether use of the term "business broker" was an intentional reference to the real estate broker definition in C.R.S. § 12-61-101(2). The Division of Securities has not previously attempted to assert control over business brokers who were subject to the real estate licensing requirements even though the statutory definition may include them in the offer and sale of securities. One would hope that the Colorado Division of Securities is not trying to put licensed real estate brokers acting as business brokers under a duplicative licensing scheme.

Colorado remains among the most restrictive jurisdictions interpreting the term "broker-dealer" and refusing to validate "finders" in any capacity. Most, if not all, cease and desist actions brought by the Division of Securities under the Colorado Securities Act involve claims against the respondents acting as unlicensed broker-dealers under Colorado law. This is likely to be a continuing focus of the Division of Securities enforcement efforts in Colorado. Importantly, compliance with the M&A Broker no action letter will not give relief under the Colorado Securities Act. State compliance is required.