Feburary, 19, 2014

SEC No-Action Letter re: M&A Brokers

On February 4, 2014, the staff of the Securities and Exchange Commission (the SEC) issued a revised no-action letter (the No-Action Letter). In the No-Action Letter the staff states it will not recommend enforcement action against parties qualifying as M&A Brokers (as defined in the No-Action Letter) for failure to register under Section 15(a) of the Securities Exchange Act of 1934, as amended (the Exchange Act) (i.e., registration as a broker-dealer) in connection with the purchase and sale of "privately-held companies" (as defined in the letter) conducted and structured in accordance with the No-Action Letter. The No-Action Letter provides significant comfort for investment banks and "advisory" or "consulting" firms not registered as broker dealers under the Exchange Act and their personnel in terms of them engaging in such transactions, including by means of the sale of 100 percent of the stock of a company. Despite these positive aspects, it does however leave some gaps and potential problems for such firms, certain of which are noted herein.

Over recent years many unregistered investment banking, advisory and consulting firms that only engaged in the business of representing sellers and buyers of businesses, and were not involved in capital raising or in representing investors, have considered whether they should or need to register as broker-dealers. Some have registered independently or affiliated with existing broker dealers, often under so-called "parking" arrangements, while others have not done so. The purpose of the No-Action Letter was to provide guidance for such firms and effectively establish a basis pursuant to which they can represent parties in purchases and sales of businesses regardless of the structure, i.e., even as sales of stock, without being registered broker-dealers. The No-Action Letter makes it clear that for those firms that meet the letter's definition of "M&A Broker" and operate in strict compliance with the conditions of the letter, no broker-dealer registration is required, even for transactions structured as stock sales. However, the terms of the No-Action Letter are strictly crafted and before deregistering or remaining unregistered, as the case may be, in reliance on the letter, firms should be confident that they can operate their businesses within its scope, which may mean limiting the nature of the deals they do based on the principals and target in the deal, as well as based on the structure of certain aspects of the deal, although the latter point is less likely to be a problem. For example, for the reasons described below, such firms could not represent either party in the purchase or sale of a company that is not "privately-held" (which in effect at least means in common terms a company that is publicly traded in the United States). Moreover, it may be problematic to take on buy-side search engagements since the appropriate target ultimately identified in the search might not be a privately-held company.

Specifically, the No-Action Letter prohibits firms from either being in the business of, or engaging in, purchases or sales of public companies, and creates an issue as to whether it even can be in the business of purchasing or selling, or can engage in the purchase or sale of, subsidiaries (or more likely material subsidiaries) of public companies, or at least subsidiaries (or more likely material subsidiaries) of companies registered under Section 15(d) of the Exchange Act. While the No-Action Letter makes no mention of subsidiaries, it would seem potentially contrary to the intent of the staff of the SEC to have the No-Action Letter apply, for example, to subsidiaries that comprise a majority or even a material portion of the assets or business of the public company on a consolidated basis, much less if it was substantially all of its business. Perhaps an additional no-action letter will be issued by the staff that clarifies the issue as to subsidiaries, perhaps based on their materiality to the public company. Furthermore, the No-Action Letter only applies in the case of control transactions and the buyer must "actively operate" the acquired company, although the letter does provide substantial leeway as to establishing "control" and "actively operating." The following provisions of the No-Action Letter demonstrate the basis for these concerns:

The company being purchased must be a "privately-held company," defined for this purpose as a company that does not have a class of securities registered under Section 12 of the Exchange Act or "with respect to which" the company files or is required to file reports under Section 15(d) of the Exchange Act. Neither the No-Action Letter, nor the letter requesting relief upon which it is based, refer to subsidiaries of public companies. Therefore, it is arguable that even a material subsidiary (as versus a division) of a publicly-traded entity (even under 15(d)) is a privately-held company. However, it may be that since even a subsidiary is generally covered by the reports filed under the Exchange Act, if nothing else as part of the consolidated financial statements, even the subsidiary is therefore not a privately-held company. However, with the possible exception of material subsidiaries, the author hereof does not understand this to be the intent of the staff.

While step transactions are permissible, the buyer has to have control from day one and cannot be a passive investor.

To be an M&A Broker, the firm itself must be "engaged in the business of effecting securities transactions solely in connection with ... privately-held companies ...."

Since the No-Action Letter requires that to be an M&A Broker a person must engage in transactions solely involving privately-held companies and per the terms of the letter, failure to comply as to even one transaction appears to mean that the firm should have been registered as a broker-dealer when it engaged in all transactions (or perhaps at least those occurring then and thereafter). It should be noted though that companies not registered under the Exchange Act, but registered under the laws of a foreign jurisdiction, should qualify as "privately-held" for purposes of the No-Action Letter.

In light of the foregoing, the No-Action letter provides meaningful comfort for firms engaged in only sell side engagements for neither public companies nor their material subsidiaries so long as any deal is a control transaction. However, the No-Action letter does not fully resolve uncertainties as to whether sell side engagements can be undertaken with respect to material subsidiaries of public companies. The No-Action Letter also will make it difficult for firms to undertake buy-side search engagements in light of the possibility of the desired target being a public company or perhaps a subsidiary of a public company. Finally, in accepting an engagement on either side the firm must be confident that any transaction will result in an acquisition of control (as defined in the letter).