BUSINESS LAW TODAY

Private Placement Brokers—The State of Play Two Years Later

By Linda Lerner and Eden Rohrer

Almost two years have passed since the staff of the Securities and Exchange Commission released its M&A Broker Letter (SEC M&A Broker Letter to Faith Colish, Martin A. Hewitt, Eden L. Rohrer, Linda Lerner, Ethan L. Silver, and Stacy E. Nathanson, Jan. 31, 2014, as revised Feb. 4, 2014) permitting unregistered "brokers" to engage, under specified conditions, in effecting M&A transactions. The M&A Broker Letter, consonant with the philosophy of the goal of the JOBS Act to create and maintain jobs, states that the staff will not recommend enforcement action if unlicensed M&A brokers (so-called "finders") assist in the purchase and/or sale of businesses to persons who will be actively involved in managing those businesses, and may receive transaction-based compensation for both bringing about the sale and locating third party financing for the purchaser, whether the transaction was structured as a sale of assets or securities.

The M&A Broker Letter Parameters

The M&A Broker Letter allowed "business brokers" to end decades of either having to develop somewhat artificial constructs to operate legally without registering as brokers under Section 15(b) of the Securities Exchange Act of 1934, as amended or being exposed, together with their clients, to the risk that the transactions they assisted in effecting could be subject to rescission under Section 29(b) of the Exchange Act. Section 29(b) deems void transactions effected in violation of any other section of the Exchange Act (in this case the broker registration requirements set forth in Section 15(b)), and simultaneously leaves the business broker or "finder" vulnerable to attack on the right to collect its fee.

The parameters stated in the M&A Broker Letter are not overly difficult to satisfy. Significantly, however, there are some important things that the M&A Broker Letter does not permit and some issues that it does not resolve.

- Relief is limited to situations in which the target company is privately held and may not be used to "backdoor" a public offering.
- David Blass, the former chief legal counsel for the SEC's Division of Trading and Markets, publicly stated on several occasions that the M&A Broker Letter did not permit private equity funds or their advisers to earn transaction fees for portfolio company transactions. This is based on the M&A Broker Letter's prohibitions against the M&A broker and its affiliates being in control of funds or securities, having the ability to bind the parties, and providing financing for the M&A transaction (which would be the case where a fund purchased a portfolio company).
- The M&A Broker Letter prohibits the M&A broker from forming the investor group that is the purchaser.
- Although an M&A broker may be compensated for obtaining third-party financing, this is limited to financing the M&A transaction. The M&A Broker Letter does not apply to capital formation activities and thus does not provide relief for a placement agent assisting in raising capital for pooled investment vehicles such as hedge funds and private equity funds nor does it apply in a situation where a finder assists an issuer that simply wants to fund its business plan.
- M&A brokers remain within the definition of "broker" as set forth in Section 3(a)(4) of the Exchange Act.

Federal Legislative Efforts

On the legislative front, congressional efforts continue to have a legislative solution to the problem enacted. The legislation currently proposed would be similar to the provisions of the M&A Broker Letter but contains certain differences, such as im-

posing size limits on the subject transactions. Whether such legislation will be adopted in the near-term is unclear. See link at www.congress.gov/bill/114th-congress/senate-bill/1010/text.

FINRA Member Firms' Ability to Share Fees with an Unregistered M&A Broker

Rule 2040(a)(1) of the Financial Industry Regulatory Authority (FINRA) prohibits its member brokerage firms from paying transaction based compensation to unregistered M&A Brokers that refer transactions to any person that is not registered as a broker-dealer under Section 15(a) of the Exchange Act but, by reason of receipt of any such payments and the activities related thereto, is required to be so registered under applicable federal securities laws and SEC rules and regulations. Supplementary Material .01 to that rule provides detail on what would constitute reasonable support for a brokerage firm's determination that a finder is not required be registered, stating as follows:

> Members that are uncertain as to whether an unregistered person may be required to be registered under Section 15(a) of the Exchange Act by reason of receiving payments from the member can derive support for their determination by, among other things, (1) reasonably relying on previously published releases, no-action letters or interpretations from the Commission or Commission staff that apply to their facts and circumstances; (2) seeking a no-action letter from the Commission staff; or (3) obtaining a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area. The member's determination must be reasonable under the circumstances and should be reviewed periodically if payments to the unregistered person are ongoing in nature. In addition, a member must maintain books and records that reflect the member's determination.

It is important that M&A brokers carefully document the factors on which they intend to rely to avail themselves of the relief afforded by the M&A Broker Letter, and especially so when making a referral to a registered broker. The M&A broker's documentation should reflect the nature of the transaction, the role of the M&A broker, and representations of the buyer and seller to evidence proper reliance on the M&A Broker Letter. Counsel can be helpful to create a process for analyzing transactions and creating form documents. With respect to member firms wishing to pay M&A brokers, FINRA noted in Regulatory Notice 15-07 that, while the rule does not specify the frequency of such reviews, FINRA believes that an annual review for ongoing payments generally would be reasonable, absent evidence of activities by the recipient of the payments that raise red flags.

State Securities (Blue Sky) Regulation

The third piece of the puzzle is each of the states of the United States. On September 29, 2015, at its annual conference, the North American Securities Administrators Association (NASAA) formally adopted a Model State Rule, which, if adopted by each state, would exempt M&A brokers from having to register as securities brokers at the state level. See link at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/MA-Broker-Model-Rule-adopted-Sept.-29-2015.pdf. The Model Rule contains some provisions that are inconsistent with the M&A Broker Letter, including a limitation with respect to the size of a transaction. To date, no state has adopted the Model Rule.

Although a few states have adopted rules permitting M&A brokers to operate, such rules must carefully be reviewed to determine how to comply in a particular jurisdiction. For example, in April 2015, Texas adopted a rule that largely tracks the M&A Broker Letter. Section 139.27 of Title 7 of the Texas Administrative Code exempts from registration persons who meet the Texas code's definition of "M&A dealer." Texas does not require any filing to take advantage of the exemption. The Texas rule imposes additional requirements. For example, the rule requires the M&A dealer to maintain and preserve, for three years, records of "all compensation received and communications, agreements, or contracts with buyers and/or sellers in connection with any transaction in which the dealer received compensation." Additionally, the M&A dealer must make available to the Texas securities commissioner the required records upon request. See link at www.ssb.state.tx.us/Texas_Securities_Act_and_Board_Rules/Proposed_Rules/PD_November_14_2014.php. On February 28, 2014, the Utah Division of Securities announced that while it will ultimately seek to adopt a formal rule exempting M&A brokers, it will rely on the M&A Broker Letter while it waits to see if a consensus develops amongst the states and whether the proposed legislation passes in Congress. See link at www.securities.utah.gov/docs/papers_MandA_brokers.pdf.

Other states require persons who are not registered brokers to register as real estate brokers or business brokers. Even though other states, at least "on the books," still require broker registration, exemptions may be available. This is clearly an evolving area and M&A brokers should not assume that the M&A Broker Letter frees them from considering the effect of applicable blue sky rules.

Recommendations for Further Relief/ Rule Clarity for Finders

What is next? On September 3, 2015, the SEC's Advisory Committee on Small and Emerging Companies wrote to SEC Chair Mary Jo White setting forth certain recommendations with respect to the regulation of finders and other intermediaries in small business capital formation. Those recommendations, on which a number of members of the ABA's Task Force on Private Placement Brokers had an opportunity to comment, include that the SEC should:

- Clarify that persons who receive transaction based compensation solely for making introductions are not required to register as brokers;
- Exempt from federal broker registration intermediaries that are actively involved in discussions, negotiations and structur-

ing private capital raises, as well as in soliciting investors, if they are registered as brokers on the state level;
- Spearhead a joint effort with NASAA and FINRA to ensure a coordinated state regulation and adoption of measured regulation that is transparent, responsive to the need for small business capital formation, proportional to investor risk, and capable of early implementation and ongoing enforcement; and
- Take immediate intermediary steps to begin to address issues regarding intermediary regulation and not wait for the development of a comprehensive solution.

On another front, on June 15, 2015, the authors of the M&A Broker Letter request, joined by Greg Yadley, former cochair of the task force, submitted to the SEC's Division of Trading and Markets a number of scenarios designed to obtain clarification on what it means to be engaged in the business of effecting transactions in securities (the definition of a broker set forth in Section 3(a)(4) of the Exchange Act). More specific than the recommendations of the SEC's Advisory Committee on Small and Emerging Companies, the seven lawyers requested clarification on whether the following scenarios constitute being engaged in the business of effecting transactions in securities.

A. Finders—in each case receiving transaction based compensation:
   1. Engaging solely in referring potential customers to a broker-dealer;
   2. Not only introducing potential counterparties, but facilitating the setting up of meetings and telephone calls in which the intermediary does not participate and transmitting offering materials. (Would the answer change if the offering were limited in size?);
   3. Same as Scenario A.2 plus attending meetings, solely as a facilitator and not soliciting, recommending structuring or negotiating the transaction;
   4. Same as Scenario A.3 plus helping the issuer structure the transaction;

B. Investor Relations Firms: without receiving transaction based compensation, may an investor relations firm receive flat fee compensation during a private placement for approaching potential investors to make them aware of the issuer's products and services?

C. Technology Providers that Wish to Receive Transaction Based Compensation for the following:
   1. Providing order-routing and/or order management services to users that direct orders to a broker-dealer. The technology does not facilitate high frequency trading or provide trading advice;
   2. Providing customer relationship management software to fund advisers and managers to assist in targeting potential investors;
   3. Providing a platform on which asset managers for high net worth clients can locate investment fund products.

D. Law Firms: a law firm wishes to structure its fee as a percentage of a resulting securities offering, but only if the offering is successful. The law firm will not solicit investors.

E. Uncompensated Shareholders:
   1. A significant shareholder regularly introduces potential investors to an issuer but is not compensated for this activity;
   2. Same Scenario as E.1 but the uncompensated shareholder arranges meetings between the parties;
   3. Same Scenario as E.1 but the uncompensated shareholder assists in structuring (but not negotiating) a potential transaction;
   4. Same Scenario as E.2 but the uncompensated shareholder sits in on meetings, although does not participate in negotiations.

F. Employees and Consultants:
   1. An employee engages in preparing business plans, shareholder relations and capital raising. After a successful fundraising, the employee is paid a salary and bonus.
   2. Same Scenario as F.1 but the person is a consultant, not an employee.
   3. Are the above Scenarios affected if the issuer considers the amount of funds raised as a factor in determining the amount of the bonus or other additional compensation?

These questions are representative of the issues we regularly encounter. We look forward to hearing from the SEC.

FINRA's Limited Corporate Financing Broker Proposal Re-proposed to SEC/ Capital Acquisition Brokers

On December 4, 2015, FINRA submitted to the SEC proposed rules governing firms that fit within the rules' definition of Capital Acquisition Brokers (CABs) (the CAB Rules). These rules replace the rules previously proposed by FINRA for Limited Corporate Financing Brokers (LCFBs) and would govern equity, debt, and municipal securities transactions effected by CABs. The proposed rules would permit CABs to engage in one or a combination of the following, but no other activities:

1. Advising an issuer, including a private fund, concerning capital raising activities;
2. Advising a company regarding its purchase or sale of assets or restructuring (including a going-private transaction, divestiture, or merger);
3. Advising a company regarding the choice of an investment banker;
4. Assisting in the preparation of offering materials;
5. Providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;
6. Qualifying, identifying, soliciting, or acting as placement agent or finder for private placements to institutional investors as defined under FINRA Rule 2210 (generally, certain types of institutions, registered investment advisers and persons or entities with assets of at least $50 million) or, in an important revision, that meet the test for "qualified purchasers" set forth in Section 2(a)(51) of the Investment Company Act of 1940,

as amended (generally a person, family investment vehicle or trust that owns assets of at least $5 million, or any person or entity acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis not less than $25,000,000 in investments); and

7. 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, in accordance with the terms and conditions of an SEC rule, release, interpretation or "no-action" letter that permits a person to engage in such activities without having to register as a broker or dealer pursuant to Section 15(b) of the Exchange Act.

CABs would not be permitted under the proposed rules to:

- Act as an introducing broker with respect to customer accounts;
- Hold or handle customer funds or securities;
- Accept orders from customers to purchase or sell securities either as principal or agent except as described in bullet points 6 and 7 above;
- Have investment discretion on behalf of any customer;
- Engage in proprietary trading or market making; or
- Participate in or maintain an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding or Regulation A under the Securities Act of 1933, as amended.

CABs would be subject to a number of existing FINRA rules, such as the suitability and antifraud rules, as well as anti-money laundering requirements (although independent testing would be required only every other year). The CAB Rules would eliminate the requirement for a fidelity bond and rules governing fair pricing of services by the CAB (FINRA expressing the belief that institutional customers have adequate negotiating power). Although the CAB Rules would require the appointment of a CCO, they would eliminate the requirement for annual CEO certification of the firm's supervisory system. CABs would not be required to maintain Business Continuity Plans and CABs would be relieved of obligations related to transactions by associated persons.

Interestingly, one of the CAB permitted activities specifically includes M&A broker activity as described in the M&A Broker Letter. FINRA noted that while a CAB is permitted to conduct M&A transactions only with institutional investors, it could also conduct activities with customers who do not meet that criteria under the M&A Broker Letter.

The authors look forward to keeping ABA members apprised of further developments both on the federal and state level regarding additional guidance and rule making affecting private placement brokers.

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