SEC Issues Broker-Dealer No-Action Letter of Interest to Private Equity Firms

On January 31, 2014, the SEC's Division of Trading and Markets issued an important no-action letter stating that "M&A Brokers," defined as persons engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of private companies, could, subject to certain conditions, engage in that activity without broker-dealer registration with the SEC.

The letter is a significant departure from the SEC's long-held view that persons receiving transaction-based compensation in connection with acquisition transactions in securities must register with the SEC as broker-dealers.

The letter is of interest to private equity firms for several reasons. First, it addresses the registration issue for persons referring possible transactions to private equity fund sponsors with the expectation of transaction-based compensation if the sponsor completes the transaction. Second, the letter implies that there is no policy reason to require broker-dealer registration of persons effecting certain types of private company acquisition transactions. Private equity sponsors often provide services to portfolio companies that are very similar to the services provided by M&A Brokers. To this extent, the letter provides a basis to suggest that private equity fund sponsors which charge portfolio companies transaction fees in connection with acquisition transactions should not be required to register with the SEC as broker-dealers.

Registration Relief for M&A Brokers

The principal conditions to the no-action relief in the SEC's letter are as follows:

1. The M&A Broker will not have the ability to bind a party to an acquisition transaction.
2. The M&A Broker will not provide financing for the transaction, but may assist purchasers to obtain financing from unaffiliated third parties.
3. The M&A Broker will not have custody, control or possession of funds or securities.
4. No acquisition transaction will involve a public offering.
5. If the M&A Broker represents both buyers and sellers, it will disclose the capacity in which it is acting, and obtain written consent to the joint representation from both parties.
6. The M&A Broker will facilitate acquisition transactions with a group of buyers only if the group is formed without the assistance of the M&A Broker.
7. The buyer in any acquisition transaction will control and actively operate the acquired company.
8. The M&A Broker and its officers, directors and employees have not been barred or suspended from association with a broker-dealer.

The letter defines the required control by the buyer in the same manner as SEC Form BD. The definition provides that control will be presumed to exist if the buyer has the right to vote or dispose of 25% or more of a class of voting securities of the target. With respect to the requirement that the buyer actively operate the target company, the letter states that the buyer could do so 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.

Implications for Private Equity Fund Sponsors: Referral and Deal Fees

Many private equity firms rely on consultants, finders and other persons for referrals to possible investment and acquisition targets. Compensation for these referrals typically depends on the consummation of the transaction, which, under the SEC's longstanding position, raised the issue whether persons making referrals should be registered as broker-dealers. In these circumstances, the question for private equity firms was whether they had exposure for facilitating transactions by an unregistered broker-dealer. The M&A Broker no-action letter addresses this concern, at least for referrals by persons meeting the requirements of the letter. In addition, the letter's approach to the requirement of buyer control and operation of the target suggests that private fund sponsors could pay referral fees to M&A Brokers not only in transactions resulting in the transfer of the entire ownership interest of the target, but also in certain types of minority and venture capital investments, if the active operation requirement is met through governance arrangements.

The SEC continues to conduct "presence exams" of newly registered investment advisers, including advisers to private equity funds. In connection with these exams, the SEC has noted the practice of private fund sponsors receiving transaction-based compensation for providing investment banking services to the sponsor's portfolio companies and raised the question whether the sponsor should register as a broker-dealer. The SEC's 2014 examination priorities letter continues the focus on this issue. Although private equity fund sponsors may not fit within the SEC's definition of an M&A Broker, and may find it difficult to satisfy at least the first two conditions in the M&A Broker no-action letter, the letter may still have favorable implications for private equity sponsors. In particular, the letter implies that broker-dealer registration is not necessary in the context of certain acquisition transactions.

In his latest public remarks on the issue of whether private equity fund sponsors should be registered as broker-dealers, David Blass, the Chief Counsel of the SEC's Division of Trading and Markets, noted that the Division's review of the registration status of business brokers could have favorable implications for private equity fund sponsors. His prediction appears to be correct, given the approach of the M&A Broker no-action letter.

If you have questions about this issue, please contact your usual Ropes & Gray advisor.