ROBERT G. HUTCHINS - LEGAL BULLETINS

December 2014 - "M&A Brokers" Get Relief from Exchange Act Registration[1]

Introduction

Private businesses often change hands through a transfer of securities rather than assets. This is obviously the case when the buyer is the survivor in a merger, but even when an acquisition is initiated as an asset purchase, the buyer's due diligence may reveal benefits (e.g., from retention of the owner's tax attributes or restricted licenses) that prompt it to close by accepting securities.

Self-styled "consultants" and "finders," business brokers, investment bankers, accountants and lawyers, routinely participate in private company acquisitions by acting as intermediaries for, or advising, one of the parties. These practitioners recognize that many such acquisitions will be consummated through a transfer of securities, but they do not think of themselves as securities brokers because transactions in investment securities are fundamentally different from acquisitions of private companies.

First, while a few stalwarts will always make their own decisions, most securities investors rely on the assistance of appropriate professionals. Listed securities are valued in light of SEC filings, other public information and "market risk;" which arises from economic, political, and systemic factors that affect the public markets in real time independently of the financial performance of a given issuer. Investors in listed securities rely on registered investment advisers who analyze issuers, industries and markets continuously. For "best execution" (obtaining the most favorable price in the shortest time period) these investors rely on registered broker dealers who "effect" securities transactions in the public markets.

Unregistered securities must necessarily be valued in light of performance data provided by the issuer or selling holder. These securities are subject to risk arising from the absence of either public information about the issuer or market pricing for its securities. Other risks can include the issuer's questionable financial statements, relatively small size, limited buying power, limited access to capital and inexperienced management. Investors in unregistered securities thus operate in an opaque world, but they can usually obtain valuation advice from investment advisers with experience in the relevant industry and, hopefully, some knowledge of the issuer. To identify counterparties and obtain best execution, "accredited investors" and "qualified institutional buyers" can rely on a secondary market driven by broker-dealers and registered internet "portals."[2] Other investors must rely primarily on their own contacts or on informal markets, e.g., issuer bulletin boards that permit holders and interested buyers to contact each other.

The reliance on investment advisers and securities brokers by investors in both listed and unregistered securities provides justification for the SEC's regulation of those professionals. By contrast, the acquisition of a private company is a negotiated transaction in which the parties may seek input from an array of advisers, but make their final decision on the basis of an intensive due diligence investigation of their own.

Second, a purchaser of securities solely for investment is a *passive* holder of a minority interest whose later actions will not affect the financial outcome of the transaction. Any subsequent gain or loss on listed securities will be attributable to changes affecting the issuer that are reported in regulatory filings or otherwise publicized. Holders of privately issued securities must rely on communications from the issuer, its other holders or industry sources to track their investment (and too often the first indication of a loss will be the issuer's financial collapse). But in *no* case will a gain or loss on investment securities be caused by anything the *purchaser* does after buying them. By contrast, the financial outcome of an

---

[1] Portions of this Bulletin reprise issues discussed in an earlier Essay. See, www.hutchins-law.com/publications *"Broker registration Issues in Stock Acquisitions."*

[2] See, e.g., www.secondmarket.com; and www.sharespost.com.

acquisition is profoundly affected by the acquirer's post-closing management of the target; something no service provider can control.

In short, the typical private company acquisition is initiated by, analyzed, structured, consummated and managed by the parties themselves, whether with or without outside help. As a result, there should be no pressing need for SEC registration and regulation of the parties' advisers; particularly those, such as accountants and lawyers, who are already subject to professional oversight. Nevertheless, when acquisitions close as securities transactions, participating advisers will encounter the broker registration, qualification and conduct requirements imposed by the Securities Exchange Act of 1934 and its state counterparts. This is especially the case when their compensation is "transaction related" and their services include structural planning, counterparty identification or intermediation between seller and buyer.[3]

****

Contents

****

The Source of the Problem

The Exchange Act defines a securities "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." The Act makes it unlawful for any such "broker" to "effect any transactions in… or attempt to induce the purchase or sale of, any security unless registered." The problem for acquisition advisers is that the Exchange Act language, taken literally, would apply to anyone who, as part of a business, plausibly "effects" or "attempts to induce" a private company acquisition structured as a transfer of securities. This would be the case even though the acquisition involved none of the risks to investors that concerned Congress when it subjected securities brokers to regulation.[4]

---

[3] Stock acquisitions of *public* companies are necessarily consummated through registered broker-dealers, who alone have both the legal authority to effect the transaction and the market contacts to carry it off.

[4] Apart from outright fraud, the major risks to securities investors that are attributable to brokers arise from inherent conflicts between the broker's interest in its fees and in its own investments and the investors' interest in obtaining the best available price at the first opportunity. These risks are exacerbated by the broker's control over the transaction process. The Exchange Act imposes registration on all securities brokers engaged in interstate commerce except those few who confine their business to exempted securities or to investments in commercial paper or bankers' acceptances. The broker definition is found in Section 3(a) of the Exchange Act; the registration requirement in Section 15(a). Under Section 15(b)(8) & (9) a registered broker must also be a member of a registered national securities association, i.e., the Financial Industry Regulatory Authority or "FINRA." The states

The SEC's Position

The SEC takes the general position that even though acquisition services are an inherent part of their business or profession, consultants, business brokers, investment bankers, accountants and lawyers must register under the Exchange Act if they act as securities brokers. They can act that way by "assisting an issuer to structure prospective securities transactions (or to)… identify potential purchasers of securities or by soliciting securities transactions…" They may be "engaged in the business" of acting that way if they receive "transaction-related" compensation or "hold themselves out" as intermediaries or finders. Securities brokers who fail to register are subject to administrative sanctions including fines and restitution to the parties of payments for "brokerage" activities. Even when its violation is obviously inadvertent, an unregistered broker's contracts, including its fee agreements, are unenforceable. If an Exchange Act violation is willful, criminal penalties can include fines up to $25,000,000 for corporations and fines up to $5,000,000 and/or imprisonment for up to 20 years for individuals.[5]

The SEC also has authority to suspend or bar persons convicted of various offenses from participation in the securities industry (by prohibiting their association with a registered broker or dealer) if it finds, after notice and an opportunity to be heard, that such action is in the public interest.[6]

The "No-Action" Letters - Tracing the Staff's Position[7]

Concededly, an adviser may function as a securities broker by helping a party structure an acquisition as a purchase of securities. "Effecting" securities transactions would logically include preliminary steps as well as the active solicitation of buyers. Furthermore, it is not surprising that an adviser is deemed to be engaged in business as a securities broker if it publicizes its willingness to act as one. However, the decision to transfer securities instead of assets is usually made by the parties on their own initiative, often for reasons that owe nothing to the advice or efforts of third parties subsequently labeled "brokers." And while "transaction based" compensation may be characteristic of a broker, it hardly follows that the broker's "business" involves transactions in securities as opposed, say, to real estate or business enterprises.

Unfortunately, some bad precedents have been set when the SEC staff allowed the form of an acquisition to drive its analysis of the roles played by the parties' advisers. As a result, when buildings or businesses are acquired by means of a securities transfer, a participating adviser can face claims that it was either a securities broker all along or chose to become one the moment the transaction was structured. Often, such claims ignore the fact that the chosen structure was unrelated to the services the adviser actually performed. The staff takes a particularly dim view of the receipt by an adviser of transaction-based

---

have their own statutes, e.g. California, (Corp. Code 25000-25023); Oregon (ORS 59.165) and Washington (RCW 21.20.005[5]). State registration is accomplished by filing copies of the Exchange Act documents, primarily Form BD. See, e.g. Washington Administrative Code, WAC 460-20B-030. Securities brokers are also subject to qualification, financial responsibility and periodic reporting requirements, plus an array of disclosure and other conduct rules.

[5] For an example of the SEC's position, see "Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, Note 82 (February 5, 2003). Section 29(b) of the Exchange Act provides that "Every contract made in violation of any provision of this title…shall be void." Section 32 imposes penalties for willful violations.

[6] See, Exchange Act Section 15(b)(6).

[7] All of the No-Action Letters cited in this Bulletin are available on the SEC's website. See, sec.gov/regulation/staff/interpretations/exemptive/interpretative/and/noaction/letters/division/of/tradingand/markets. The letters are searchable by subject category (i.e., "Broker-Dealer Registration - Limited Broker-Dealer Functions") or by the release dates in the chronological list of letters. The latter search reference is used here.

compensation, reasoning that such compensation is a "hallmark" of broker-dealer activity that confers a "salesman's stake" in the transaction, i.e., an incentive to engage in selling efforts.[8]

The staff also asserts that participating "at key points" in the "chain of distribution" of securities is "effecting" transactions in them. "Participation" includes providing assistance in the "structuring" or "solicitation" of securities transactions, the identification of "potential purchasers" or the "taking of orders." In an acquisition consummated by a transfer of securities, "distribution" occurs at closing, but the "chain" culminating in that event begins much earlier and the factors cited by the staff as requiring registration can clearly be present, though labeled differently. Thus, "structural" assistance is provided by advising on the form of an acquisition. Soliciting bids is the acquisition equivalent of "soliciting securities transactions" and identifying "potential purchasers." Accepting bids is the acquisition equivalent of "taking orders."[9]

Limited Relief Prior to 2006

Prior to January 2006, there were scattered instances, some involving stock acquisitions, others private placements, in which unregistered intermediaries obtained assurance from the SEC staff that, if the intermediary acted within specific limitations, the staff would not recommend that the Commission respond with an enforcement action. In some instances, the assurance was based on the fact that the transaction was an isolated occurrence, clearly not part of a regular business. In others, the intermediary provided limited services or promoted only asset acquisitions and did not receive transaction-based compensation.[10]

Unfortunately, these letters are of limited practical value because they are conditioned on the absence of transaction-based compensation or curtail substantially the very services that M&A professionals are engaged to perform (e.g., *CommandTrade, LP, note 10)*. Others are not models of clarity or consistency or are based on questionable assumptions. For example, compare the denial of relief in *John W. Loofbourrow Associates, Inc.* (Note 6) with *International Business Exchange Corporation*[11] in which an unregistered business broker participated in stock acquisitions as part of its regular business in exchange for a commission based on the final price (i.e. "transaction-based compensation"). Nevertheless, the staff granted no-action assurance on representations by the broker that its commissions were not dependent on structure, that it promoted only assets, made no structural recommendations and neither participated in negotiations nor provided valuation advice if the transaction closed as a stock sale. Neither the broker nor

---

[8] See, *Brumberg, Mackey & Wall, P.L.C.,* SEC No-Action Letter (May 27, 2010) and *Hallmark Capital Corporation,* SEC No-Action Letter (June 11, 2007). No-action assurance was denied without comment when a registered broker-dealer acting as a placement agent in private offerings proposed to pay transaction-based referral fees to an unregistered mortgage banker that would limit its role to introducing the parties. Presumably, the staff viewed the mortgage banker as an unregistered sales agent of the broker and the referral fee as a fatal indicator of the banker's sales focus. See, *John W. Loofbourrow Associates, Inc.,* SEC No-Action Letter (March 7, 2006).

[9] See, *MuniAuction, Inc.*, SEC No-Action Letter (March 13, 2000) in which no-action assurance was summarily denied the host of a website auction established for issuers and registered brokers. The host solicited both issuers and selling security holders, transmitted orders and selected the broker-dealer that executed the transactions.

[10] See, e.g., *Paul Anka,* SEC No-Action Letter (July 24, 1991), in which a singer introduced promoters of privately offered hockey team securities to well-heeled friends in the entertainment industry, but did not participate in negotiations and was compensated by a flat fee. His involvement was treated as an isolated occurrence. In *CommandTrade, LP,* SEC No-Action Letter (December 28, 2005), an unregistered software developer sold computerized investment analysis "platforms" to registered broker-dealers and thus provided technical support for brokerage activities. Nevertheless, it obtained no-action relief because it did not (a) charge transaction-based fees, (b) hold funds, (c) engage in execution, settlement or clearance activities, (d) solicit or open brokerage accounts, (e) answer questions, provide advice or engage in negotiations between customers or among brokers respecting transactions or strategies; (f) recommend particular securities or brokers or (g) screen customers for brokers.

[11] SEC No-Action Letter (December 12, 1986)

the staff explained how the broker's participation in initial asset sale negotiations, or its advice about asset values, selling strategies and appropriate buyers, would cease to be relevant when the parties later determined to transfer securities. The fact that the broker's commission did not vary with the form of the transaction did not lessen the "transaction basis" for it and a commission always provides selling incentive.

The "CBI" Letter

In a 2006 letter, however, the staff relaxed somewhat its prohibition of transaction related compensation and reacted sympathetically, if somewhat illogically, to a detailed operational method proposed by Country Business, Inc., ("CBI") a self-described and unregistered "business broker for small businesses."[12]

√ *CBI would limit its clients to businesses that did not exceed the "Size Standards" for entities eligible for SBA loans, or equity funding by Small Business Investment Companies.* The significance of the size limitation for anyone but CBI itself is not clear. There is no correlation between the size of a private issuer and the need to protect its investors by regulating its brokers. The need arises when the investors are *passive* holders who turn to securities professionals for advice and transaction assistance.

√ *CBI would represent only selling companies and their controlling stockholders.* This would eliminate the conflict of interest inherent in representing both buyers and sellers, but is needlessly limiting. CBI could resolve the conflict issue (a) by representing either buyers or sellers but not both in the same transaction; or (b) by obtaining consent to any dual representation from both parties after full disclosure.

√ *Although CBI would promote transactions over the internet and by other mass media, only assets would be listed or offered for sale and the target would be offered as a going concern, not a "shell corporation."* This avoids any implication that the parties set out to sell stock and it eliminates the taint associated with "shells," dormant corporations with a registered class of securities but no assets or business. Shells are offered as merger candidates for companies wishing to "go public" on the cheap. They are a product of bad management and utterly worthless. Shells exist in a legal quagmire that leaves any merger survivor with the very filing and disclosure requirements it intended to sidestep.

√ *If the transaction is consummated as a stock acquisition, all equity securities would be sold to a single purchaser or group of purchasers formed without CBI's assistance.* This distances CBI from the decision to sell stock, curtails its ability to generate business on its own initiative and avoids the conflict of interest inherent in providing services to both seller and buyer in the same transaction.

√ *CBI would not advise any party whether to issue securities nor would it opine on the value of any securities actually sold, although it would be prepared to value the assets of the business on a going concern basis.* This is not a distinction without a difference. Of course the aggregate value of all outstanding equity securities of a close corporation and the aggregate value of all its net assets and business are the same, so at first blush it would not seem to matter how an adviser's valuation opinion is characterized. But a corporation may issue multiple classes of securities that vary in their rights, preferences and limitations and therefore in their value to the holder. Moreover, it is usually possible to acquire control of a business entity without purchasing all of its outstanding securities and there is no inevitable correlation between the entity's asset value and any control premium paid by the acquirer for the securities it did purchase.

√ *If the parties determined to consummate the transaction as a sale of securities, CBI would not participate in negotiations other than to transmit documents, value the assets, provide administrative support and assist with preparation of financial statements. CBI expressly would not offer advice respecting the terms of the transaction.* From a regulatory perspective, this limitation might be more

[12] See, *Country Business, Inc.*, SEC No-Action Letter (November 8, 2006).

effective if it stopped at prohibiting CBI from participating in negotiations, directly or indirectly. As written, the limitation may be difficult to police because it permits unrestricted communication by CBI with all parties, even in a securities transaction. An adviser recommends terms to a party. A broker induces the acceptance of common terms by all parties. Document transmission, asset valuation and administrative services can easily become inducements, but the point at which that transformation occurs is difficult to identify. The CBI no-action request finessed the issue neatly and the staff did not object.

√ *CBI would prepare a disclosure memorandum based on information provided by the seller, but would disclaim any representation respecting the accuracy of such information. The memorandum would not discuss a possible sale of securities.* A prudent intermediary will disclaim any implied warranty of accuracy, but by stressing the disclaimer and omitting any discussion of a stock acquisition, CBI distinguished itself from securities brokers who make representations and offer opinions on whether securities investments are "suitable" for their clients.

√ *CBI would be paid a fixed fee, an hourly fee, or a commission based on a percentage of the final price, but the fee would be negotiated in advance of any decisions about structure. The fee would be payable in cash or on a deferred basis corresponding to any deferral of the price and would not vary with the form of the transaction.* The staff's formal endorsement of a percentage commission paid under the circumstances described by CBI reinforces the position taken in the earlier *International Business Exchange Corporation* letter and moves the staff further from a blanket rejection of "transaction related compensation."[13]

√ *CBI would not help purchasers obtain financing other than to assist with paperwork and provide uncompensated introductions to possible lenders.* In an acquisition effected through a transfer of securities, assisting the buyer with financing is equated with inducing the purchase of those securities, to say nothing of the fact that loans are evidenced by notes which, with minor exceptions, are themselves "securities" for legal purposes. This disclaimer also helps eliminate the potential for profiting from both sides of the transaction, a fact of life with broker-dealers.

Thus, after the CBI letter, M&A practitioners could engage in stock acquisitions, and even receive transaction-based compensation, but only if they accepted the conduct limitations summarized above. Those limitations prevented a prudent, but unregistered intermediary from promoting, providing structural advice for, or soliciting parties in any acquisition that plausibly might be closed as a sale of securities.

The "M&A Brokers" Letter

On January 14, 2014, six lawyers, writing as counsel to clients involved in "business brokerage transactions," obtained no-action assurance that the SEC staff would not recommend enforcement against a person who, without registering as a securities broker under the Exchange Act, performed limited services to facilitate the purchase and sale of a private company that closed as a stock acquisition. The staff granted this relief to carefully defined "M&A Brokers" based on the following representations by the lawyers:[14]

√ *Applicable Definitions*

An *"M&A Broker"* "effects" securities transactions only when ownership and control of a "privately held company" is transferred by means of the purchase, sale, issuance or redemption of securities to a buyer

[13] See Note 9 above.

[14] See, *"M&A Brokers,"* SEC No-Action letter, January 14, 2014. The lawyers requesting relief were Faith Colish and Ethan L. Silver, Carter Ledyard & Milburn LLP, New York City; Martin A Hewitt, Attorney at Law, East Brunswick, New Jersey; and Eden L. Rohrer, Linda Lerner and Stacy E. Nathanson, Crowell & Moring LLP, Washington D.C. The responsive "No-Action" Letter was written for the staff by David W. Blass, Chief Counsel and Associate Director, Division of Trading and Markets.

that will *not* be a passive investor, but will operate actively either the company or a new business conducted with the company's assets.

A *"privately held company"* is an operating company (not a "shell") that does not, and need not, register a class of securities or file information and reports with the SEC under the Exchange Act. The size of the company is irrelevant. In fact, given the 2012 JOBS Act increase in the shareholder threshold for mandatory registration, any tenuous connection in the SEC's mindset that may once have existed between the regulation of securities brokers, the protection of investors and the size of a private issuer should vanish.[15]

An *"M&A Transaction"* is an acquisition of a privately held company of any size that is structured as a merger, share exchange, business combination or other sale, issuance or redemption of securities.

√ *Limits on Services*

An M&A Broker must not have authority to bind a party to, or provide financing for, an M & A Transaction; nor may the Broker have custody or control over funds or securities exchanged in such Transaction (or in any other securities transaction for the account of others). An M & A Broker may represent both sellers and buyers, but only if it obtains informed written consent from both parties to the dual representation after providing "clear" written disclosure respecting the resulting conflict of interest. The Broker may "facilitate" an M&A Transaction with a group of buyers, but only if the Broker did not assist in the formation of the group. The Broker may assist Transaction parties in obtaining financing from non-affiliates, but must disclose any compensation for doing so and comply with applicable regulations, including Regulation T.[16]

√ *Limits on Transaction Structure*

M&A Transactions must not involve public securities offerings. Offers or sales of securities that are involved in such Transactions must comply with an exemption from registration under the Securities Act. Accordingly, the securities will be "restricted" within the meaning of Rule 144(a)(3) under the Act and, as such, they may not be resold without registration or an exemption. No party to an M&A Transaction may be a "shell" corporation (unless formed by an operating company solely to complete the Transaction). After the Transaction is closed, the buyer or buying group must operate the target actively i.e., must not be "passive" investors. Interestingly, the staff agreed that sufficient operating "control" would be presumed if the buyer acquired or had the right to direct the sale of 25% or more of the target's voting securities; or contributed (or would receive on dissolution) 25% or more of the capital of a target organized as a partnership or limited liability company. The 25% threshold is roughly comparable to the threshold for "open market" control of a public company.

√ *Permissible Transactions and Services Going Forward*

---

[15] The JOBS Act of 2012 increased the threshold for mandatory registration by amending Section 12(g) of the Exchange Act to replace the existing private company limit of 500 record shareholders with new alternative limits of *either* 2,000 record shareholders *or* 500 who are *not* "accredited investors." "Record shareholders" do not include beneficial owners whose securities are held by brokers in "street name." As a result, very large companies can remain private indefinitely. See, www.hutchins-law.com/publications/essays/corporate/finance. "*Advertising 'Private' Securities Offerings - The 'JOBS Act' and Amended Securities Act Rules 506 & 144A."*

[16] The Federal Reserve Board's Regulation T prohibits the extension of credit by broker-dealers if the borrower will use the proceeds to purchase securities. The Regulation's most common application is to the purchase of publicly traded securities on margin. Its application to a private company acquisition could cover such financing techniques as a buyer's sale of its debt securities to a third party followed by its use of the proceeds to purchase stock of the target. The participation by an M & A Broker in such a technique involves a question of degree. The SEC would permit the Broker to arrange the sale, but prohibit it from purchasing the debt securities.

The M&A Brokers letter clears the air in several critically important respects because it takes account of the real differences between transactions in securities and transactions in private companies. Thus, the letter removes the size of the target as a constraint on permissible transactions, recognizing that passive investment, not size, is what triggers the need for regulation. The letter also removes the outright prohibition of broker involvement without registration in securities-based acquisitions in favor of requirements that the target be a private, operating company and that the buyer operate the target or its assets actively after the closing. The letter allows M&A Brokers to facilitate stock acquisitions directly so long as no public offering is involved and an exemption from registration is available for any securities transferred. Finally, the letter removes transaction based compensation as a fatal indicator of a brokerage business and allows M&A Brokers to arrange acquisition financing from non-affiliates provided they do not hold funds or securities or form buying groups.

Recommendations

Limit Involvement to Acquisitions of "Private Operating Companies"

The most important contribution made by the M&A Brokers letter is its clear eyed focus on the distinction between acquisitions of investment securities by passive holders and acquisitions of private, operating companies by active managers. Unless registered, practitioners should systematically limit their involvement to acquisitions of the latter type by confirming that the target company has not registered a class of securities with the SEC, has no obligation to do so and is, in fact, an operating company. This can be readily be done during preliminary due diligence by reviewing the company's stock or securities register, interviewing company management and counsel and examining any SEC filings involving the company using "EDGAR" (the SEC's "electronic data gathering, analysis and retrieval" system).

Ensure that the Acquirer will operate the Target "Actively"

M&A practitioners should avoid transactions in which the buyer would arguably lack control of the target after the closing. If the issue is in doubt, all transaction documents should be reviewed by practitioners with their own counsel to confirm that control will be vested in the buyer even if it emerges from the transaction with only a minority interest. Practitioners should not rely without specific inquiry on the presumption in the M&A Brokers letter that control exists if the buyer holds or has the right to receive as little as 25% of the target's voting securities or capital. Presumptions are rebuttable and nothing in the letter suggests the 25% threshold is a safe harbor under all circumstances.

Ensure that an Exemption is Available for any Securities Issued or Transferred

If securities are issued to consummate a private company acquisition, the relevant exemptions will include those provided by Sections 4(2) and 4(6) of the federal Securities Act and the safe harbor provided by Rule 506 of SEC Regulation D. (State law is preempted for a compliant Rule 506 transaction under Section 18(b)(4)(D) of the Securities Act.)

If there is a significant probability that an acquisition billed as an asset sale will actually close as a sale of securities, practitioners should confine their solicitations to prospective purchasers that the seller could solicit in an exempt, private placement. This will help avoid the registration problem and may mitigate the practitioners' risk of civil liability to the buyer or to an innocent seller based on a claim that the seller's exemption from registration was lost because of the practitioner's conduct.

In an acquisition setting, it is likely that potential buyers will be sought by means of advertising or some other form of "general solicitation." This will trigger new Rule 506(c) which requires, among other things, that if general solicitation is used, all purchasers must be "accredited investors" as defined in Rule 501(a) and the issuer must take reasonable steps to verify their status as such. In many such acquisitions, particularly of smaller private companies, the accreditation and verification requirements will be easily

satisfied. In others, however, the compliance issue should be analyzed carefully; particularly if the acquirer is a buying group comprised of individuals or newly formed entities.[17]

If no general solicitation is to be used, the acquisition is probably an industry play and the seller's representatives will assert that they have the pre-existing "substantive" relationship with each potential bidder required by the staff for offerings under Rule 506(b). Here, the compliance issues can be even more nuanced and complex. This is another area in which M&A practitioners are well advised to consult with their own securities counsel before offering structural advice or intermediation to an acquisition party.

Finally, M&A practitioners involved in Rule 506 transactions should brace themselves for a possible inquiry from regulators. Rule 503 requires that an issuer offering or selling securities in reliance on Rule 506 must file Form D with the SEC and provide copies to the securities administers in all states in which purchase reside. On the face of it, that filing is obviously inconsistent with the practitioners' claim that they are not effecting transactions in securities within the meaning of the Exchange Act and the current version of Form D has only limited space for an explanatory statement. Nothing can be done to prevent this red flag except to prepare a coherent and documented explanation should inquiry be made.

Ensure that no Acquisition Party is a Prohibited "Shell"

Acquirers often house a target in a newly formed entity to align the post-closing capital and management structure of the acquired business with transaction requirements while keeping the assets and obligations of the business separate from those of the acquirer and its other subsidiaries. In a typical case, the acquirer merges the target with and into a new corporation or LLC which will be the surviving entity. "Newco" enters the merger without assets but, by virtue of the applicable merger statute, emerges automatically as owner of all assets and business of the target and obligor for all of the target's liabilities. The target ceases to exist ("disappears") and the merger consideration, whether cash, securities or other assets, is distributed to its former owners.

Though Newco is technically a "shell" when it enters the transaction, its business objective is to acquire the target as an operating company and it was not formed until the target was identified and a bargain was struck with its former owners. Accordingly, Newco is not the kind of shell that would concern the SEC and provision is made for it in the M&A letter. However, no M&A practitioner should agree, without registration, to assist a shell in its initial effort to *identify* an acquisition target or line of business.

Avoid the financing of Buyers and/or the Formation of Buying Groups

Most acquirers will seek acquisition financing from lenders who have already extended some form of credit to them. Experienced M&A practitioners can offer assistance in negotiating loan documents tailored specifically to the acquirer's transaction. These practitioners may also have developed relationships with alternative capital sources that can be approached if the acquirer's lender insists on unacceptable terms. Certainly, nothing prevents an adviser from offering consulting services in acquisition finance and being compensated for providing them. But the M&A brokers letter draws a bright line between providing financing consultation and providing the financing itself; directly or through an affiliate. The latter activity is a compelling indication that the adviser is engaged in the business of effecting securities-based acquisitions, i.e. "effecting" transactions in securities for others. A similar analysis applies to an adviser who assists in the formation of a buying group; which is nothing more than bringing multiple investors together so that their combined financial resources will finance the acquisition of the target.

[17] See, "Advertising 'Private" Securities Offerings - The 'JOBS Act' and Amended Securities Act Rules 506 & 144A, Note 15."

Consider Registering as a Business Broker

M&A practitioners who intermediate between sellers and buyers should consider registering under applicable state law as a "business" or "business opportunity" broker. Many states include such laws as part of a comprehensive scheme that also requires registration by securities, life insurance and franchise brokers, among others. The procedure is relatively simple and inexpensive. There is absolutely no basis for assuming such registration would, as such, constitute a defense to an enforcement action or claim based on a failure to register under the Exchange Act. Nevertheless, a business brokerage license might add a valuable aura of legitimacy and good faith in a close case.[18]

Address Registration Issues in the Engagement Contract

Given the risks that face them, unregistered M&A practitioners should cover registration issues frankly and comprehensively in their brochures, engagement letters and fee agreements. The securities laws are, from beginning to end, disclosure statutes. Full disclosure of the terms of engagement of a business broker or acquisition advisor should be an indispensable component of their securities law compliance programs. The brochures of most professionals contain a laundry list of their degrees, honors and memberships along with a glittering summary of past deals and triumphs. It is not difficult to add a statement to the effect that the professional is not a registered securities broker, is not in the business of effecting securities transactions for others and is not being engaged to do so. Finally, practitioners should consider including representations by their clients, or at least carefully drawn recitals, to the effect that, to the clients' best knowledge, no acquisition party is a shell entity and the acquirer will operate the target actively after the closing.

Remember that No-action letters are Limited in Scope

No-action letters form a valuable database of the interpretations and evolving policies of the SEC staff and past letters are routinely cited to favorable effect in current no-action requests. Nevertheless, the relief granted by a no-action letter is limited expressly to the requesting party and is based solely on the facts and representations made by that party in the requesting letter. The views of the SEC staff are not substantive law and are not equivalent to a ruling or determination by the SEC itself. Accordingly, M&A practitioners who are not registered as securities brokers should ensure that their conduct falls clearly within the limits of existing letters granting relief. They would be well advised to apply for relief on their own behalf before accepting an engagement that may exceed those limits.

****

Legal Essays and Bulletins are published periodically by the Law Offices of Robert G. Hutchins, PS on subjects potentially of interest to clients and others with whom the firm maintains business or professional relationships. These publications do not address a specific situation, are necessarily general in scope and should not be construed as legal advice. For more information, please contact Robert G. Hutchins at PO Box 7570, Tacoma, WA 98417-7570; 253-272-5480; rghutchins@msn.com.

[18] See, e.g., the Illinois Business Broker's Act of 1995. Other states require a real estate broker's license when the transaction involves a business enterprise; even one that owns no real estate. See. e.g., Section 475-01(1)(a) Florida Statutes. Washington regulates sellers of business opportunities, but not business opportunity brokers. See, Chapter 19.110, RCW.