Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

May 22, 2018

Merger and Acquisition Brokers: Overview and Proposals for Relief

Introduction

Merger and acquisitions (M&A) brokers are also known as Main Street brokers. In general terms, they are intermediaries who conduct privately negotiated sales of privately held small- and mid-sized companies by facilitating securities transactions that transfer ownership and control of such firms to a buyer who intends to operate the firm.

The Exchange Act of 1934 (Exchange Act, P.L. 73-291) is a major federal securities law that authorized the creation of the Securities and Exchange Commission (SEC) and provides for a regulatory regime requiring most brokers and dealers to register with the agency and also become members of the Financial Industry Regulatory Authority (FINRA, the frontline regulator of securities brokerage firms and their brokers overseen by the SEC). The Exchange Act broadly defines a broker as a firm or individual who effects transactions in securities on behalf of others. Dealers are defined as firms or individuals who trade their own securities for profit, called "trading for its own account."

Historically, there has been some uncertainty over whether M&A brokers, many of whom self-identify as *finders*, meet the definition of a broker under the Exchange Act. For example, some observers have argued that broker-dealer regulations were originally conceived to prevent "high pressure selling tactics" and the "third party custody" of securities trade-related funds. And they have noted that neither role appears to be associated with the firm acquisitions that M&A brokers routinely manage.

By contrast, in a 1985 U.S. Supreme Court case, *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), the court ruled that the sale of all or a controlling interest in a firm constitutes a securities transaction. It found that a person involved in facilitating the sale of an operational business could fall within the definition of a broker under the Exchange Act. According to some accounts, the ruling led to greater numbers of unregistered M&A brokers registering with the SEC under the Exchange Act. Still, unregistered M&A brokers reportedly constitute a majority of brokers.

Historically, among other things, an unregistered M&A broker could face the risk of having a client's corporate sale rescinded if the acquired firm falters under the new owner. Some acquirers have reportedly cited a broker's unregistered status to convince the courts to rescind a corporate sale.

On the other hand, being a registered M&A broker can be relatively costly compared to an unregistered broker. There are estimates that initial SEC registration costs for M&A brokers can exceed $150,000, with annual registration running as high as $75,000, costs that at least in part can be passed on to a broker's client, potentially increasing the expense of such corporate sales.

The 2014 SEC No-Action Letter

In January 2014, in what many observers described as a major advance over earlier SEC guidance on unregistered M&A brokers and their intermediated transactions, the SEC staff issued a no-action letter on unregistered broker liability. (A no-action letter is a response to an individual or entity who is uncertain if a certain product, service, or action would violate federal securities law. Such letters express the view that the prospective activity or product would not result in adverse agency action.)

In the 2014 no-action letter to several attorneys who had raised the issue, entitled *M&A Brokers*, the SEC's Division of Trading and Markets stated that it would not recommend SEC enforcement action in the event that an intermediary were to facilitate a securities transaction connected to the transfer of ownership of a privately held firm. The letter contained a number of stipulations, including (1) the broker cannot provide financing for the transaction; (2) the broker cannot provide custody services for funds used in the transaction or for securities issued or exchanged in connection with the transaction; (3) the transaction cannot involve a public securities offering and is limited to offerings that are exempt from SEC registration under the Securities Act of 1933 (P.L. 73-22); (4) the transaction's buyer "must control and actively operate the company or the business conducted with the assets of the company" when the transaction is finalized; (5) the broker can facilitate an M&A transaction with a group of buyers only if the group was initially formed without the broker's assistance; and (6) the broker cannot have been barred or suspended by the SEC, a state, or by a self-regulatory organization such as FINRA.

Within the M&A broker community, a frequently encountered reaction to the letter was that the letter was a "welcome relief as private companies …[were] previously concerned about whether they had exposure for M&A transactions facilitated by unregistered broker-dealers…[within the letter's qualifying limits]"

Legislation

Two legislative proposals in the 115th Congress, Section 401 of H.R. 10 (the Financial CHOICE Act, which passed the House on June 7, 2017); and H.R. 477 (which

unanimously passed the House on December 7, 2017), are aimed at "clarifying and simplifying the registration regime for M&A brokers [thus reducing] … the burdens on the M&A brokers, which in turn will reduce the costs borne by their small business clients that need the services of the M&A broker to assist them in with merger or acquisition opportunities."

The current legislation attempts to do so by amending the Exchange Act so that certain M&A brokers would be exempted from registration as broker-dealers with the SEC. Under the legislation, a registration-exempt M&A broker would be defined as an entity who is involved in facilitating the transfer of ownership of a privately held company with annual earnings of less than $25 million or annual revenues of less than $250 million.

Under the legislation, the exemption from registration would not be granted to M&A brokers who do any of several things, including the following:

- They provide custody services for funds used in the transaction or for securities issued or exchanged in connection with the transaction.
- They are engaged in a public securities offering on behalf of a securities issuer.
- They cannot provide financing for the transaction.
- They are engaged in a transaction involving the transfer of ownership of an eligible privately held company to passive buyers. (These are defined as buyers who do not who have an active involvement in the managing of the acquired firm.)
- They are engaged on behalf of any party to a transaction involving a shell company. (A shell company is defined as a company with (1) either no or a nominal level of operations; (2) either no or a nominal amount of assets; (3) assets that consist entirely of cash and cash equivalents; or (4) assets that consist of any amount of cash and cash equivalents and nominal amounts of other assets.)
- They can facilitate a transaction with a group of buyers only if the group was initially formed without the broker's assistance.

The current legislation also contains several "bad actor" disqualifications, which would disqualify a broker from the registration exemptions. One key "bad actor" disqualifier would apply if a broker has had their SEC registration suspended or revoked.

The legislation appears to be broadly similar to the SEC's January 2014 no-action letter on M&A brokers, which is discussed above.

Responses to the Legislation

In March 2017, the International Business Brokers Association (IBBA), a group of brokers and transaction intermediaries, wrote to the House Financial Services Committee In support of the current legislation. They argued that the current "one-size-fits all" broker-dealer regulatory regime unfairly conflates M&A brokers involved in the sale of privately held firms with "Wall Street" investment bankers who intermediate between public company issuers and buyers of their shares. The letter also argued that the current regulatory regime imposes regulatory burdens and costs on M&A brokers that are passed on to the buyers and sellers of the private businesses whose acquisitions are managed by the brokers.

The North American Securities Administrators Association (NASAA) is an association of state and provincial securities regulators that tends to take an investor protection stance on many policy issues. In an October 2017 letter to the House Financial Services Committee, the group lent its support to the legislation. In addition, it argued that the legislation's federal regulatory exemption is very similar to the NASAA's own model state regulation for M&A brokers, which generally exempts M&A brokers from state securities registration.

The Americans for Financial Reform (AFR) is a coalition that includes consumer advocacy; civil rights, investor, and retiree advocacy; and labor and faith-based groups. In an October 2017 letter to the House Financial Services Committee, the group, which also tends to take a pro-investor stance on financial policy issues, argued that the legislation improved on similar bills in the 114th Congress by including the aforementioned disqualifications for "bad actors." The group, however, pointed to the 2014 SEC no-action letter and argued that the letter effectively made the legislation unnecessary.

Supporters of the current legislation counter that the no-action letter, which they say the current legislation is consistent with, merely serves as interpretive guidance that the SEC can always rescind. As such, they argue that there is a need for a more permanent statutory fix via the current legislation. Historically, however, very few SEC no-action letters appear to have been rescinded.

In 2015, criticizing legislation in the 114th Congress similar to the current legislation, Theresa A. Gabaldon of the George Washington University Law School invoked the question of M&A broker fairness. She argued that the legislation would allow unregistered brokers to compete with brokers who have put "in the time and effort [and expense] to register and who are willing to submit to inspection and other controls." The law professor also commented that lost in much of the discussion on the legislation was the notion that registered M&A brokers might actually do a better job of serving the needs of smaller companies than unregistered brokers.

Gary Shorter, Specialist in Financial Economics

IF10893

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.