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Simplifying Securities Regulation of M&A Intermediaries and Business Brokers (Finders) in the Sale of Privately Owned Businesses[1]

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Introduction

Professional merger and acquisition ("*M&A*") intermediaries and business brokers ("*M&A Brokers*") introduce buyers and sellers, help prepare and value the businesses for sale, assist with pre-purchase investigations, advise about possible sale terms and structures, assist with negotiations, and sometimes help the parties in closing sales of privately held businesses. M&A Brokers often market sellers' companies to private equity and venture capital groups, sometimes assist those groups in finding potential sellers meeting buyer-defined characteristics, and sometimes assist in selling a portfolio company to new owners. Sometimes transactions involving private equity and venture capital groups bear both M&A and capital-raising characteristics such as in a recapitalization that buys out existing stockholders and brings new money into the company. Smaller M&A transactions are often accomplished through the sale of the business's assets in exchange for cash, which is generally not subject to securities regulation. However, when for a variety of reasons the ownership of a privately held business is transferred by means of the purchase, sale, exchange, recapitalization, repurchase, issuance, merger, consolidation, or other business combinations involving stock or other securities, then federal and one or more state securities laws apply[3] to the parties, the transaction, and regulate the transaction-related activities of the M&A Broker.

Since the U.S. Supreme Court's opinion in *Landreth Timber Co. v. Landreth*,[4] the federal securities laws have been applied to the offer and sale of a business regardless of whether the transaction involves the sale of one or all of the outstanding shares of a company's securities. When an intermediary is brokering the sale of businesses involving securities, the intermediary often comes within the broad definition of a "broker" under the Securities Exchange Act of 1934, as amended ("*Exchange Act*"). The Exchange Act generally requires the intermediary to be registered and regulated as a "broker-dealer" by the Securities and Exchange Commission ("*SEC*" or "*Commission*") and to be a member of, and regulated by, the Financial Industry Regulatory Authority ("*FINRA*"). Offering-related registration exemptions (*e.g.*, SEC Regulation D) do not

[1] Written for the American Bar Association, Business Law Section, Private Equity and Venture Capital Committee CLE Program, *Navigating the Confusing Waters of Broker-Dealer Regulation (Finders) in the Context of Capital Raising and M&A Involving Private Equity and Venture Capital Funds and Private Companies* , April 6, 2013, Washington D.C.

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[3] *See, e.g.*, SEC Rule 145, *Reclassification of Securities, Mergers, Consolidations and Acquisitions of Assets* .

[4] *Landreth Timber Co. v. Landreth*, 471 U.S. 681; 105 S. Ct. 2297 (May 28, 1985).

exempt broker registration requirements. State securities laws impose registration and regulatory requirements on brokers, dealers, or broker-dealers as those terms are similarly defined. State real estate and business brokerage licensing laws also apply to these activities, creating multiple layers of initial and on-going regulatory requirements, professional qualifications, and compliance-related costs for M&A Brokers.

An M&A Broker's initial and on-going costs of complying with federal and state securities laws in private business sales is substantial no matter whether the intermediary handles just one securities transaction or multiple securities transactions in a year. These compliance-related costs are necessarily passed on to each transaction's parties if the M&A Broker is to remain in business. These largely fixed compliance-related costs unnecessarily and disproportionately burden M&A Brokers and the private business owners who use their services. M&A transactions bear multiple characteristics that greatly reduce the need for the full panoply of investor protections under federal and state securities regulation that are applicable to traditional retail broker-dealers and investment bankers handling public company transactions. A simplified system of regulation is urgently needed to reduce those costs, bring unregistered intermediaries into compliance, and thereby promote the cost-effective transfer of privately held businesses. These reforms are especially critical now as the generation of baby boomers sell their businesses, the proceeds of which they intend to live on during their retirement.

"Broker" Status

Section 3(a)(4)(A) of the Exchange Act defines a "broker" broadly as "any person engaged in the business of effecting transactions in securities for the account of others". Section 15(a)(1) of the Exchange Act provides, in pertinent part, that:

> It shall be unlawful for any broker or dealer . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered in accordance with subsection (b) of this section.

15 U.S.C. § 78o. This proscriptive language applies not only to either purchases or sales, but also to solicitations intended to result in purchases or sales whether or not a transaction ultimately occurs.

The SEC's *Guide to Broker-Dealer Registration*[5] provides guidance about and various examples of "broker" status. According to the *Guide*, each of the following individuals and businesses may need to register as a broker, depending on a number of factors:

- "finders," "business brokers," and other individuals or entities that engage in the following activities:
  - Finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers, investment companies (or mutual funds, including hedge funds) or other securities intermediaries;

[5] Available on the SEC's website at http://www.sec.gov/divisions/marketreg/bdguide.htm#II.

- Finding investment banking clients for registered broker-dealers;
- Finding investors for "issuers" (entities issuing securities), even in a "consultant" capacity;
- Engaging in, or finding investors for, venture capital or "angel" financings, including private placements;
- Finding buyers and sellers of businesses (*i.e.*, activities relating to mergers and acquisitions where securities are involved);

* * *

The SEC looks at the activities that the intermediary actually performs and the *Guide* lists some of the questions that, in the staff's view, bear upon whether an intermediary is acting as a broker:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?

- Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? Do you receive trailing commissions, such as 12b-1 fees? Do you receive any other transaction-related compensation?

- Are you otherwise engaged in the business of effecting or facilitating securities transactions?

- Do you handle the securities or funds of others in connection with securities transactions?

In the staff's view, a "yes" answer to *any* of these questions indicates the intermediary may need to register as a broker (which encompasses registration as a dealer and hence is commonly referred to as a "broker-dealer").[6] SEC registration as a broker also requires membership in FINRA. A similar analysis is applied under state securities laws, which all define "broker" in essentially the same terms.

In recent years, the SEC's application of these criteria through various enforcement cases and no-action letters has focused upon the presence of transaction-based compensation—a "hallmark of broker-dealer activity"[7]. Transaction-based compensation, including success fees and commissions, is generally contingent on the outcome and is often measured by the consideration exchanged in the transaction. This type of incentive compensation creates inherent

[6] For additional factors relevant to private equity funds, venture capital funds, business development companies, and similar issuers *see*, Speech, *A Few Observations in the Private Fund Space*, , David W. Blass, Chief Counsel, SEC Division of Trading and Markets (April 5, 2013), available at: http://www.sec.gov/news/speech/2013/spch040513dwg.htm (the "Blass Speech").

[7] *See Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration*, SEC Release No. 34-61884 (April 9, 2010). *See also, 1st Global, Inc*., 2001 SEC No-Act. LEXIS 557 (May 7, 2001) (reiterating the staff's position that "the receipt of securities commissions or other transaction related [sic] compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of 'broker' or 'dealer'... generally is required to register as a broker-dealer." (internal citations omitted)).

conflicts of interest that the SEC considers to be a paramount concern in protecting investors. Other forms of compensation may satisfy the "engaged in the business" element in the "broker" definition, but typically carry somewhat less weight when there is no incentive or "salesman's stake" tied to the transaction's outcome (thus helping lawyers and accountants to distinguish their role and fees in an M&A transaction). While old SEC no-action letters implied that a mere introduction of the parties might be permissible[8], more recent no-action letters express the SEC staff's skepticism about a broader scope of involvement or the regularity of participation in capital-raising activities being present in the fact patterns presented (*e.g.*, actively soliciting prospective investors, transmitting offering documents, or recommending an offering).[9] For example, seeking and introducing prospective investors to different issuers in exchange for a finder's fee may be deemed to be engaging in the business of a broker.[10] The SEC staff has publicly stated that the oft-cited ***Paul Anka*** no-action letter[11] is to be limited to its facts[12]—an issuer's use of a singer's rolodex without any contact between the Canadian singer and potential investors.

The associated persons of some issuers may qualify for an exclusion from the definition of a "broker" under SEC Rule 3a4-1, *Associated Persons of an Issuer Deemed Not to Be Brokers*. This rule provides a non-exclusive safe harbor for a person associated with an issuer (*i.e.*, an issuer's directors, officers, partners, or employees) who participates in offers or sales of that issuer's securities. As a safe harbor, the rule cannot be violated. The rule evidences several of the factors the SEC deems relevant to this analysis. The rule's scope would typically cover the senior executives managing an operating company, but several of its conditions are problematic for a private equity or venture capital fund that wishes to employ an internal securities sales team to raise capital.[13] Under the safe harbor, no incentive or transaction-based compensation may be paid, either directly or indirectly, to an issuer's associated persons in connection with securities-related activities and the associated person may not be subject to a statutory disqualification. There are a couple alternatives that, if other conditions are satisfied, would permit an issuer's associated person to: (i) participate in offers and sales of the issuer's securities to qualifying financial institutions (e.g., broker-dealers, investment advisers, banks, insurance companies); or (ii) participate in capital-raising activities if he or she has a "day job" at the company not involving the offer or sale of the issuer's securities, provided he or she has not been associated with a broker-dealer and has not participated in more than one offering for any issuer within the preceding 12 months; or (iii) participate in preparing or mailing written communications that do not involve the solicitation of a potential purchaser.[14]

While the SEC places considerable weight on the presence of transaction-based compensation, a number of federal district court decisions have articulated other factors to be

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[8] *See, e.g., Mike Bantuveris*, 1975 SEC No-Act. LEXIS 2158 (1975).

[9] *See, e.g., Brumberg, Mackey & Wall*, 2010 SEC No-Act. LEXIS 406 (2010) a law firm could not introduce its issuer clients to potential investor clients in exchange for a finder's fee.

[10] For a summary of SEC no-action letters, *see the Report and Recommendations of the Private Placement Broker-Dealer Task Force*, Business Law Section, American Bar Association, 60 *Business Lawyer* 959-1028 (2005), and available at http://sec.gov/info/smallbus/2009gbforum/abareport062005.pdf (the "ABA PPB Task Force Report").

[11] *Paul Anka*, 1991 SEC No-Act LEXIS 925 (1991).

[12] SEC 2008 Small Business Capital Formation Forum Transcript, Private Placement and M&A Brokers Panel (Nov. 20, 2008).

[13] *See* the Blass Speech.

[14] *See* SEC Release No. 34-22172, 1985 SEC LEXIS 1217 (June 27, 1985) for additional guidance on the rule's scope and the SEC's related views.

considered in analyzing key aspects of the definition of "broker". In ***SEC v. Kenneth Kramer***[15] the court criticized the SEC for failing to provide sufficient proofs with respect to factors beyond transaction-based compensation. The *Kramer* opinion summarized various factors identified in prior court decisions:

> Because the Exchange Act defines neither "effecting transactions" nor "engag[ing] in the business," an array of factors determines whether a person qualifies as a broker under Section 15(a). The most frequently cited factors, identified in ***S.E.C. v. Hansen,*** consist of whether a person (1) works as an employee of the issuer, (2) receives a commission rather than a salary, (3) sells or earlier sold the securities of another issuer, (4) participates in negotiations between the issuer and an investor, (5) provides either advice or a valuation as to the merit of an investment, and (6) actively (rather than passively) finds investors. See also ***Cornhusker Energy Lexington, LLC v. Prospect St. Ventures*** (Bataillon, J.) (identifying as evidence of broker activity a person's "analyzing the financial needs of an issuer," "recommending or designing financing methods," discussing "details of securities transactions," and recommending an investment); ***S.E.C. v. Margolin*** (Leisure, J.) (finding evidence of "brokerage activity" in the defendant's "receiving transaction-based compensation, advertising for clients, and possessing client funds and securities.").
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> However, "[t]he factors articulated in Hansen . . . [a]re not designed to be exclusive," and some factors (i.e., those factors typically associated with broker activity) appear more indicative of broker conduct than others. For example, ***S.E.C. v. Bravata*** (Lawson, J.), describes "[t]he most important factor in determining whether an individual or entity is a broker" as the "regularity of participation in securities transactions at key points in the chain of distribution." [S]ee also ***S.E.C. v. Kenton Capital, Ltd.*** (Kollar-Kotelly, J.) (describing "regularity of participation" as one of the primary indicia of "engag[ing] in the business"). [48] Cornhusker describes "transaction-based compensation" as "one of the hallmarks of being a broker-dealer." (stating that "[t]he underlying concern has been that transaction-based compensation represents a potential incentive for abusive sales practices that registration is intended to regulate and prevent."). In other words, transaction-based compensation is the hallmark of a salesman. By contrast, a person's recommending a particular investment or participating in a negotiation typically occurs in an array of different commercial activities and professional pursuits, including brokering.

Kramer, p. 1334-1335(internal citations omitted). The court's contrasting statement above fails to note that giving investment advice for compensation usually requires registration and regulation as an "investment adviser" under federal and state securities laws.

Historically, the SEC's enforcement actions against unregistered brokers (finders) and intermediaries have primarily involved fraudulent activities where investors have been de-

[15] *SEC v. Kenneth Kramer*, 778 F. Supp. 2d 1320, 2011 U.S. Dist. LEXIS 38968 (M.D.Fla. 2011). The SEC's initial appeal of the decision was dismissed by the court because final judgments had not yet been entered as to all parties. Final judgments were entered on February 22, 2013. The SEC did not renew its appeal of the decision, which has now become final.

monstrably harmed.[16] However, the presence of fraud is not a prerequisite to an SEC enforcement action.[17] A few recent enforcement cases have not involved fraudulent conduct at all, but merely alleged broker-dealer registration violations of Section 15(a) of the Exchange Act.[18] The SEC's enforcement activity appears to becoming more aggressive, and this change may be accelerated with the recent Senate confirmation of Mary Jo White, formerly a federal prosecutor in New York, as the new SEC chairman and her appointment of a new director for the SEC Division of Enforcement.

Of particular interest to private equity and venture capital groups, on March 8, 2013, the SEC announced its settlement of two administrative proceedings, one against William M. Stephens and one against Donald W. Phillips and Ranieri Partners LLC.[19] The SEC alleged Stephens acted as more than a finder merely introducing prospective investors to this New York-based private equity group by: (1) sending private placement memoranda, subscription documents, and due diligence materials to potential fund investors; (2) urging at least one investor to consider adjusting its portfolio allocations to accommodate an investment with one of Ranieri Partners' funds; (3) providing potential investors with his analysis of Ranieri Partners' funds' strategy and performance track record; and (4) providing potential investors with confidential information relating to the identity of other investors and their capital commitments. The Ranieri Partners/Phillips case is remarkable because the SEC imposed willful aiding and abetting liability on the private equity group and its senior manager for their role in knowingly facilitating Stephens' unregistered broker activities.

Ranieri Partners paid Stephens 1% of all capital commitments they received from investors he introduced pursuant to a consulting services agreement prepared by Ranieri Partners' outside counsel.[20] Ranieri Partners and Phillips, its then Senior Managing Partner, also provided Stephens with key offering-related documents and information related to Ranieri Partners' private equity funds and did not take adequate steps to prevent Stephens from having substantive contacts with potential investors (*i.e.*, more than a mere introduction), thus willfully aiding and abetting Stephens' primary broker registration violation. Indeed, given these facts the SEC said Ranieri Partners caused Stephens' violations. Phillips was responsible for coordinating the capital-raising activities for Ranieri Partners' funds. Phillips was also a senior executive of Ranieri Residential Investment Advisors, LLC, a subsidiary of Ranieri Partners that served as the private funds' adviser. This subsidiary had recently registered with the SEC as an investment adviser on March 26, 2012. It is believed that the SEC's investigation commenced as a result of a routine SEC examination of the private fund adviser, rather than a complaint from an investor,

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[16] *E.g.*, *SEC* vs. *U.S. Pension Trust Corp., et al.*, 2009 U.S. Dist. LEXIS 66026 (S.D.Fla. 2009).

[17] *See, e.g.*, the Blass Speech, cited above.

[18] *E.g., In the Matter of Ram Capital Resources, LLC*, *et al*., 2009 SEC LEXIS 2035 (June 19, 2009).

[19] *In the Matter of William M. Stephens,* File No. 3-15233 (March 8, 2013), and *In the Matter of Ranieri Partners LLC and Donald W. Phillips*, File No. 3-15234 (March 11, 2013), both available at: http://www.sec.gov/news/press/2013/2013-36.htm.

[20] A contract for services to be performed in violation of the Exchange Act is void and unenforceable (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation. Waivers of compliance with any requirements or prohibitions of the Exchange Act or related rules are similarly void and unenforceable. *See* Section 29, *Validity of Contracts*, of the Exchange Act. *See also Torsiello Capital Partners LLC v. Sunshine State Holding Corp*., 2008 N.Y. Misc. LEXIS 2879 (N.Y.S.Ct. 2008).

competitor, or whistle-blowing former employee.[21] There were no allegations of fraud or wrongdoing other than Stephens' broker registration violations.

By issuing a press release announcing these settlements, the SEC is sending a message to private equity and venture capital groups, their senior managers, and others who employ unregistered finders—you too may be the subject of an enforcement action involving unregistered brokers (finders) who do more than make an initial introduction and then walk away without any further involvement of any kind in the transaction. The SEC's press release said:

> The federal securities laws require that an individual who solicits investments in return for transaction-based compensation be registered as a broker. An SEC investigation found that William M. Stephens of Hinsdale, Ill., solicited investors as a hired consultant for Ranieri Partners and was paid fees by the firm, but never registered as a broker. Stephens' longtime friend Donald W. Phillips, a senior managing director who headed up capital raising efforts for Ranieri Partners, was responsible for overseeing Stephens' activities as a purported "finder" who would merely make initial introductions to potential investors. But Stephens' role went far beyond that of a finder. He consistently communicated with prospective investors and their advisors and provided them with key investment documentation that he received from Ranieri Partners.

Besides agreeing to cease and desist orders, Ranieri Partners was ordered to pay a civil fine of $375,000, its former senior executive, Phillips, was ordered to pay personally a civil fine of $75,000 and was suspended from serving in a supervisory capacity for nine months, and the unregistered broker, Stephens, agreed to what is effectively a lifetime bar from the securities industry. Stephens was ordered to disgorge all of his transaction-based compensation plus prejudgment interest, totaling in excess of $2.8 million, but he established to the SEC's satisfaction an inability to pay any of it. Notably, Stephens had previously been the subject of a settled SEC enforcement action while he was with an unrelated investment adviser and appears to have violated the terms of that earlier SEC order.

Essentially the same analysis is applied to the role of an intermediary in both capital-raising and M&A transactions, though these commonly represent distinctly different contexts with different risks to the investors/buyers. While the SEC's cases against William M. Stephens, Donald W. Phillips, and Ranieri Partners LLC pertain to capital-raising transactions, the fact pattern can be translated into the M&A context with the same unpleasant consequences. A business seller (a/k/a an issuer or its control affiliates) knowingly hires an unregistered intermediary to help prepare, market, and present "teasers", "pitch books", and other information about the seller's company to prospective buyers (a/k/a investors). The purpose of those oral and written communications is to induce the sale of some or all of the company's ownership to a new own-

[21] We are likely to see more SEC enforcement actions involving private equity fund advisers and their finders as a result of their examination by the SEC. Many private fund advisers are now required to register with the SEC under the Investment Advisers Act of 1940, as amended by the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, 124 Stat. 1376 (2010). *See* SEC Rule 275.203(m)-1, *Private Fund Adviser Exemption*. Investment advisers to private funds having $150 million or more in assets are required to file Form PF with the SEC. See SEC Rule 275.204(b)-1, *Reporting by Investment Advisers to Private Funds*. The Blass Speech provides additional examples of when broker-dealer registration may be required in the private fund context with respect to both a fund's capital-raising activities and a fund's compensation for investment banking-type services associated with its sale of portfolio companies.

er/investor. In the SEC's view, activities such as preparing, marketing, and/or presenting sales-oriented materials to prospective buyers/investors go beyond merely making an introduction of the parties—Joe, meet Harry, see you later and don't forget to pay me my finder's fee. The SEC and most states consistently view this fact pattern as generally requiring the intermediary's federal and state broker-dealer registration. Finally, an intermediary's failure to disclose its unregistered status to either or both of the parties may be a violation of the antifraud prohibitions in Section 10(b) and Section 15(c) of the Exchange Act.

Importantly, the SEC has granted limited relief to M&A intermediaries and business brokers who may meet the "broker" definition through a small number of no-action letters, notably including *Country Business, Inc.*, *Victoria Bancroft*, and *International Business Exchange Corp*.[22] These no-action letters include a number of significant factual limitations but they are commonly relied upon by business brokers to conduct their activities without federal broker registration (states may or may not follow the SEC staff's guidance). For example, among the nine enumerated factual predicates in the *Country Business, Inc.* letter, the entire business must be sold, that business must meet the "small business" definition under the Small Business Administration's standards[23], and the intermediary may not talk about securities-related transaction structures (e.g., a purchase of stock versus a sale of assets). The SEC has also denied no-action relief in similar M&A contexts but without providing meaningful explanations,[24] perhaps reflecting the lack of factual detail in the requestors' letters.

If asked, many states may follow the SEC's no-action letter guidance, even though it is not binding on them; some states may impose their own conditions, while others may not grant any relief. State regulators are often unfamiliar with how the activities of an M&A Broker differ from those of investment banking or retail broker-dealers. Some states impose specific registration and related requirements on all types of finders.[25] Some states have broker-dealer registration exemptions when the owner/investor qualifies as an "institutional investor" as the term is defined in their blue sky law or rules.[26] California exempts by rule "any person who effects transactions in securities in this state only in connection with mergers, consolidations or purchases of corporate assets, and who does not receive, transmit, or hold for customers any funds or securities in connection with such transactions", generally referred to as a "merger and acquisition specialist".[27]

Regulatory Impacts

The burdens and costs of initial broker-dealer registration and on-going compliance with current SEC and FINRA requirements are substantial. Initial set-up and compliance-related costs often exceed $150,000. On-going compliance costs often exceed $75,000 per year.

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[22] *Country Business, Inc.*, 2006 SEC No-Act. LEXIS 669 (2006); *Victoria Bancroft*, 1987 SEC No-Act. LEXIS 2517 (1987); and *International Business Exchange Corp*. 1986 SEC No-Act. LEXIS 3065 (1986).

[23] Available on the Small Business Administration's website at: http://www.sba.gov/content/table-small-business-size-standards.

[24] *Hallmark Capital Corporation*, 2007 SEC No-Act. LEXIS 509 (2007); and *Mike Bantuveris*, 1975 SEC No-Act LEXIS 2158 (1975).

[25] *See, e.g.*, Texas Administrative Code, Title 7, Chapter 115, Section 115.11, *Finder registration and activities*; and Administrative Rules of South Dakota, Article 20:08, Section 20:08:03:17, *Finders*.

[26] *See, e.g.*, Section 401(b)(1)(C) of the Uniform Securities Act of 2002.

[27] *See* 10 CCR Section 260.204.5, 10 CA ADC Section 260.204.5, *Merger and Acquisition Specialists*, adopted in 1974.

Applying for and obtaining FINRA membership typically takes six to nine months, and frequently longer. There are competency exams that test on substantive material totally irrelevant to the professional knowledge base required to advise about M&A transactions. Accrual-based GAAP accounting is required and minimum net capital must be maintained at all times regardless of the ebbs and flows of transaction-related income and expenses. Monthly or quarterly financial reporting is required prepared by specially qualified financial and operations principals. Annually audited balance sheets and related schedules and attestations must be filed with the SEC and FINRA. Anti-money laundering programs, procedures, and independent third-party AML testing are required, even though M&A Brokers rarely, if ever, handle the parties' funds or securities. Membership in the Securities Investors Protection Corporation ("*SIPC*") is required and membership fees are assessed, even though M&A Brokers do not handle securities. The SEC, FINRA, and the states charge the firm annual registration fees and membership assessments based on the firm's gross revenues, as well as annual registration fees for each registered representative.

The body of existing SEC and FINRA rules impose significant requirements affecting every aspect of a broker-dealer's business ownership, staffing, marketing, operations, and recordkeeping. These rules have become highly complex over the years in response to, among other things, evolving financial markets, major securities frauds, national financial crises, and perceived regulatory gaps. This "one size fits all" body of regulation has been written largely to address investor protection in the context of retail brokerage services and investment banking services for publicly traded companies. Most of the SEC's and FINRA's rules and related guidance require "translation" when applied in the M&A and business brokerage context. For example, FINRA's "know your customer" and "suitability" rules must be applied to "customers" in the context of transactions between business buyers and sellers. Even the basic registration application, Form BD, does not explicitly identify either M&A or investment banking activities as a category of regulated activities—in Item 12 of the form the registrant must mark "Private placements of securities", "Other", and explain its activities in a supporting schedule. Newly released regulatory guidance comes from FINRA weekly and must be monitored for changes pertinent to the narrowly focused activities of M&A Brokers.

All of this complexity and cost disproportionately impacts smaller businesses and the professional intermediaries who serve them because they typically handle smaller transactions that generate smaller success fees, so they are less able to spread these fixed costs over multiple transactions. The commitment of management and staff time, as well as largely fixed compliance-related costs, are annually required to maintain registered status regardless of the number of securities-regulated business sale transactions closed by the M&A Broker in any given year, which for smaller firms may be one or perhaps two per year since smaller M&A transactions are often cash-for-assets sales not regulated under securities laws. Substantially all of these costs are necessarily passed on to the business sellers and buyers who use the registered broker-dealer's services. These high costs drive some business sellers and buyers to engage unregistered M&A Brokers if they want professional assistance with their transactions.

Regulatory Reform

"Right-sizing" federal regulation of M&A Brokers and finders has been among the top recommendations in the 2006, 2007, 2008, 2009, 2010, and 2011 Government-Business

Forum on Small Business Capital Formation hosted by the SEC[28] at the direction of Congress (the topic of M&A Brokers and finders was not on the SEC's agenda for the 2012 forum). The Final Report of the Advisory Committee on Smaller Public Companies (2006), reached the same conclusion in Recommendation IV.P.6, page 81[29], as did the Report and Recommendations of the Private Placement Broker-Dealer Task Force of the Business Law Section of the American Bar Association.[30]

In light of this well-articulated need, in 2006 the Alliance of Merger and Acquisition Advisors ("*AM&AA*"), with the support of the International Business Brokers Association, the M&A Source, and 14 regional professional associations of M&A Brokers began developing and actively seeking a simplified system of "broker" registration and regulation under the Exchange Act for M&A Brokers advising buyers or sellers in purchases, sales, mergers, and acquisitions of privately-owned companies ("*Private M&A Transactions*"). The AM&AA developed and presented proposed rules to the SEC staff in March 2007. The rulemaking proposal was expanded in March 2008 to add a proposed codification of the *Country Business, Inc*. no-action letter into an SEC rule defining circumstances when no type of broker registration would be required. On a parallel track, the AM&AA also developed and presented proposed model state rules to the North American Securities Administrators Association ("*NASAA*") to develop a coordinated and complementary system of simplified state registration and regulation in March 2007. The model rule proposal was expanded in March 2008 to create a model state-level codification of the *Country Business, Inc*. no-action letter.

The primary objective of the proposed SEC rule was to create an exemption from SEC registration and FINRA membership for a defined class called an "M&A Broker" and its associated persons who are involved in qualifying transactions.[31] A qualifying transaction would include the purchase, sale, or business combination conveying ownership of a business, regardless of the transaction's legal structure, to one or more eligible buyers acting alone or in concert. As defined, an eligible buyer would include among others a person (corporate or natural) who will be actively involved in the corporate governance, management, and operation of the business with access to substantially all of its financial, accounting, tax, and other books and records. No minimum ownership percentage would be prescribed. No publicly traded securities could be sold. Other conditions are spelled out in the SEC rulemaking proposal.

Important investor protections would be preserved and some new ones would be added. Existing state-level registration and regulation would be simplified by the proposed model state rule, thus assuring continuing regulatory oversight.[32] Existing broker-specific anti-fraud

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[28] Available on the SEC's website at http://sec.gov/info/smallbus/sbforum.shtml.

[29] Available on the SEC's website at http://sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

[30] The ABA PPB Task Force Report is available on the SEC's website at http://sec.gov/info/smallbus/2009gbforum/abareport062005.pdf.

[31] Section 15(a)(2) of the Exchange Act authorizes the Commission to exempt any class of brokers from the registration requirements of Section 15(a)(1). Similarly, Section 15(b)(9) authorizes the Commission to exempt any class of brokers from the self-regulatory organization membership requirements of Section 15(b)(8) of the Exchange Act. Section 15(c)(3) authorizes the Commission to establish minimum financial responsibility requirements for all brokers and an amendment to SEC Rule 15c3-1 would define the minimum financial responsibility requirements of an M&A Broker.

[32] Section 412, *Rules, Forms, Orders, and Hearings*, of the Uniform Securities Act of 1956 and Section 605, *Rules, Forms, Orders, Interpretative Opinions, and Hearings*, of the Uniform Securities Act of 2002 authorize the administrator to define terms and classify securities, persons, and transactions, and adopt different requirements for different classes.

prohibitions would continue, as would regulatory jurisdiction to conduct examinations and inspections of the firm and its associated persons. An annual regulatory filing with simplified prescribed content would be made in the M&A Broker's home state, together with the state's prescribed filing fee. The existing WebCRD System or a simplified electronic filing system would be used for all filings. A compliance manual and simplified books and records would be required, including a "client complaint" file, and subject to regulatory examination. The firm and its associated persons would be required to satisfy qualifications and requirements imposed by the M&A Broker's home state securities laws and related rules. Prior to closing a transaction within the jurisdiction of another state, a copy of the M&A Broker's home state filings would be notice-filed there, together with that state's prescribed filing fee. While no minimum net capital, financial reporting, or bonding would be required, the firm would have to be solvent and maintain financial records. New investor protections would be added, including requiring a written engagement and delivery of a disclosure document describing the firm, its associated persons, their services, relevant disciplinary events, and any associated conflicts of interest. Various permitted, prohibited, and unethical business practice relevant in the M&A context would also be prescribed by the proposed SEC and model state rules.

Similar to the Congressionally-mandated allocation of federal and state regulation of "investment advisers," the proposed SEC and model state rulemaking is believed to represent an appropriate allocation of limited federal and state regulatory resources. The nature of Private M&A Transactions lessens the need for extensive regulatory oversight of M&A Brokers. Unlike passive investors in other types of private placements of securities, private business buyers and sellers are typically knowledgeable and involved in the business to be bought or sold and they are each advised by their own lawyers and/or accountants. Indeed, merger and acquisition transactions involving privately owned companies are typically "lawyered-up". The larger the transaction, the more professional hours of lawyers and accountants are spent on investigating, negotiating, documenting, and closing the transaction, often without significant involvement from the M&A Broker. The M&A Broker rarely, if ever, handles the cash, securities, or other consideration exchanged in the transaction; these functions are typically handled by the parties through their respective banks and legal counsel. Statutory antifraud prohibitions would continue to protect buyers and sellers in addition to their negotiated contractual remedies. Regulators would retain examination and enforcement jurisdiction. Professional qualifications and licensing under state real estate and business brokerage laws would be unaffected by the proposals. These proposals, in full text, accompany this article or are available upon request.

Since the rulemaking proposals were presented in 2008, a number of meetings have been held, respectively, with the SEC staff and with representatives of NASAA. Informal communications have been generally favorable and supportive, but without timetables or any commitments. The SEC and NASAA have also been in direct communication, including their annual SEC-NASAA "Section 19d" meetings. Inquiries about FINRA's position have also been made. Informally, a senior FINRA official expressed his view that FINRA had no regulatory interest or ability to recoup its costs of bringing several thousand, if not tens of thousands, of small, widely geographically disbursed M&A Brokers into its regulated population and periodically examining them. He also indicated that FINRA had conveyed this view to the SEC staff when they asked.

Good progress is believed to have been made behind the scenes, but in the absence of visible progress a bipartisan group of Congressmen wrote to then SEC Chairman

Schapiro in December 2011 asking about the status of the SEC's consideration of the recommendations from the SEC-Government Small Business Capital Formation Forums. Chairman Schapiro's response to the Congressmen and her response to a similar question for the record following her December 2011 Senate testimony were encouraging. Specifically, in response to the Senate question for the record, Chairman Schapiro wrote:

> The staff of the Division of Trading and Markets, which is primarily responsible for administering the regulation of brokers and dealers, is analyzing the SEC's rules and regulations that apply to business brokers. The Division staff is developing options that it could recommend that the Commission consider to revise those regulations in light of the role that business brokers play in the purchase, sale, exchange or transfer of the ownership of privately owned businesses. The Division staff is also revisiting existing guidance about whether certain business brokers must be registered with the SEC as brokers in order to determine whether the Commission or the staff should provide further guidance in this area. We are mindful of the importance of considering both the burdens on small businesses' capital formation arising from our regulatory requirements and the benefits of those requirements to investors and other market participants.

Despite this encouragement, in the last two plus years the SEC has continued to be backlogged by the rulemaking and studies prescribed by the Dodd-Frank Act and the JOBS Act. During the last six years there has continued to be a significant turn-over of personnel at the SEC, including two chairmen, several commissioners, several directors of the Division of Trading and Markets, and multiple staff attorneys assigned to the Division, greatly impacting corporate continuity and internal priorities. The new SEC chairman has already begun to make more senior staffing changes.

Legislative Solution

With the timing of SEC rulemaking still uncertain, on June 6, 2013, H.R. 2274, the *Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013*,[33] was introduced in U.S. House of Representatives with bi-partisan co-sponsors and referred to the Committee on Financial Services. On June 12, 2013, the Subcommittee on Capital Markets and Government Sponsored Enterprises convened a hearing entitled, "*Reducing Barriers to Capital Formation*",[34] which among other topics included testimony by this author about the bill.

Unlike the previously proposed SEC and model state rulemaking, if enacted, H.R. 2274 would direct the SEC to create a simplified system of broker-dealer registration through a public notice filing with the SEC. H.R. 2274 would also direct the SEC to tailor its rules governing M&A brokers in light of the limited scope of their activities, the nature of privately negotiated M&A transactions, and the active involvement of buyers and sellers in those transactions. The bill contains a financial "size cap" defining eligible private small and mid-sized businesses that is easily measured before an engagement commences, permitting an M&A broker to embark upon a lengthy engagement without being concerned about its ultimate legal structure.

[33] The text and status of H.R. 2274 is available at http://www.govtrack.us/congress/bills/113/hr2274.

[34] Archived video and written statements of the hearing are available on the Committee's website at: http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=336906.

Important investor protections would be added and preserved by the bill. The notice-filed registration would be publicly available on the SEC's website. Similar to today's disclosure requirements for registered investment advisers, H.R. 2274 would require the delivery of a client disclosure document, the content of which would be prescribed by the SEC working with NASAA. The content would likely describe the M&A brokerage firm, its associates and credentials, its services and fees, and any potential conflicts of interest. These client disclosures would significantly aid a prospective client's decision-making to engage an M&A broker. Federal law would continue to control the capital, custody, financial responsibility, recordkeeping, bonding, and financial or operational reporting requirements applicable to M&A brokers, tailored by the SEC to their circumstances. Statutory disqualifications from registration would continue to apply. The SEC, in coordination with NASAA, could establish uniform and consistent standards of training, experience, competence, and qualifications for the associates of M&A brokers, which would be described in the client disclosure document. M&A brokers could not have custody of the funds or securities exchanged by the parties. An M&A broker could not be involved in capital-raising beyond the context of M&A transactions and could not be engaged by an issuer in a public offering of its securities. M&A brokers would be exempt from membership in and regulation by FINRA. Existing state securities laws would continue to apply.

This proposed legislative solution is intended to clarify compliance requirements applicable to M&A brokers. The perception of public protection under the existing regulatory regime is illusory because most M&A brokers today are not registered as broker-dealers, even though most should be in order to provide services beyond the limited relief granted by the SEC in the *Country Business* and *International Business Exchange Corporation* no-action letters. A simplified system of registration and regulations would bring more M&A brokers into compliance and relevant information about them available to the public.

Finally, if enacted as proposed, H.R. 2274 would bring clarity for registered investment banking firms who would like to pay or receive compensated client referrals from M&A brokers, thus better assuring that small business clients could be cost-effectively served by appropriately regulated brokers. Because M&A brokers would be SEC-registered, it would alleviate the uncertain status of referral fees paid for business sale engagements to unregistered M&A brokers under NASD Rule 2420, *Dealing with Non-Members*, and related FINRA guidance.[35]

Looking Ahead

Regulatory reengineering is urgently needed to lower regulatory costs incurred by smaller privately held businesses and the M&A professionals who serve them. A high Congressional priority has been the critical need to preserve and create jobs in order to fuel our nation's economic recovery. Today, jobs preservation and growth would be significantly boosted by assuring that retiring baby boomers and aspiring younger entrepreneurs can be professionally and cost-effectively advised by competent M&A intermediaries. An estimated $10 trillion of wealth is passing between these generations. Reducing the cost of professional business brokerage services to privately-owned companies would facilitate an efficient, free-flow of capital between business buyers and sellers. Investor protections can not only be preserved but enhanced be-

[35] See also FINRA Regulatory Notice 09-69, *Payments to Unregistered Persons*.

cause today most of the public and thousands of unregistered intermediaries do not—or choose not to—know they are regulated as a broker-dealer under federal and state securities laws just like all other registered investment banking firms, regardless of their size, the size of their transactions, or the number of transactions brokered in any year.

While hopes remain high for a rulemaking solution, the SEC's timing remains uncertain. If enacted, H.R. 2274 would Congressionally mandate SEC rulemaking to address this important small business issue. In the meantime, several states have already undertaken finder-related rulemaking, while others like California have exemptions from broker-dealer registration, but a patchwork of inconsistent regulation under existing state securities laws is developing. Prompt regulatory reform is urgently needed and, as proposed, H.R. 2274 should coalesce the effort around a well understood and uniform method of M&A broker registration.

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U.S. Securities and Exchange Commission

SEC Charges Private Equity Firm, Former Executive, and Consultant for Improperly Soliciting Investments

FOR IMMEDIATE RELEASE
2013-36

Washington, D.C., March 11, 2013 — The Securities and Exchange Commission today announced charges against New York-based private equity firm Ranieri Partners, a former senior executive, and an unregistered broker who violated securities laws when soliciting more than $500 million in capital commitments for private funds managed by the firm.

Additional Materials

- SEC Order: William M. Stephens
- SEC Order: Ranieri Partners LLC and Donald W. Phillips

The federal securities laws require that an individual who solicits investments in return for transaction-based compensation be registered as a broker. An SEC investigation found that William M. Stephens of Hinsdale, Ill., solicited investors as a hired consultant for Ranieri Partners and was paid fees by the firm, but never registered as a broker. Stephens' longtime friend Donald W. Phillips, a senior managing director who headed up capital raising efforts for Ranieri Partners, was responsible for overseeing Stephens' activities as a purported "finder" who would merely make initial introductions to potential investors. But Stephens' role went far beyond that of a finder. He consistently communicated with prospective investors and their advisors and provided them with key investment documentation that he received from Ranieri Partners.

Ranieri Partners, Phillips, and Stephens agreed to settle the SEC's charges.

"Registered brokers are subject to SEC oversight and examinations in order to monitor their conduct and protect the interests of investors," said Merri Jo Gillette, Director of the SEC's Chicago Regional Office. "Investors in Ranieri Partners' funds were denied these protections because Stephens acted outside the boundaries of the law, and Phillips and the firm ignored the essence of his activities."

According to the SEC's orders instituting settled administrative and cease-and-desist proceedings, Stephens engaged in the business of effecting transactions in securities in several ways despite not being registered as a broker or affiliated with a registered broker-dealer. Stephens sent private placement memoranda, subscription documents, and due diligence materials to potential investors, and urged at least one investor to consider adjusting portfolio allocations to accommodate an investment with Ranieri

Partners. Stephens provided potential investors with his analysis of the strategy and performance track record for Ranieri Partners' funds, and also provided confidential information identifying other investors and their capital commitments. The SEC charged Stephens with violating Section 15 (a) of the Securities Exchange Act, which requires people acting as brokers to be registered with the SEC.

The SEC's order against Phillips and Ranieri Partners found that Phillips, who lives in Barrington, Ill., aided and abetted Stephens' violations by providing Stephens with key fund documents and information while ignoring red flags indicating that Stephens had gone well beyond the limited role of a finder and was actively soliciting investments. The order found that Ranieri Partners caused Stephens' violations.

In settling the SEC's charges, Ranieri Partners agreed to pay a penalty of $375,000, Phillips agreed to pay a penalty of $75,000, and Stephens agreed to be barred from the securities industry. The SEC's orders require each of them to cease-and-desist from further violations of Section 15(a). The SEC also suspended Phillips from acting in a supervisory capacity at an investment adviser or broker-dealer for nine months. Ranieri Partners, Phillips and Stephens consented to the entry of the SEC's orders without admitting or denying the findings.

The SEC's investigation was conducted by Jason Howard, Steven L. Klawans and John J. Sikora, Jr., in the Chicago Regional Office with assistance from examiners John T. Brodersen and Eric P. Donofrio.

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http://www.sec.gov/news/press/2013/2013-36.htm

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SHANE B. HANSEN
BIOGRAPHICAL SUMMARY

SHANE B. HANSEN is a partner and co-chairs the Broker-Dealer and Investment Adviser Practice Group in the law firm of Warner Norcross & Judd LLP. His law practice concentrates in the area of financial services regulation, primarily including federal and state securities and banking laws and related rules. He advises banks, broker-dealers, M&A and business brokers, investment advisers, investment managers, private fund advisers, financial planners, and registered representatives about a wide range of business, corporate, contract, compliance, and regulatory topics. He has substantial experience involving formations, mergers, acquisitions, and sales of financial services firms. He was recognized in *The Best Lawyers in America®, Corporate Law and Securities Regulation, 2007 through 2012 editions* and named a "super lawyer" in the 2006, 2007, and 2009 through 2012 editions of *Michigan Super Lawyers®*.

Mr. Hansen chairs the Committee on State Regulation of Securities in the Business Law Section of the American Bar Association (2011-present). The committee is comprised of more than 600 lawyers, paralegals, state regulators, and law professors from around the country. He also co-chairs its Subcommittee of Liaisons to Securities Administrators in the U.S. and Canada (2007-present), producing an annual report on state securities law developments. He is an active member of the ABA's Committee on Federal Securities Regulation and the State Bar of Michigan's Securities and Financial Institutions Committees. Other professional memberships and associate memberships include the Compliance and Legal Society of the Securities Industry and Financial Markets Association (SIFMA), the Financial Services Institute (FSI), the Investment Adviser Association (IAA), the Financial Planning Association (FPA), and the National Society of Compliance Professionals (NSCP). Mr. Hansen graduated with honors from the University of Michigan Law School in 1982. He graduated with high honors from Albion College in 1979.

Warner Norcross & Judd LLP is a full service law firm with over 220 attorneys practicing from offices located in Grand Rapids, Southfield, Holland, Muskegon, Lansing, and Sterling Heights, Michigan. The firm's Broker-Dealer and Investment Adviser Practice Group is an interdisciplinary group of attorneys with experience dealing in the full range of matters and issues that are important to broker-dealers, investment advisers, financial planners, merger and acquisition intermediaries, finders, and others who may be subject to federal and state securities laws, rules and regulations, as well as FINRA rules, regulation, and enforcement. Client matters include corporate, contracts, formation and registration, compliance, mergers and acquisitions, as well as responding to examination deficiencies, enforcement, customer arbitration, and litigation. Other client matters include human resources, labor, and benefits, trusts and estates, and tax. The firm represents a wide range of clients from large to small, with various business models, and located in various parts of the country.

More information about Shane and the law firm can be found on the Internet at: www.wnj.com. He can be reached at 616-752-2145 or shansen@wnj.com. 9047941-3/22/2013