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BACKGROUNDER

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Don't Overregulate Business Brokers

David R. Burton

Abstract

Business brokers make the market for closely held small businesses more efficient, by helping entrepreneurs to sell their business for full value and by helping aspiring business owners find business opportunities that match their skills and financial resources. The current Securities and Exchange Commission (SEC) position on who should be required to register as a securities broker-dealer is overbroad and significantly exceeds the scope of the statutory requirement. The SEC or Congress needs to clarify that business brokers are not subject to the burdensome securities broker-dealer regulations. The best means of accomplishing this is to exempt business brokers helping to buy and sell small businesses from the broker-dealer requirements. Proposals to register and reasonably regulate business brokers are constructive, but not the best solution.

In contrast to its practice for most of its history, current Securities and Exchange Commission (SEC) policies seek to subject business brokers to the same complex and expensive regulatory regime as large Wall Street broker-dealers. This policy has a significant negative impact, particularly on small businesses. Business brokers make the market for closely held small businesses more efficient, by helping entrepreneurs sell their businesses for full value and by helping aspiring business owners to find business opportunities that match their skills and financial resources. The current regulatory ambiguity surrounding business brokers impedes small firms' ability to raise capital and adversely affects economic growth and

Key Points

- Business brokers help small business owners achieve full value when they sell their businesses.
- Business brokers help aspiring entrepreneurs find businesses to buy that match their skills and financial resources.
- The Securities and Exchange Commission (SEC) is seeking to regulate business brokers as if they were large Wall Street broker-dealers.
- The current regulatory ambiguity surrounding business brokers impedes small firms' ability to raise capital and adversely affects economic growth and job creation because more sophisticated investors such as venture capital funds will be reluctant to get involved with firms that have used business brokers in the past.
- Preferably, the SEC or Congress should exempt most business brokers from the securities broker-dealer registration requirements.
- A second best alternative is for Congress to create a reasonable regulatory regime for business brokers.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2883**

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

job creation. This problem can best be addressed by providing either a statutory or regulatory exemption for business brokers.

A Business Broker, Not a Broker-Dealer

Section 3(a)(4)(A) of the Securities Exchange Act defines a broker generally as "any person engaged in the business of effecting transactions in securities for the account of others."[1] Section 3(a)(5)(A) defines a dealer generally as "any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person's own account through a broker or otherwise."[2] Each definition contains a long list of exceptions, generally for the benefit of banks. Section 15 requires brokers or dealers to register with the SEC.[3]

Business brokers fall outside the definition of securities broker-dealers, and until recently, the SEC has agreed. Business brokers are in the business of buying and selling businesses, usually small businesses. They do not trade stocks and bonds on behalf of customers. Often, the transaction involves the sale of the assets of the business. Sometimes, however, the business owner prefers to sell his or her stock because that is simpler, or for tax reasons. Whether they can do so should not be a function of rules meant to govern stock brokers.

Transaction-Based Compensation

The SEC appears to believe that structuring compensation so that it is "transaction-based" will almost always necessitate registration as a broker-dealer, barring some specific statutory exemption (usually for banks). This is both an incorrect reading of the law and bad public policy. Transaction-based compensation is compensation that is determined as a percentage of the sales price and is contingent on the sale actually occurring.

The statutory definitions of a broker and a dealer make absolutely no mention of the type or nature of compensation involved. The primary focus of the law is whether the person is "engaged in the business" of "effecting transactions in securities" for the account of others. Thus, the focus on transaction-based compensation is an unwarranted regulatory creation of the SEC. Significantly, a number of federal courts have recently rejected the SEC's view that transaction-based compensation definitively requires registration as a broker-dealer.[4] SEC staff analysis appears to center on concerns about "conflict of interest."[5] However, for small businesses trying to raise capital or sell their business, success-based compensation usually creates a commonality of interest between the business broker and the broker's principal rather than a conflict of interest. With success fee compensation, the business broker has the same interest as his or her small business principal: selling the business for the best price. With other forms of compensation, the business broker simply has an interest in being paid. Transaction-based compensation is not regarded as a problem for real estate brokers, commodities brokers, or insurance brokers as long as it is made clear for whom the broker works (i.e., it is not a case of dual agency).[6]

A business-broker representing a seller does not have any fiduciary duty to the buyer. They have a duty of fair and honest dealing, as does the business

1. 15 U.S. Code § 78c(a)(4)(A).
2. 15 U.S. Code § 78c(a)(5)(A).
3. 15 U.S. Code § 78o.
4. For example, see *SEC v. Kramer,* 778 F. Supp. 2d 1320 (M.D. Florida, 2011); *Foundation Ventures LLC v. F2G Ltd.*, 2010 WL 3187294 (S.D.N.Y., 2010); *Salamon v. Teleplus Enterprises Inc.*, 2008 WL 2277094 (D.N.J., 2008); and *Cornhusker Energy Lexington LLC v. Prospect Street Ventures*, 2006 WL 2620985 (D. Neb., 2006).
5. "The SEC and SEC staff have long viewed receipt of transaction-based compensation is a hallmark of being a broker. This makes sense to me as the broker regulatory structure is built, at least in large part, around managing the conflict of interest arising from a broker acting as a securities salesman, as compared to an investment adviser which traditionally acts as a fiduciary and which should not have that same type of conflict of interest." David W. Blass, "A Few Observations in the Private Fund Space," remarks before the Trading and Markets Subcommittee, American Bar Association, Washington, DC, April 5, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1365171515178#.Ut6JHNIo5R0 (accessed January 21, 2014).
6. Dual agency is when a broker represents both the buyer and the seller. This obviously creates conflicts of interest although both parties may choose to consent to it to reduce costs or for other reasons.

owner, imposed by other provisions in the securities law[7] and, for that matter, the common law and many state statutes. But that constraint creates no conflict of interest.

In fact, success-based compensation is generally preferable to other forms of compensation in the context of small firms. Allowing small business owners to pay a business brokerage fee to someone who actually did what they said they would do and helped to sell a business is one thing. Forcing business owners to pay business brokers whether or not they were successful is another. If the regulation's aim is to prevent misrepresentation, fraud, and false dealing, paying people for actually doing what they said they would do is preferable to forcing business owners to guess whether the person will deliver. Moreover, capital-starved small businesses are not generally in a position to pay consultants who do not deliver.

The regulatory effort to channel these activities to registered broker-dealers—with their attendant large fees—or to consultants who bill on a basis other than actual success benefits large issuers and broker-dealers, but harms small business seeking to grow.

The SEC Position Is Overbroad

The current SEC position on who should be required to register as a broker-dealer is overbroad and significantly exceeds the scope of the statutory requirement. The SEC *Guide to Broker-Dealer Registration* illustrates the point. The *Guide* suggests that those "finding investors," "making referrals," "finding buyers and sellers of businesses," or participating "in important parts of a securities transaction" "may need to register" as brokers. This is significantly beyond the scope of the statutory definition of a broker, to wit, "any person engaged in the business of effecting transactions in securities for the account of others."[8]

These criteria are so broad that almost anybody involved in the transaction would be required to register as a broker-dealer. The issuer's accountant and attorney play an "important part" in a securities transaction, as might a business broker. The "important part" standard enunciated by the SEC is simply inconsistent with the statutory standard.

The current SEC position is also a relatively recent innovation dating from the withdrawal of the 1985 Dominion Resources no-action letter in 2000.[9] For the previous six and half decades, the SEC position was substantially different than its position for the past 13 years.

The inconsistency of the current SEC position with both the underlying statute and previous SEC practice combined with the lack of clear regulatory standards has introduced significant regulatory uncertainty into the analysis of whether registration is required and in what activities unregistered persons may engage. Most importantly, it impedes small firms' ability to access needed capital both by restricting the availability of business brokers and by causing potential problems when successful small firms later seek venture capital or public financing and encounter counsel raising questions about their prior use of business brokers.[10]

Solutions

There are two primary means of addressing this problem: a statutory or regulatory exemption from the broker-dealer registration requirements for business brokers or a different, simpler registration and regulatory regime for business brokers that does not require them to register as broker-dealers.

A Business Broker Exemption. A business broker exemption could be provided by SEC regulation or by legislation. Such an exemption should be consistent with the principles of the Country Business no-action letter dated November 8, 2006,[11] but

7. Most notably, Section 10 of the Securities Exchange Act. 15 U.S. Code § 78j.
8. U.S. Securities and Exchange Commission, *Guide to Broker-Dealer Registration,* April 2008, http://www.sec.gov/divisions/marketreg/bdguide.htm (accessed January 21, 2014).
9. For a discussion of previous SEC practice, see the American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker-Dealers," June 20, 2005, http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf (accessed January 21, 2014). See also John Polanin Jr., "The 'Finder's' Exception from Federal Broker-Dealer Registration," *Catholic University Law Review*, Vol. 40, No. 4 (Summer 1991), p. 787.
10. It should be noted that the use of "finders" or "private placement brokers" raises the same concerns.
11. Brian A. Bussey, "Country Business, Inc. Request for No-Action Relief," letter to Craig McCrohon, November 8, 2006, http://www.sec.gov/divisions/marketreg/mr-noaction/cbi110806.htm (accessed January 21, 2014).

extended to include the sale of a controlling interest in the business rather than being limited to the sale of the entire business.

Such an exemption would require that:

1. The business broker has a limited role in negotiations between the seller and potential purchasers or their representatives;
2. The business broker does not have the power to bind either party in the transaction;
3. The business being sold is a going concern and not a "shell" organization;
4. The business being sold satisfies the size standards for a "small business" pursuant to the small business size regulations issued by the U.S. Small Business Administration;
5. Only assets will be advertised or otherwise offered for sale;
6. If the transaction is effected by means of securities, it will convey a controlling interest of the business's equity securities to a single purchaser or group of purchasers;
7. The business broker does not advise the two parties whether to issue securities (or otherwise effect the transfer of the business by means of securities) or assess the value of any securities sold, other than by valuing the assets of the business as a going concern;
8. The business broker's compensation will be determined prior to the decision on how to effect the sale of the business, will be a fixed fee, hourly fee, a commission, or a combination thereof that is based upon the consideration received by the seller, regardless of the means used to effect the transaction and will not vary according to the form of conveyance (i.e., securities rather than assets); and
9. The business broker will not assist purchasers with obtaining financing, other than providing uncompensated introductions to third-party lenders or help with completing the paperwork associated with loan applications.

The contemplated business broker exemption should bar those subject to a statutory disqualification from using the exemptions.[12]

Alternatively, Congress could enact a substantially similar statutory exemption.

Business Broker Registration and Regulation. The exemption approach is preferable to an approach that requires registration of business brokers. First, such a registration requirement would create needless compliance costs and complexity, and small businesses would ultimately bear these costs. In contrast, an exemption approach is effectively self-administering and simple. The only costs incurred in an exemption approach are those necessary to ensure that the business broker is operating within the scope of the exemption. Second, it is unclear what the SEC would really do with such registrations or how and on what basis it would regulate or impose sanctions on business brokers. To the extent it starts applying broker-dealer type requirements to business brokers, the benefits of creating a more lightly regulated business broker category will evaporate. Given the complexity of the SEC regulations implementing the Jumpstart Our Business Startups (JOBS) Act,[13] which was meant to reduce the regulatory burden on entrepreneurs, this is a highly likely outcome. Third, a registration requirement will require the expenditure of taxpayer funds to administer the new regulatory regime.

Nevertheless, a business broker registration and regulation regime is superior to the current situa-

12. See Securities Exchange Act, § 3(a)(39) [15 U.S. Code § 78c(a)(39)]. Obviously, the scope of the unavailability could be narrowed or broadened, but dovetailing the unavailability of the exemptions to the statutory disqualification language seems reasonable.
13. Jumpstart Our Business Startups Act, Public Law 112–106 (April 5, 2012). The SEC regulation of crowdfunding portals is a cautionary example. Congress created a "funding portal" regulatory category meant to be more lightly regulated than broker-dealers. The SEC recently released a 585-page proposed rule that would impose such heavy regulation on funding portals that few intermediaries will likely choose this path. Instead, broker-dealers will probably dominate crowdfunding to the extent that it gets off the ground under the weight of the regulation of crowdfunding issuers and intermediaries. See David R. Burton, "File No. S7-09-13, 'Crowdfunding,'" February 3, 2014, http://www.sec.gov/comments/s7-09-13/s70913-192.pdf (accessed February 5, 2014).

tion, provided that the regulation of business brokers is reasonable. The Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013 (H.R. 2274) is an example of a reasonable business broker registration regime. This legislation was reported out of the House Financial Services Committee on a bipartisan basis on November 14, 2013. It would improve the current situation of business brokers and their small firm clients who are in sustained legal limbo because of the uncertain state of the law.

This proposal would create a new regulatory category called "Merger and Acquisition Brokers" or "M&A Brokers" and allow, but not require, M&A brokers to register with the SEC. Registering as a business broker would be substantially less burdensome than registering as a securities broker-dealer. The M&A broker provisions would generally apply only where at least 25 percent of voting securities or capital of a privately held company with revenues of less than $250 million annually or earning less than $25 million annually was being sold.

Under this proposal, the SEC would determine what information would be required in the registration application. This information would be publicly available. The registration would be effective immediately, unless the prospective M&A broker was disqualified for one of several enumerated reasons, such as being barred from the securities field by the SEC or committing a felony involving the securities law. The bill would preempt applicable state laws.

The proposal explicitly permits M&A brokers to engage in certain activities, explicitly prohibits others, and instructs the SEC to make "tailored application" of still others. For example, holding customer funds or being involved with the sale of registered (i.e., public) securities is prohibited. It would be some time before the combination of the SEC rulemaking process, SEC staff-issued no-action letters, and litigation determines how all of this would work in practice.

The bill gives the SEC 180 days to issue regulations implementing the bill and to "codify the interpretative guidance issued by the SEC staff in the no-action letter to International Business Exchange Corporation dated December 12, 1986[14] and in the no-action letter to Country Business dated November 8, 2006."[15] These no-action letters indicate the position of the SEC staff that these two business brokers need not register as broker-dealers if they sold a business and met a series of criteria, including advertising only the sale of assets, the sale to only a single purchaser, and so on. This, of course, is highly constructive compared with the present ambiguity.

However, it is not clear how the effective exemptions from broker-dealer registration requirements created by these no-action letters, which would now be codified, would co-exist with the registered M&A broker rules created by the bill. Nor is it clear how the sale, for example, of a controlling interest in a business that was nevertheless less than 100 percent of the business would fare under the proposed codification.

Conclusion

It is time for Congress, the SEC, or both to clarify the regulatory environment in which business brokers operate. Preferably, this will be done by exempting business brokers from the broker-dealer registration requirements. Alternatively, Congress can create a reasonable regulatory regime for business brokers. Doing so will help small business owners realize full value for their business, help aspiring entrepreneurs buy businesses appropriate for their skills and financial resources, and eliminate an impediment to small firms raising capital.

*—**David R. Burton** is Senior Fellow in Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

14. Edward L. Pittman, letter to Bobby J. Johns, December 12, 1986, http://www.scribd.com/doc/159787172/International-Business-Exchange-Corporation (accessed January 21, 2014).
15. Bussey, "Country Business, Inc. Request for No-Action Relief."