SEC Staffer Highlights Private Fund and Private Equity Broker-Dealer Issues

On April 5, 2013, David Blass, Chief Counsel of the SEC's Division of Trading and Markets (which regulates broker-dealers), gave an important speech highlighting two "significant areas of concern" about broker-dealer registration which private fund sponsors should consider. The Securities Exchange Act of 1934 (the "1934 Act") defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." The SEC is currently conducting "presence exams" of newly registered investment advisers, including advisers to hedge funds and private equity funds. In connection with these exams, the SEC has noted the practice of private fund sponsors paying transaction-based compensation to personnel for selling fund interests or having personnel whose only or sole functions are to sell interests in the sponsor's funds. Blass also described the practice of PE sponsors receiving transaction-based compensation for providing investment banking services relating to the sponsor's portfolio companies. Blass urged private fund sponsors to consider these issues before SEC examiners arrive. Our experience to date with presence exams confirms that the SEC is focusing on these issues.

Sales of Interests in Private Funds

Blass stated that activities such as marketing interests in a private fund or soliciting or negotiating transactions with respect to those interests might require private fund personnel to register as a broker-dealer, noting that "the importance of each of these activities is heightened where there also is compensation that depends on the outcome or size of the securities transaction." This aspect of Blass's remarks is potentially of interest to all private fund managers in connection with fundraising activities, including managers of private equity funds, hedge funds, real estate funds and private funds of funds. As reported in our Alert of March 13, 2013, the SEC recently announced the settlement of enforcement proceedings against a private equity firm, one of its partners and an unregistered finder, for the finder's solicitation of more than $500 million in capital commitments for two private funds in violations of the broker-dealer registration provisions of the 1934 Act. Blass observed that these cases "demonstrate that there are serious consequences for acting as an unregistered broker, even where there are no allegations of fraud." The fund sponsor paid a penalty of $375,000, the partner paid a penalty of $75,000 and agreed to a nine month suspension from acting in a supervisory capacity at an investment adviser or a broker-dealer, and the finder agreed to be barred from the securities industry. Additionally, Blass suggested that an investor may have the right to rescind its investment in a fund if the investment transaction was consummated using an unregistered broker-dealer.

Blass suggested some questions about private fund fundraising activities—which are the same type of questions the SEC asks in considering whether broker-dealer registration is required. These questions include the following:

--How does the adviser solicit and retain investors? What are the duties and responsibilities of personnel performing solicitation and marketing efforts? In that connection, Blass noted that the presence of a dedicated sales force of sponsor employees "may strongly indicate that they are in the business of effecting transactions in the private fund, regardless of how the personnel are compensated."

--Do employees who solicit investors have other responsibilities? If so—what are they and what are their primary functions?

--How are personnel who solicit investors for a private fund compensated?

In his address, Blass referred briefly to Rule 3a4-1 under the 1934 Act, a non-exclusive safe harbor under which associated persons of an issuer can participate in the sale of an issuer's securities without being considered a broker. Blass stated that the rule is generally not used by private fund advisers, presumably because the associated persons must have substantial duties for the issuer other than in connection with transactions in securities, and may not participate in selling an offering of securities more than once every 12 months. However, Blass did state he would be interested in hearing whether a broker-dealer registration exemption written specifically for private fund advisers is needed and would be helpful.

Payment of Investment Banking Fees to PE Fund Sponsors

A second focus of Blass's remarks is of interest primarily to private equity fund managers that may receive transaction fees in connection with their advisory activities. Blass said that the practice of a portfolio company paying fees to a fund sponsor in connection with the company's acquisition, disposition (including an IPO), or recapitalization, raises broker-dealer registration issues because such fees are compensation for negotiating securities transactions and identifying and soliciting purchasers or sellers of securities of the company, or structuring transactions. Presumably referring to the dialogue the SEC staff has already had with some PE fund sponsors, Blass said that if the fund management fee is "wholly" reduced by the transaction fees, there are no broker-dealer registration concerns.

However, Blass was not receptive to the theory apparently offered by some registered advisers that the recipient of transaction fees is not a broker-dealer because it is not engaged in securities business "for the account of others" within the meaning of the 1934 Act. He noted that transaction fees are received by the sponsor, one of its affiliates, or some other entity other than the private fund, leading him to conclude that "at least for potential broker-dealer status questions, the fund and the general partner are distinct entities with distinct interests." Elsewhere in his remarks, Blass observed that the receipt of transaction-based compensation gives the recipient a "salesman's stake" in the transaction, and that broker-dealer regulation is in part built around managing the conflict of interest arising from a broker acting as a securities salesman, compared to an investment adviser with fiduciary duties.

The full text of Blass's speech is available here.

We expect that these broker-dealer issues will continue to be raised by the SEC staff in investment adviser examinations, and will be the subject of further public discussion and analysis. If you have questions about either of these issues, please contact your usual Ropes & Gray advisor.