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POTENTIAL BROKER-DEALER PITFALLS FOR PRIVATE INVESTMENT FUNDS AND THEIR MANAGERS

The managers of private investment funds – and particularly of private equity funds – have not generally regarded their business as requiring broker-dealer registration. Nonetheless, in recent remarks (the "Blass ABA Speech"),[1] David W. Blass, the Chief Counsel of the Division of Trading and Markets of the Securities and Exchange Commission (the "SEC"), identified a number of issues relating to broker-dealer registration that private investment funds and their managers should be keenly following. These remarks deserve particular attention from private investment fund managers given that they follow on the heels of the SEC's enforcement action (the "Ranieri Order") charging a private equity fund manager with causing, and one of its principals with aiding and abetting, a third-party finder's failure to register as a broker-dealer in violation of Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act").[2]

The Blass ABA Speech raised two important concerns:

- situations in which broker-dealer registration is required in connection with the sale of interests in the private investment fund, including where the offering activity is conducted by the private investment fund itself (or its sponsor or adviser, or their personnel); and
- "success fees" and similar "investment banking" fees collected by private equity managers in connection with portfolio company transactions that may give rise to a broker-dealer registration requirement.

While David Blass caveated his presentation with the standard disclaimer that the views expressed represent only his own views, and not those of the SEC, any SEC Commissioner, or other member of the SEC staff, his remarks certainly shine a light on issues that concern the SEC and how its staff may in practice analyze these issues.

MARKETING INTERESTS IN PRIVATE INVESTMENT FUNDS

A person engaged in the business of effecting transactions in securities for the account of others must, in the absence of an available exemption or other relief, register as a broker under Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act").[3] And, while the Blass ABA

[1] David W. Blass, Chief Counsel, SEC's Div. of Trading and Mkts., Address to the American Bar Association Trading and Markets Subcommittee: A Few Observations in the Private Fund Space (Apr. 5, 2013), *available at* http://www.sec.gov/news/speech/2013/spch040513dwg.htm.

[2] *In the Matter of Ranieri Partners LLC & Donald W. Phillips,* SEC Release No. 34-69091 (Mar. 8, 2013). This enforcement action and its implication for issuers and sponsors are discussed in *Is an Issuer Responsible for the Acts of its Unregistered Finder*, LEGAL UPDATE (Pryor Cashman, New York, N.Y.), Apr. 3, 2013, *available at* http://www.pryorcashman.com/assets/attachments/939.pdf.

[3] Section 3(a)(4) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." The Blass ABA Speech indicates that participation in a portion of the conduct that results in a securities transaction being effected may be sufficient to require registration. Mass. Fin. Serv., Inc. v. Sec. Investor Prot.

Speech confirms that the SEC regards the receipt of compensation based on the percentage of the funds raised as the "hallmark of being a broker," it goes on to clarify that percentage-based compensation is highly relevant to, but not by itself determinative of, whether broker-dealer registration is required. When the relevant conduct brings a person within the definition of a "broker," registration is required even in the absence of percentage-based compensation.[4]

Within this framework, the Blass ABA Speech cites some questions that private fund advisers and sponsors should consider in evaluating whether they and/or their personnel are required to register as broker-dealers:

- How does the private fund manager solicit and retain investors in its private fund?
- Do the employees who solicit investors in the private funds have other responsibilities? Is their primary responsibility soliciting investors, or is this a subsidiary duty?
- How are personnel who solicit investors for the private funds compensated? Do these personnel receive bonuses or other types of compensation that are linked to the amount of funds actually invested by the investors they solicited?
- Does the private fund manager charge a transaction fee in connection with a securities transaction?

According to the Blass ABA Speech, when a private fund adviser or sponsor has a "dedicated sales force" that works within a "marketing department," it will have created a strong indication that the personnel in this department are in the business of effecting transactions in the securities issued by the private investment fund – regardless of whether they receive percentage-based compensation. Moreover, the "issuer exemption" under Rule 3a4-1 under the Exchange Act, while sometimes cited as a possible safe-harbor from broker-dealer registration for private funds that "self-market," can be difficult, in practice, for private funds and their sponsors to comply with if they have dedicated internal marketing units.[5]

Corp., 411 F. Supp 411, 415 (D. Mass), *aff'd*, 545 F.2d 754 (1st Cir. 1976), *cert denied*, 431 U.S. 904 (1977) (noting that the definition of "broker" in the Exchange Act connotes a "certain regularity of participation in securities transactions at key points in the chain of distribution").

[4] See *In the Matter of Warrior Fund LLC*, Release No. 34-61625 (Mar. 2, 2010), 4 n.8.

[5] Rule 3a4-1 is a non-exclusive safe harbor from the requirement that an associated person (e.g., an officer, director, or employee of the issuer or of an affiliate of the issuer) who is involved in marketing the issuer's securities register as a broker-dealer. In order to claim the benefits of this safe harbor in connection with offering interests in a private fund, an associated person (among other requirements):

- must not receive compensation in connection with the sale of the private fund's securities by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities; and
- must not be an associated person of a broker or a dealer (as defined in Rule 3a4-1) at the time of the sale of the private fund's securities.

In addition, this safe harbor requires that one of the following three sets of conditions be satisfied:

- the offering and sales of interests in the private fund are made to only broker-dealers and other specified types of financial institutions (which is, incidentally, a significantly more restrictive list than the types of persons included in the definition of "accredited investor"); or such interests are exempted securities under Section 3(a)(7), 3(a)(9), or 3(a)(10) (these exemptions, which include bankruptcy exchanges, issuer exchanges, and court- or agency- supervised exchanges, would be unlikely to apply to private fund securities); or the sales of such interests are made pursuant to specified types of approved reclassification, merger, or asset transfer plans or agreements or pursuant to specified types of profit-sharing, retirement, or similar plans (which, again, are unlikely to apply to private fund securities); or
- the associated person primarily performs or is intended primarily to perform at the end of the offering substantial duties for the private fund other than in connection with transactions in securities; was not a broker-dealer or an associated person of a broker-dealer within the preceding 12 months; and does not participate in selling an offering of securities for any issuer more than once every 12 months (other than in reliance on the exceptions under Rule 3a4-1); or

Interestingly, recognizing that emerging advisers and other advisers with relatively few assets under management may not be able to afford to hire a registered broker-dealer, or to register (and comply with the requirements of registration) as a broker-dealer themselves, Mr. Blass indicated that he would be interested in hearing from industry participants whether a broker-dealer registration exemption tailored to private fund marketing is needed and/or potentially useful. In light of this invitation, we will monitor industry response and developments in this area.

Private Equity Portfolio Transactions Triggering Broker-Dealer Registration

When a private equity fund executes a transaction, fees are often paid to (among others) the private equity fund's adviser and its affiliates. These fees have various designations and, in fact, cover many different activities in which the adviser and its affiliates may be involved. Consider, for example, a portfolio company of a private equity fund that is acquired by a strategic investor, consummates a public offering of its securities, or recapitalizes. When, in connection with such a transaction, the portfolio company is directed to pay directly (or indirectly) to the fund's adviser or one of its affiliates a "success fee" or other fee for its "investment banking activity" – whether for negotiating the transaction, identifying and soliciting acquirers of the portfolio company's securities, or for structuring the transaction – the SEC will be inclined to question whether the adviser's activities require broker-dealer registration. Where the private equity fund adviser receives fees that are not clearly advisory fees, the adviser should anticipate greater scrutiny from the SEC staff and, potentially, a conclusion that broker-dealer registration is required for these activities.

In this regard, it is useful to note that the Blass ABA Speech expresses an interest at the SEC in learning more about the way these fees are charged and the rationale for these fees, especially given that the practice of charging these fees may be relatively common among certain private equity advisers. Further, the Blass ABA Speech indicates some receptivity to the rationale that, where these sorts of "investment banking fees" are used solely to offset the advisory fee otherwise due from the private equity fund, one might view them as merely a manner of payment of the advisory fee and potentially not a separate fee that raises broker-dealer registration concerns. The Blass ABA Speech is significantly more harsh in evaluating the argument that fees of this type cannot give rise to broker-dealer registration requirements because they are paid to the general partner of the private equity fund – and, if the general partner of the fund is viewed as being the same person as the fund, then there is no transaction for the account of others. Without attempting a full analysis of this rationale, the Blass ABA Speech certainly makes clear that this highly technical argument can expect to meet deep criticism among the SEC staff.

Conclusion

In light of the Ranieri Order and these recent remarks in the Blass ABA Speech, private investment funds and their advisers and sponsors should consider themselves on notice that the SEC is aware of the various ways that they market interests in their private funds and is increasingly eager to pursue enforcement when they perceive that a broker-dealer registration obligation has not been complied with.

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If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Bertrand C. Fry at bfry@pryorcashman.com, Stephen M. Goodman at sgoodman@pryorcashman.com, Michael T. Campoli at mcampoli@pryorcashman.com or Durre S. Hanif at dhanif@pryorcashman.com..

- the associated person limits his or her activities to one or more specified types of "passive" (or limited) selling activities, including delivering approved written communications by means that do not involve the associated person's making an oral solicitation of a potential purchaser and responding in a limited way to inquiries of a potential purchaser in a communication that such purchaser initiated.

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Bertrand Fry is a partner in Pryor Cashman's Corporate Group and is co-head of the firm's Investment Management Group. Bert has nearly twenty years of general corporate and transactional experience that includes extensive experience with alternative investment vehicles. In addition to having launched and advised a diverse array of U.S. and non-U.S. investment products, including vehicles engaged in macro, distressed, private equity, venture capital, and real estate investing, debt origination, and quantitative trading of securities and futures, his practice has included, among other things, structuring and advising investment managers and advisers, private company mergers & acquisitions, and joint ventures.

Bert is particularly well attuned to the business needs of his clients, based on more than a decade of in-house experience at the D. E. Shaw group, where Bert was a Senior Vice President and served for a period as Acting General Counsel. During his tenure there, the D. E. Shaw group included several SEC-registered investment advisers and, at its apex, managed approximately $40 billion across various strategies and multiple funds. Bert also launched and advised a wide range of hedge funds, funds of funds, and their managers as a member of the London office of Dechert LLP.

Bert earned his A.B., with honors, from the University of Chicago and his J.D., with honors, from The University of Texas at Austin School of Law, where he was also an articles editor for the Texas Law Review and received the Outstanding Second-Year Member Award from the Texas Law Review, the Gilbert I. Low Endowed Presidential Scholarship in Law, and Highest Achievement in Contracts.

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Durre received her Honors B.A. from Trinity College, University of Toronto in 2004, where she was a recipient of the National Book Award and the Plaque for Exemplary Service to the University Community.

In her free time, Durre volunteers to help promote literacy and women's rights in South Asia.