DAY PITNEY LLP

alert

April 12, 2013

Alert: Increased SEC Focus on Broker-Dealer Registration Issues for Private Fund Managers

The Securities and Exchange Commission (SEC) is cracking down on private fund [1] managers for not using registered broker-dealers for fundraising. At the same time, recent public comments by the SEC staff indicate that certain activities of private fund managers may require that they become registered with the SEC as broker-dealers. These recent comments also indicate a willingness to entertain suggestions to create a useful exemption from broker-dealer registration specific to private fund managers.

Ranieri Partners Enforcement Action

The SEC charged Ranieri Partners LLC ("Ranieri"), a private equity fund, with raising over $500 million in capital commitments through a third-party consultant who was not registered with the SEC as a broker-dealer. Under the terms of the settlement, announced on March 8, 2013, Ranieri agreed to pay a $375,000 fine, one of Ranieri's managing directors (who functioned as a marketing/sales employee of Ranieri) agreed to pay a $75,000 fine and refrain from acting in a supervisory role at any investment adviser or broker-dealer for nine months, and the SEC permanently barred the third-party consultant from working in the securities industry. Notably, the SEC did not allege when bringing the enforcement action that fraud was committed against the investors in Ranieri (either by Ranieri or the third-party consultant). Moreover, in addition to charging the third-party consultant with violating the Securities Exchange Act of 1934 (the "Exchange Act") by acting as an unregistered broker-dealer, the SEC charged Ranieri with causing such violations and charged the employee of Ranieri with aiding and abetting such violations. This appears to be a novel SEC enforcement action in that it is focused on penalizing the private fund manager and its marketing personnel as well as the unregistered broker-dealer.

Recent Comments of SEC's Chief Counsel to the Division of Trading and Markets

On April 5, 2013, less than a month after the announcement of the *Ranieri* settlement, David Blass ("Blass"), the chief counsel of the SEC's Division of Trading and Markets, delivered a speech on these issues to the American Bar Association's Trading and Markets Subcommittee at the

Related practice areas:

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For more information, please contact any of the individuals listed below:

R. Scott Beach CT
rsbeach@daypitney.com
(203) 862 7824

Jeffrey A. Clopeck MA
jaclopeck@daypitney.com
(617) 345 4612

Henry Nelson Massey NJ, NY
hmassey@daypitney.com
(973) 966 8105

Shawn T. Wooden CT, DC, NY
stwooden@daypitney.com
(860) 275 0157

Greg H. Kahn NY
gkahn@daypitney.com
(203) 977 7370

Julia M. Boyd NY
jboyd@daypitney.com
(212) 938 8221

Samuel A. Jennings MA, CT, NY
sjennings@daypitney.com
(617) 345 4652

ABA's Business Law Section 2013 Spring Meeting held in Washington, DC. Blass's remarks, which were later posted on the SEC's website, focused on the SEC staff's "increased examination focus on private fund managers, both due to the new regulatory requirements and [the SEC's] own observations in the private fund space."

Blass highlighted in his remarks the SEC's growing concern and focus with respect to private fund managers' use of fundraisers (internal and external) to attract capital. In particular, Blass discussed private fund managers that pay their personnel "transaction-based compensation" for selling interests in a fund.

It is well known that persons engaged in the business of effecting transactions in securities for the account of others must generally register under Section 15(a) of the Exchange Act as a broker. Common broker activities include (1) marketing securities or interests in funds to investors; (2) soliciting or negotiating securities transactions; and (3) handling customer funds and securities. Blass stated that:

> [T]he importance of each of these activities is heightened where there also is compensation that depends on the outcome or size of the securities transaction — in other words, transaction-based compensation, also referred to as a "salesman's stake" in a securities transaction. The SEC and SEC staff have long viewed receipt of transaction-based compensation as a hallmark of being a broker.

Noting the *Ranieri* settlement, Blass emphasized that the SEC's recent focus on the use of unregistered broker-dealer fundraisers by private fund managers "demonstrate[s] that there are serious consequences for acting as an unregistered broker, even where there are no allegations of fraud." Blass notes that, in his view, private fund managers may not be fully aware of all the activities that could be viewed as soliciting securities transactions or the implications of compensation methods, including compensation of internal staff of the private fund managers.

Beyond "transaction-based compensation," Blass commented on the not-uncommon situation where a private fund manager has personnel whose only or primary functions are to sell interests in a fund. Blass noted that:

> [A private fund manager with] a dedicated sales force of employees working within a "marketing" department may strongly indicate that [such employees] are in the business of effecting transactions in the private fund, regardless of how the personnel are compensated.

Accordingly, private fund managers should not consider themselves out of the ambit of the SEC's scrutiny simply because their fundraising efforts may be conducted solely "in-house" or because their compensation is not expressly tied to capital-raising efforts (e.g., fixed salaries and fixed bonuses).

Determining whether a person should register as a broker-dealer is often a fact-intensive determination. Blass offered some basic questions that private fund managers should consider when making this determination. These included:

- How does the private fund manager solicit and retain investors?
- Do employees who solicit investors have other responsibilities or is their primary responsibility soliciting investors?
- How are employees who solicit investors for a private fund compensated? Do those individuals receive bonuses or other types of compensation that are linked to capital raising?
- Does the private fund manager charge a transaction fee in connection with a securities transaction (e.g., a "closing" fee in connection with the closing of an acquisition of a portfolio company by a private equity fund manager that is paid at the closing to the private fund manager)?

In sum, private fund managers need to look at not just their fundraising activities but also their fee arrangements, including fees paid to employees of the private fund manager, in connection with the underlying investment activities of the fund. This also reinforces the SEC's trend toward constraining the permissible activities of "finders," and more often than not, these persons will be deemed to be, just as in *Ranieri*, "engaged in the business of effecting transactions in securities for the account of others." Fund managers should be aware that issuances of interests in the funds marketed by private fund managers, if intermediated by an inappropriately unregistered broker-dealer, could potentially be subject to a right of rescission by the investors in such fund.

Inapplicability of the Issuer's Exemption

Additionally, Blass commented on the difficulty of private fund managers in utilizing the Exchange Act's "issuer's exemption," found under Rule 3a4-1, that is a nonexclusive safe harbor under which associated persons of certain issuers can participate in the sale of an issuer's securities in certain limited circumstances without being considered a broker. In order to rely on the "issuer's exemption" from broker-dealer registration, a person must satisfy one of the following three conditions: (1) the person limits the offering and selling of the issuer's securities only to broker-dealers and other specified types of financial institutions; (2) the person performs substantial duties for the issuer 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; or (3) the person limits activities to delivering written communication by means that do not involve oral solicitation of a potential purchaser by the associated person. It is often difficult for private fund managers and their marketing personnel to satisfy any of these three conditions, which is why Exchange Act Rule 3a4-1 is not always an available exemption for private fund managers.

Potential Exemption for Private Fund Managers?

Importantly, Blass noted that he was "keenly aware that many advisers, particularly smaller advisers, may not be able to afford or be able to either hire a broker-dealer or register as broker-dealers themselves." Accordingly, he invited comments as to whether a broker-dealer exemption specific to private fund managers would be helpful, and also stated that he had in mind a "potential exemption like the issuer exemption, but one written specifically for private fund managers."

Broker-Dealer Issues Arising in Private Equity Fund Transactions

Blass also discussed the common practice in private equity transactions of the private fund manager receiving certain fees in addition to advisory fees (e.g., "closing fees" or "success fees"), paid in connection with certain liquidity events such as a purchase or sale of a portfolio company (including in an IPO context). He stated that this practice may trigger activities requiring broker-dealer registration for the fund manager, if the transaction involves an issuance or sale of securities (e.g., an equity or debt financing conducted in connection with the liquidity event). Given how common this practice is in the private equity business, including for services involving negotiating deals, identifying and soliciting purchasers or sellers of securities, and/or structuring transactions, these comments from Blass should not go unnoticed.

Blass notes that on the surface, these types of fees may cause an adviser to fall within the meaning of the term "broker" (described above). However, Blass does state that he recognizes such transaction fees are common in the private equity business. He notes that if management fees otherwise due the private fund manager are wholly offset by such transaction fees (which is a fairly common practice for control investments, at least in part if not in the entirety), then the payment of such transaction fees, if done in such manner, would not, in itself, in his opinion, appear to raise broker-dealer registration concerns. Blass notes that the SEC staff is interested in talking these issues over and encourages private fund managers to think about their practices in this regard.

Conclusion

The *Ranieri* settlement and the comments by Blass highlight the SEC's heightened focus and crackdown on the use of unregistered fundraisers and placement agents by private fund managers. Further, Blass's comments reiterate the difficulty private fund managers face in using unregistered fundraisers, both internally and externally, without running afoul of the securities laws. Although Blass indicated his willingness to consider a broker-dealer registration exemption specific to private fund managers, without such an exemption in place, private fund managers should examine carefully their retention of fundraisers and placement agents and the role of employees of the fund manager who focus on the fundraising process. Additionally, the comments from Blass pertaining to the common private equity practice of paying certain types of fees to

private fund managers (or their affiliates) in connection with the closing of purchases or sales of portfolio companies indicate that these are areas that should be carefully reviewed by fund managers and their portfolio companies to ensure compliance with applicable securities laws.

Please contact the Day Pitney attorneys listed to the right to discuss any questions you may have about broker-dealer registration, the use of fundraisers and placement agents, and the issues arising from "closing fees" or "success fees" payable to a fund manager.

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[1] A "private fund" is defined as an issuer that would be an investment company under the Investment Company Act of 1940 but for the exemptions under Section 3(c)(1) and Section 3(c)(7) of that Act.

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