CLIENT UPDATE

SEC'S DIVISION OF TRADING AND MARKETS DELIVERS A MESSAGE TO PRIVATE FUND SPONSORS ABOUT POTENTIAL BROKER-DEALER REGISTRATION ISSUES

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The staff of the Securities and Exchange Commission (the "SEC") has become increasingly focused on whether certain activities of private equity fund sponsors require them to register as broker-dealers under the Securities Exchange Act of 1934 (the "Exchange Act"). The SEC's Office of Compliance Inspections and Examinations ("OCIE") has raised this question in recent examinations of private fund sponsors and, in a speech on April 5, David Blass, the chief counsel of the SEC's Division of Trading and Markets, discussed certain of the staff's concerns. [1]

Mr. Blass' remarks focused specifically on two contexts: (i) the marketing of interests in the fund by the private fund sponsor, and (ii) activities in connection with the acquisition or disposition (including through an initial public offering) of a portfolio company or the recapitalization of a portfolio company.

Private fund sponsors should consider whether any of their activities raise any of the concerns discussed by Mr. Blass and should be prepared to address these issues during examinations by OCIE, or in queries from other areas within the SEC.

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[1] David W. Blass, *A Few Observations in the Private Fund Space*, Speech to American Bar Association, Trading and Markets Subcommittee (April 5, 2013), *available at* http://www.sec.gov/news/speech/2013/spch040513dwg.htm. As is customary, Mr. Blass noted that his remarks reflected his personal views and not those of the SEC, the Commissioners or his colleagues on the staff.

THE DEFINITION OF "BROKER"

The term "broker" is defined in Section 3(a)(4) of the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others," subject to certain narrow exceptions. Consistent with previous SEC guidance, Mr. Blass stated that "[a] person may be found to be acting as a broker if that person participates in securities transactions at key points in the chain of distribution." He did not enumerate all of the "key points" in the distribution chain but mentioned the following specific activities:

- Marketing interests in a private fund to investors;
- Soliciting or negotiating securities transactions; or
- Handling customer funds and securities.

Mr. Blass observed that the importance of each of these activities to the registration analysis is heightened where the sponsor or its personnel also receive "compensation that depends on the outcome or size of the securities transaction — in other words, transaction-based compensation." He noted that the SEC and its staff have long viewed receipt of transaction-based compensation as a hallmark of being a broker. However, Mr. Blass made clear that "one can be acting as a broker-dealer without having received transaction-based compensation."

MARKETING OF FUND INTERESTS

Mr. Blass noted that the SEC recently settled an enforcement action with a private equity fund sponsor and its consultant who actively solicited investors to invest in the private fund and received transaction-based compensation.[2] However, as mentioned above, Mr. Blass noted that transaction-based compensation is not necessary for a person to fall within the definition of "broker." Mr. Blass set forth certain questions that a private fund sponsor should consider in evaluating its marketing activities, focusing in particular on the activities of marketing personnel.

- How does the fund sponsor solicit and retain investors? Mr. Blass stated that "a dedicated sales force of employees working within a 'marketing' department may strongly indicate that they are" engaged in brokerage activities.

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2 Please see our Client Update: SEC Sanctions Private Fund Sponsor for Using Unlicensed Broker to Sell Private Fund Interests, (March 29, 2013), *available at* http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=945dff22-4dad-4632-bcec-29b38e91bfda.

- Do employees who solicit have other responsibilities (*i.e.*, are the primary functions of these employees to solicit investors)?
- How are the employees who solicit investors compensated? Do the employees receive bonuses or other types of compensation that are linked to successful investments?
- Does the sponsor charge a transaction fee in connection with the transaction?

These questions appear to track the requirements included in the so-called "issuer exemption" set forth in Rule 3a4-1 under the Exchange Act. Under certain conditions, Rule 3a4-1 provides a non-exclusive "safe harbor" from broker-dealer registration for, among other persons, an employee of an entity issuing securities (the "issuer"), an employee of the general partner of the issuer or an employee of another entity that controls or is under common control with the issuer (*e.g.*, a marketing, investor relations or investment professional who is involved in fundraising for a private fund and who is employed by its sponsor). An employee would satisfy the conditions of the safe harbor if he or she (i) does not receive transaction-based compensation, (ii) performs substantial duties for the issuer other than in connection with transactions in securities, (iii) was not a broker-dealer or an associated person of a broker-dealer within the preceding 12 months and (iv) does not participate in selling an offering of securities for any issuer more than once every 12 months. In his remarks, Mr. Blass asserted that "Rule 3a4-1 generally is not used by private fund advisers" and "[i]t could be difficult for private fund advisers to fall within these conditions." He did not provide any elaboration on this assertion.[3]

Although Mr. Blass raised these issues and noted that registration as a broker may be problematic for many private fund sponsors (particularly smaller private fund sponsors), he did not propose any immediate solutions. Mr. Blass did invite input from the private fund industry on these issues and specifically asked whether an issuer exemption specifically written for private fund sponsors "is needed or would be helpful."

ACTIVITIES ASSOCIATED WITH PORTFOLIO COMPANIES

Mr. Blass also discussed at some length the receipt of transaction-based compensation by private equity fund sponsors relating to "investment banking" services provided to portfolio companies, including "negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions." Mr. Blass asserted that these "investment banking" services, combined with the

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[3] Our experience has been different than that described by Mr. Blass. Many private fund managers do rely on the Rule 3a4-1 safe harbor. Other firms may not fully satisfy all the requirements of Rule 3a4-1, but their activities may be such that they would not fall within the definition of "broker."

transaction-based compensation (*e.g.*, the transaction fees) sometimes charged by private equity firms to portfolio companies, appear to cause such a fund sponsor to fall within the definition of "broker."

Mr. Blass addressed three rationales that have been shared with the SEC staff as to why these situations do not require a private equity fund sponsor to register as a broker. One rationale is that the transaction fees are used to reduce the investment advisory fee. Mr. Blass appeared to find merit in this approach to "the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee."

Another rationale he mentioned focuses on the recipient of the fee— the fund's general partner, in his example. The analysis would be that "the general partner should be viewed as the same person as the fund, so there are no transactions for the *account of others*." Mr. Blass stated that this explanation did not "seem plausible to [him]" because, if the general partner was the same person as the fund, the fee would be paid to the fund.

Finally, Mr. Blass appeared to be unreceptive to policy-related arguments that there is little regulatory incentive to require private equity fund sponsors to register as brokers. Mr. Blass stated his view that (i) a sponsor should not engage in "broker" activities unless the sponsor is prepared to register as a "broker" and (ii) it is not "difficult … for a private equity fund adviser to change its practices so it is not engaging in activities that raise broker-dealer status questions."

IMPLICATIONS

Mr. Blass closed by emphasizing that the issues that he raised should not be viewed as presenting "technical" violations and that private fund sponsors should "grapple with them hopefully in advance of a visit from the SEC's examiners." In particular, Mr. Blass noted that, in addition to SEC sanctions, other possible consequences of acting as an unregistered broker-dealer include the potential right of rescission and the securities transactions intermediated by the unregistered broker-dealer potentially being rendered void.

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We will continue to monitor this area. Please do not hesitate to contact us with any questions.

April 18, 2013