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SEC Staffer Cautions Private Funds Industry on Potential Broker Registration Issues

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In a recent speech given to the ABA Trading and Markets Subcommittee, David W. Blass (Chief Counsel of the SEC's Division of Trading and Markets) focused on a number of activities commonly conducted by private fund advisers that, depending on how these activities are conducted, could raise potential broker registration issues under the Securities Exchange Act of 1934 (the '34 Act). Mr. Blass identified two areas that are of particular concern:

- capital-raising activities, particularly in circumstances (i) where employees of a private fund adviser may be compensated based on how successful they are in selling interests in the adviser's funds, or (ii) where an employee's sole or primary function is to sell interests in the adviser's funds; and

- the receipt of transaction fees relating to one or more of a private fund's portfolio companies for services that could be characterized as investment banking or other broker activities.

Mr. Blass noted that most private fund advisers are rightly focusing their compliance efforts on the requirements of the Investment Advisers Act of 1940. However, he cautioned the industry not to overlook either of these potential broker registration issues.

Fund-Raising Activities That May Trigger Registration

Mr. Blass noted that that the definition of a "broker" under the '34 Act is quite broad and includes any person "engaged in the business of arranging securities transactions for the account of others." In general, any person engaged in such activities is required to be registered as a broker under the '34 Act unless a specific exemption applies.

Mr. Blass stated that certain activities in which private fund advisers typically engage while fund-raising can fall within this broad definition of a broker, including:

- marketing securities (including interests in private funds) to investors;
- soliciting or negotiating securities transactions; or
- handling customer funds and securities.

Mr. Blass acknowledged that the determination of whether a private fund adviser or its employees are engaged in broker activities can be highly fact-specific. He nevertheless identified a series of factors that private fund advisers should consider in reviewing whether their activities might raise broker registration issues:

- *How are the personnel who solicit investors compensated*? Transaction-based compensation based on an employee's success in selling interests in an adviser's private funds can create a significant risk of regulatory scrutiny. According to Mr. Blass, the SEC has long viewed such compensation arrangements as the "hallmark" of being a broker because it creates a "salesman's stake" in the outcome of the securities transaction. On the other hand, bonuses based on an employee's overall performance or a firm's overall financial performance (or some combination of the two) should run a lower risk of regulatory challenge.
- *How does the manager solicit and retain investors*? In this context, Mr. Blass stated that the existence of a dedicated sales force working within a "marketing" department could be a strong indicator that the adviser is engaged in broker activities, regardless of how such marketing personnel are compensated.
- *Do the employees who solicit investors have other responsibilities*? The professionals at many private fund advisers often split their time between raising capital for their funds and performing other functions and duties. As noted above, however, if an adviser employs marketing professionals whose job functions are solely or primarily focused on raising capital, this could raise broker registration issues under the '34 Act.
- *Does the adviser charge a transaction fee in connection with securities transactions* ? As discussed further below, the receipt of fees for services in connection with securities transactions also may raise broker registration issues under the '34 Act. Private fund advisers typically do not charge such fees in connection with their own fund-raising activities.

In passing, Mr. Blass discussed the "issuer exemption" from broker registration (Rule 3a4-1 under the '34 Act), and he suggested that it could be difficult for private fund advisers and their personnel to fully meet all of the conditions of that non-exclusive, safe harbor exemption. However, Mr. Blass also acknowledged that the alternatives of registering as a broker or outsourcing marketing activities to a registered broker-dealer would be unduly costly and burdensome for most private fund advisers, particularly smaller firms. He indicated that the SEC staff is interested in possibly creating a new exemption from registration under the '34 Act that would be specifically tailored to the needs of private fund advisers. While he specifically identified paying transaction-based compensation to personnel who solicit investors as a problematic practice, he invited the audience to provide the staff with feedback as to what other parameters might apply to such an exemption.

Investment Banking Activities for Portfolio Companies That May Trigger Registration

Mr. Blass also identified the receipt of transaction-based fees from portfolio companies in connection with a private fund adviser's investment activities as a practice that could raise potential registration issues under the '34 Act. In particular, Mr. Blass noted that the practice of having portfolio companies pay transaction fees to the adviser or one of its affiliates for investment banking-type services in connection with the acquisition, disposition or recapitalization of the portfolio companies (such as negotiating transactions, identifying and soliciting purchasers and sellers of a portfolio company's securities, or structuring transactions) can create the types of conflicts of interest that the '34 Act is designed to address by giving the adviser a "salesman's stake" in the outcome of the transaction. As a result, an adviser that receives transaction fees for investment banking-type services may be required to register as a broker under the '34 Act.

Mr. Blass suggested, however, that the receipt of such fees might not raise broker registration issues if such fees resulted in a dollar-for-dollar reduction in a fund's management fees. Under these facts and circumstances, Mr. Blass stated that the receipt of transaction-based fees from portfolio companies could be viewed as simply another way to pay the fund's management fees, which would not, in and of itself, appear to raise broker registration issues.

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Mr. Blass' speech raises potential issues for the private funds industry insofar as the SEC staff is signaling that it is concerned that private fund managers may be crossing the line into activities that, under current rules, should be regulated as broker activities and conducted through a registered broker. However, Mr. Blass' speech also suggests that the Division of Trading and Markets is open to discussion with regard to its analysis of broker registration issues related to the activities of private fund managers. In this regard, it is notable that Mr. Blass indicated that the staff is aware of the challenges private fund firms would face if they were required to register as brokers and would consider creating an exemption from registration for capital-raising activities that would be more specifically tailored to meet the needs of the private funds industry. It is also notable that Mr. Blass was receptive to the notion that private fund advisers may receive transaction-based fees from or related to portfolio companies, so long as such fees wholly offset a fund's management fees.

Private fund managers should be aware that questions related to these issues may be asked by SEC staff in connection with investment adviser examinations. We expect that these issues will receive additional commentary from industry participants and regulators, and we will continue to monitor developments in this area closely.

A copy of Mr. Blass' speech is available here.

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