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Alert

SEC Focuses on Broker-Dealer Registration Issues Facing Private Fund Managers

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The Securities and Exchange Commission recently has made broker-dealer registration an area of focus for private fund managers. On March 8, 2013, the SEC filed and settled charges against a private fund manager, one of the manager's senior executives and an external marketing consultant regarding the consultant's failure to register as a broker-dealer. Just a few weeks later, on April 5, 2013, the Chief Counsel of the SEC's Division of Trading and Markets spoke at an American Bar Association meeting, and posted his remarks on the SEC's website, indicating his views with respect to broker-dealer registration concerns raised by (1) sales of interests in private funds and (2) fees related to portfolio company transactions. Managers of hedge funds and private equity funds should review and consider their marketing and business practices in light of the current SEC focus in this area.

Recent Enforcement Action

On March 8, 2013, the SEC filed and settled charges against Ranieri Partners LLC, Donald Phillips (a former senior executive at Ranieri Partners) and William Stephens (an external marketing consultant to Ranieri Partners).[1] The *Ranieri* case has two particular points of interest for private fund managers:

- *First*, unlike many other cases brought for failure to register as a broker-dealer, there were no allegations of fraud.[2] The SEC filings did not indicate that any investors or potential investors were defrauded by Stephens or by the actions of Ranieri Partners.
- *Second*, in addition to charging the consultant for failing to register as a broker-dealer, the SEC charged the private fund manager itself and a former senior executive at the manager. Ranieri Partners was charged with causing Stephens' violations of the Securities Exchange Act and Phillips was charged with willfully aiding and abetting that violation.

The SEC alleged that Stephens acted as an unregistered broker in violation of Section 15(a) of the Securities Exchange Act in marketing and receiving placement fees for the sale of interests in two real estate funds organized and advised by Ranieri Partners. The settlement orders cite a number of factors as support for this

[1] *In the Matter of Ranieri Partners LLC and Donald W. Phillips,* Securities Exchange Act Release No. 69091, Investment Advisers Act of 1940 Release No. 3563, Administrative Proceeding File No. 3-15234 (March 8, 2013); *In the Matter of William M. Stephens*, Securities Exchange Act Release No. 69090, Investment Company Act of 1940 Release No. 30417, Administrative Proceeding File No. 3-15233 (March 8, 2013).

[2] The orders did note that (i) Stephens was subject to an industry bar for previous violations and (ii) the time period for that bar had expired and Stephens was eligible to apply to have it lifted.

allegation, including the fact that Stephens received "transaction-based compensation totaling approximately $2.4 million." The SEC cited additional conduct by Stephens as evidence of broker-dealer status,[3] including:

- Stephens repeatedly sent private placement memoranda, subscription documents and due diligence materials directly to potential investors;
- He personally (and repeatedly) attempted to convince at least one investor to invest with Ranieri Partners;
- The solicitation efforts included in-person meetings and telephone calls in which Stephens was a participant;
- Stephens provided potential investors with his analysis of the strategy and performance of the Ranieri Partners funds; and
- He provided potential investors with confidential information (i.e., the identities of current investors and details on their capital commitment amounts).

The SEC concluded that Stephens had "engaged in the business of effecting transactions in securities" without being properly registered as a broker or dealer or being associated with a registered broker or dealer. In addition to the imposition of cease-and-desist orders: (1) Stephens was barred from the securities industry and ordered to pay an amount of nearly $3 million in disgorgement and interest;[4] (2) Ranieri Partners was assessed a penalty of $375,000; and (3) Philips was assessed a fine of $75,000 and suspended from holding a supervisory position in the securities industry for nine months.

Remarks by the SEC's Chief Counsel to the Division of Trading and Markets

On April 5, 2013, David Blass, the Chief Counsel to the SEC's Division of Trading and Markets, addressed a subcommittee of the American Bar Association in remarks posted later that day on the SEC's website.[5] While these remarks reflect the personal view of the Chief Counsel, they — along with the Ranieri Partners enforcement action — indicate increased attention at the SEC to issues related to broker-dealer registration in the private fund context. The Chief Counsel's remarks raise two separate issues: (1) whether marketing by a fund manager's internal personnel requires broker-dealer registration and (2) whether the receipt of transaction-based fees in connection with the sale of portfolio companies requires broker-dealer registration.

> *Internal marketing personnel:* The Chief Counsel suggested that private fund managers consider how they raise capital from investors and whether their activities could be viewed as "soliciting securities transactions." He noted that this suggestion "is not to say that all investment-raising by a private fund adviser results in the adviser being a broker-dealer[;]" he acknowledged that the receipt of transaction-based compensation has long been viewed as a "hallmark" of being a broker and that the SEC alleged that such compensation was paid to the consultant in the *Ranieri* case. The Chief Counsel specifically stated that advisers might want to consider: "How are personnel who solicit investors for a private fund compensated? Do those individuals receive bonuses or other types of compensation that is linked to successful investors? As previously noted, a critical element to determining whether one is required to register as a broker-dealer is the existence of transaction-based compensation." Broker-dealer registration "makes sense" when there is transaction-based compensation for securities sales, the Chief Counsel indicated, in order to manage the conflict that arises from acting as a "securities salesman."

[3] In two cases in 2011, courts required more than just the receipt of transaction-based compensation to find that a party was functioning as a broker-dealer, focusing on whether the party was involved at "key points in the chain of distribution" of the relevant securities: *SEC v. Kramer,* 778 F. Supp. 2d 1320 (M.D. Fla. 2011) (rejecting the argument that the defendant's receipt of transaction-based compensation, without more, caused him to be a "broker" as an "inaccurate statement of the law"); and *Maiden Lane Partners v. Perseus Realty Partners,* 28 Mass. L. Rep. 380 (Mass. Super. Ct. 2011) (rejecting the assertion that the receipt of transaction-based compensation in connection with a securities transaction automatically triggers "broker" status for the recipient, stating, "the evidence must also show involvement at key points in the chain of distribution, such as participating in the negotiation, analyzing the issuer's financial needs, discussing the details of the transaction, and recommending an investment").

[4] Payment of this amount was waived based upon Stephens' financial condition.

[5] David W. Blass, Chief Counsel, Division of Trading and Markets, U.S. Sec. and Exch. Comm'n, "A Few Observations in the Private Fund Space" (April 5, 2013).

In addition to transaction-based compensation, the Chief Counsel noted other relevant factors, such as whether the private fund manager has a dedicated "marketing" department. He indicated that having an internal group designated as the "marketing" department with a dedicated sales staff "may strongly indicate . . . that they are in the business of effecting transactions in the private fund" and notes that this may be true "regardless of how the personnel are compensated." He also questioned whether the employees involved in marketing have other responsibilities, including whether the "primary functions" of these personnel consist of soliciting investors. Based on these statements from the Chief Counsel, private fund managers will want to consider not only the titles and terminology used with respect to internal personnel involved in soliciting investments, but also the full spectrum of activities engaged in by such personnel.

Noting that it "could be difficult for private fund advisers" to fit within the specific conditions of the "issuer exemption" under Exchange Act Rule 3a4-1, the Chief Counsel also asked whether an exemption from broker-dealer registration written specifically for private fund advisers is needed or would be helpful, and invited a dialogue on these and similar issues.

Fees related to portfolio company transactions: The Chief Counsel separately indicated his belief that private fund managers — for example, advisers to private equity funds executing a leveraged buyout strategy — may receive fees in addition to advisory fees that could require the adviser to register as a broker-dealer. Fees for investment banking activity, such as for negotiating transactions, finding buyers and sellers of the company's securities or for structuring transactions were specifically mentioned. The Chief Counsel noted his view that "to the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee" that could be viewed as just another way to pay the advisory fee and, therefore, not raise the broker-dealer registration concern.

The Chief Counsel also considered a rationale brought to the SEC staff's attention focusing on situations where a fund's general partner, and not its investment manager, receives what may be characterized as a transaction-based fee. According to this rationale, there is no brokerage activity for "the account of others" because the general partner and the fund are effectively the same entity. The Chief Counsel did not find this rationale plausible because the fund and the general partners are "distinct entities with distinct interests."

Summary

It is clear that there is increased focus at the SEC on issues related to broker-dealer registration in the private fund context. Private fund managers should re-examine their internal and external marketing and solicitation efforts, including reviewing compensation agreements as well as the scope of responsibilities of personnel involved in soliciting investors. Private fund managers who receive fees in connection with the sale of portfolio companies also should review these practices in light of the SEC's concerns.

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