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SEC Chief Counsel Cautions Newly Registered Private Fund Advisers on Broker-Dealer Registration Issues Relating to In-House Marketing and Other Activities

BY THE INVESTMENT MANAGEMENT PRACTICE

On April 5, 2013, David Blass, the Chief Counsel of the SEC's Division of Trading and Markets, spoke before the Trading and Markets Subcommittee of the American Bar Association and confirmed that the SEC staff continues to focus on issues relating to unregistered broker-dealers marketing private investment funds – such as hedge funds, private equity funds, and real estate funds – that are advised by SEC-registered investment advisers. He particularly noted issues arising in connection with the marketing efforts of in-house personnel of fund advisers. He also pointed out that many new post-Dodd-Frank adviser registrants that are still acclimating to the requirements of the Investment Advisers Act of 1940 may be unfamiliar with the broker-dealer issues that can arise under the Securities Exchange Act of 1934 (the "Exchange Act") when marketing private funds, even in the absence of an external placement agent.

In his remarks, he questioned whether the existing "issuer exemption" from the Exchange Act broker-dealer registration requirements covering in-house marketing activities is a good fit for the private fund community, and asked for industry feedback on whether an exemption tailored to private funds might be worth exploring.

One of the conditions to reliance on the "issuer exemption" in connection with the sale of fund interests is that the persons inside the organization engaging in marketing activities must "perform substantial duties for the issuer other than in connection with transactions in securities, and … not participate in selling an offering of securities for any issuer more than once every 12 months…." Consequently Mr. Blass noted that private fund advisers that pay their personnel transaction-based compensation for selling interests in a fund (a hallmark of broker-dealer activity) and/or have personnel whose only or primary functions are to sell fund interests, may have broker-dealer registration issues of concern.

Mr. Blass noted some examples of activities, or factors, that might require private fund adviser personnel to register as a broker-dealer, such as marketing of securities (shares or interests in a private fund) to investors; soliciting or negotiating securities transactions; or handling customer funds and securities. He then suggested some questions private fund advisers might want to ask themselves with respect to activities or services that they may perform:

- How does the adviser solicit and retain investors? This is an important consideration because a dedicated sales force of employees working within a "marketing" department may strongly indicate that they are in the business of effecting transactions in the private fund, regardless of how the personnel are compensated.

- Do employees who solicit investors have other responsibilities? If so, consider what those responsibilities are (*i.e.*, are the primary functions of these employees to solicit investors).

- 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 investments? A critical element to determining whether one is required to register as a broker-dealer is the existence of transaction-based compensation.

- Does the adviser charge a transaction fee in connection with a securities transaction? In addition to considering compensation of employees, advisers also need to consider the fees they charge and in what way, if any, they are linked to a security transaction.

Mr. Blass separately addressed a second concern, which may be more common with private equity fund and LBO fund managers, involving the receipt by the private fund adviser, its personnel, or its affiliates of transaction-based compensation for purported "investment banking," "consulting," or other broker activities relating to one or more of the fund's portfolio companies.

Examples include fees that the adviser directs a portfolio company of the fund to pay, directly or indirectly, to the adviser or one of its affiliates in connection with the acquisition or disposition (including an initial public offering) of a portfolio company or a recapitalization of the portfolio company. The fees are often described as compensating the private fund adviser or its affiliates or personnel for "investment banking activities," including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions. Mr. Blass also suggested, however, that to the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, a valid argument could be made that the transaction fee is simply another way to pay the advisory fee, and that no separate brokerage compensation was generated.

In addition to the regulatory risk of losing an enforcement action, acting as an unregistered broker-dealer can expose fund managers to reputational risk, as well as to the economic risk of loss of fees and possibly rescission of investments in the fund. Consequently, investment advisers are well-advised to consider these issues in connection with their marketing of private funds and structuring of their internal organizations.

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