JACKO LAW GROUP, PC

Legal Risk Management Tip
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BROKER-DEALER REGISTRATION

Last April in a speech to the American Bar Association, the Securities and Exchange Commission's ("SEC") Chief Counsel of the Division of Trading and Markets, David Blass, sent shock waves throughout the investment advisory community when he suggested that employees who market an investment adviser's private fund may need to be registered representatives of a licensed securities broker-dealer, with the investment adviser being the registered broker-dealer. Even though the Chief Counsel retreated somewhat from this controversial position and the SEC has not published any official clarifying guidance or rulemaking on the matter, the SEC Staff remains focused on broker-dealer issues. Accordingly, it is important for investment advisers to private funds to take note of this focus and maintain awareness of the rules governing their marketing activities.

Many investment advisers choose to market and solicit sales in interests in the private funds they manage. The approaches they use are as varied as the organizations themselves. In some organizations, portfolio managers may market and sell fund interests in addition to selecting fund investments. In other organizations, individuals with multiple functions may be involved in the marketing effort. For example, a chief operating officer, members of the portfolio management team or administrative assistants may be involved. Finally, there are organizations that employ dedicated teams of sales persons whose primary functions are to market interests in the investment adviser's private funds. So which of these three organizations would need to register as a broker-dealer? Perhaps none of them, or perhaps all of them would need to register. The answer depends on one or more factors.

Regulation of securities broker-dealer activity is governed by the Securities Exchange Act of 1934 (the "Exchange Act"). One relevant provision for private fund marketing activities is section 3(A), which defines a broker as "any person engaged in the business of effecting transactions for the account of others."

The operative words in section 3(A) are "engaged in the business." Obviously, a person who sold all or a portion of the interests in his or her own business to a third party investor would not be "engaged in the business." "Engaged in the business" considers a number of factors. One key factor in determining whether a person is "engaged in the business" is whether compensation is paid based on the outcome or the size of the transaction, *i.e.*, a success fee or sales commission. The SEC refers to this type of compensation arrangement, also known as the "salesman stake," as the hallmark of being "engaged in the business." Accordingly, it would seem that an investment adviser that pays its personnel a sales commission based on the completion of the sale would be "engaged in the business" and thus would need to be registered as a broker-dealer. Courts in California have gone as far as to say that "engaged in the business" would arise from a single transaction involving the payment of a sales commission.

Absent a sales commission, the analysis turns to whether the person is engaged in securities transactions with sufficient recurrence to justify the inference that the activity is part of the person's business. Those factors include (1) actively soliciting investors, (2) advising investors on the merits of an investment, (3) regularly participating in handling securities transactions for clients and (4) holding ones' self out as handling securities transactions. Accordingly, it would seem that an investment adviser that employs dedicated full-time salaried sales personnel to solicit purchases from prospective investors would come under considerable scrutiny as being "engaged in the business."

A more common scenario for smaller investment advisers, and the one that the SEC's Chief Counsel left most in an area of uncertainty, arises where employees are involved from time to time in the sales of fund interests in addition to performing other duties. For example, portfolio managers participate in the selling process because they realize many prospective investors will not invest without having a thorough explanation of the investment process. Senior managers may participate in the selling of fund interests in addition to performing their managerial duties because increasing assets under management is in the best interest of the investment adviser. Administrative assistants may participate just as a way of helping out. Typically, these employees receive a salary plus an annual bonus.

In this scenario, it would seem the analysis would center on the factors referred to above. Is the solicitation efforts ancillary to the employee's duties or whether they comprise a majority of the employee's time? Is there any inkling in the employee's job description or job title that suggests he or she is expected to act in a sales capacity? Would the investing public perceive this person as acting in a salesperson's capacity? Is the annual bonus based primarily on the amount of fund shares sold? Or is the annual bonus based on a wide variety of factors such as, overall job performance evaluation; adherence to the firm's values, culture and compliance policies; and overall firm performance? The answers to these questions will influence the analysis of whether the investment adviser and its employees are acting in a broker-dealer capacity.

Registering under the Exchange Act's broker-dealer provisions is time consuming, costly, and beyond the means of many small investment advisers. So, until the SEC provides clarity, investment advisers, particularly those with employees who perform multiple functions and are paid on a salary plus bonus model, are left in a sort of legal limbo. Their vulnerability lies in Exchange Act section 15(a)(1) and section 29(b). Section 15(a)(1) makes it unlawful for any broker or dealer to effect any transaction in the purchase or sale of any security unless the broker or dealer is registered pursuant to Section 15(b). Section 29(b) voids every contract made in violation of any provision of this title. Given these two sections, employees who, in connection with sales of interests in the fund, are deemed to be "engaged in the business" have sold those interests with rights of rescission attached. An end result in which every investor has the right to a full refund of their purchase price could be devastating to any investment adviser.

Until the SEC publishes official guidance on the issue, it is best for investment advisers to tread cautiously when marketing interests in the private funds they manage. Be sure to carefully review employee job descriptions, and specifically duties and compensation arrangements of such employees to assess what actions, if any, are required.

For more information on this topic, including broker-dealer issues or registering as a broker-dealer, please contact us at info@jackolg.com, or (619) 298-2880. To learn more about our services, please visit our website at www.jackolg.com.

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