JACKO LAW GROUP, PC
SECURITIES & CORPORATE COUNSEL

Legal Risk Management Tip
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IS BROKER-DEALER REGISTRATION ON THE HORIZON FOR PRIVATE FUND MANAGERS?

Fundraising is a key consideration for launching any private fund. But beware - the Securities and Exchange Commission ("SEC") is scrutinizing private fund managers for not using registered broker-dealers for fundraising activities. This can be seen both in recent enforcement actions, as well as from statements made by SEC officials. This month's JLG Legal Tip focuses on what generally triggers broker registration, recent developments regarding private fund's use of non-registered brokers and tips for determining when registration might be required.

Broker Registration Requirements

Section 3(a)(4)(i) of the Securities Exchange Act of 1934 (the "Act") broadly defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[1] Furthermore, Section 15(a) of the Act states that it is unlawful to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security"[2] without first registering. Violation of Section 15(a) may bring serious sanctions by the SEC (as seen in the Ranieri matter summarized below). However, these sanctions can become compounded when reading Section 29(b) of the Act, which states in pertinent part, "…every contract made in violation of any provision of this title or of any rule or regulation thereunder…shall be void…" Thus, when a firm enters into a contract induced by the efforts of an individual who was required but failed to register as a broker, that contract may be voided pursuant to violation of the stipulations within Section 15(a). As such, the offending firm is not only in violation of Section 15(a), but it has also exposed itself to the potential right of rescission of all such contracts, which have now become void.

Determining whether someone intends to act in a broker capacity, and therefore is subject to registration, is normally a straight-forward process. For instance, a person who executes transactions for others on a securities exchange clearly is a broker. However, other situations and relationships are less clear, and require scrutiny. For example, many private funds employ "finders" for attracting prospective clients to invest in the fund (as seen in Ranieri) in exchange for a flat fee. As the name implies, a finder typically is a person who finds, introduces and/or brings parties together for a transaction and then leaves any negotiation and closing to the parties.[3] Where trouble often arises is when these finders go beyond their duties. In order to determine whether any of these individuals (or any other person or business) is a broker, regulators generally consider the activities that the person or business actually performs. Receiving contingent fees (commonly referred to as "success fees") or any compensation tied to obtaining or completing a transaction, negotiating and consummating transactions, advising on or evaluating the investment or actively soliciting investors (*i.e.*, distributing promotional

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[1] http://www.sec.gov/about/laws/sea34.pdf.
[2] Id.
[3] http://www.sec.gov/divisions/marketreg/bdguide.htm#II.

materials) all may be considered actions of a broker, and as such, any finder engaged in these activities would need to register as a broker or face stiff penalties.

Recent Developments

A. Lessons Learned In the Matters of Stephens, Ranieri Partners LLC and Phillips

Recently, the SEC settled parallel actions against a private equity firm, Ranieri Partners, LLC ("Ranieri"), its former senior management partner, Donald Phillips ("Phillips"), and William Stephens ("Stephens"), an independent consultant hired by Ranieri.[4] The SEC claimed that Ranieri raised over $500 million in capital commitments through Stephens who was acting as a finder for the firm, but whose actions actually should have required registration as a broker pursuant to Section 15(a) of the Act. Specifically, the SEC cited such actions as: receiving "transaction-based" compensation, sending private placement memoranda, subscription documents and due diligence materials directly to potential investors and providing analysis of the strategy and performance of Ranieri's funds to potential investors as primary reasons for why Stephens should have registered.

The SEC further alleged that because the private fund adviser permitted Stephen's actions to occur on behalf of the fund, Ranieri "caused" the violation of Section 15(a) to occur, and as the supervisor, Phillips willfully aided and abetted the firm and Stephens to cause that violation. As such, terms of the settlements punished not only Stephens (who is barred from the securities industry and required to pay approximately $2.83 million in disgorgement and prejudgment interest), but also Ranieri, who was fined $375,000 and ordered to cease and desist current and future violations of Section 15(a), and Phillips, who was fined $75,000, ordered the identical cease and desist order and suspended for nine-months from acting in a supervisory capacity in the securities industry.

The Ranieri matter has left the industry with two striking considerations moving forward. First, not only are finders put on notice of the consequences they may face for failure to register as a broker, but moreover, private fund managers and senior executives may be found culpable for causation, aiding and abetting. Secondly, unlike many other cases for failure to register as a broker, the SEC did not allege fraud and/or misleading clients in this matter. Thus, the mere act of failing to register as a broker when required is alone sufficient to bring charges against all parties involved.

B. SEC Chief Counsel Heeds Warnings for Those in the Private Fund Space

On April 5th, less than a month after the Ranieri matter settled, David Blass ("Blass"), the chief counsel of the SEC's Division of Trading and Markets, addressed a subcommittee of the American Bar Association.[5] While Blass emphasized the comments he made that day were his own, and not necessarily the views of the SEC, Blass did point out that there has been an "increased examination focus" of private fund managers for not using registered broker-dealers

[4] http://www.sec.gov/news/digest/2013/dig031113.htm.
[5] Blass, David W., *A Few Observations in the Private Fund Space*, April 5, 2013. For more information, *please see*: http://www.sec.gov/news/speech/2013/spch040513dwg.htm.

for fundraising. Blass stated these violations are not only technical violations that carry penalties, but also may lead to past deals becoming void. The speech highlighted two specific areas of concern about broker-dealer registration as it relates to private fund sponsors.

- First, Blass put private equity fund managers on notice stating they may be engaging in unregistered broker-dealer activities as a result of internal and/or external marketing personnel's activities and the manner by which such fund managers compensate their personnel. Blass discussed the recent "Ranieri" matter reinforcing the scope of the "finder's" exemption.[6] He also reiterated that while not sufficient in and of itself to require registration, receiving transaction-based compensation is an important consideration.

- Second, Blass discussed activities in connection with the fees paid by portfolio companies to funds and/or fund managers for merger, acquisition and/or financing assistance. Blass stated that fees for "investment banking" activities (*i.e.,* negotiating transactions, finding buyers and sellers of the company's securities, etc.), while common in the private fund area, also may raise broker-dealer registration concerns as they "involve transaction-based compensation that is linked to the manager effecting a securities transaction." Mr. Blass noted, though, that transaction fees that offset or wholly reduce the amount of the advisory fee payable to the fund may not raise broker-dealer registration concerns.

In addition, Blass addressed the "issuer exemption" in the context of private find advisers. The exemption, found in Exchange Act Rule 3a4-1, provides a safe harbor for associated persons of certain issuers allowing them to participate in the sale of an issuer's securities without being considered a broker. Blass stated that this exemption is generally not used by private fund advisers as it is difficult to fall within the conditions required to utilize this exemption.

Blass's remarks may be viewed as a warning to the industry. However, Blass also acknowledged that each situation is fact-specific, and appreciates that the expense of registering or hiring a broker-dealer to conduct marketing could be quite burdensome to smaller advisers. In closing, Blass expressed hope that the industry and the SEC Staff could work together in generating new exemptive relief methods tailored to certain private fund sales activities.

Considerations for Registration

Before entering into an arrangement utilizing a finder, internal and/or external marketing consultant or other individual/business designed to attract investors to a private fund, it is important to weigh the risks associated with such an arrangement, and to mitigate these risks whenever possible. Whether or not registration as a broker is required should be a top priority, and as such, an objective evaluation of the arrangement should be conducted. According to the

[6] The "finder exemption" has been articulated in several SEC no-action letters; however, use of the exemption is highly fact-specific. For more, *please see*: Henry C. Goppelt dba May-Pac Management Company, 1974 SEC No-Act. LEXIS 2,415 at 2-3 (May 13, 1974).

SEC's "Guide to Broker-Dealer Registration," [7] and the speech given by Blass, some of the questions that you should ask to determine whether you are acting as a broker include:

1. Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
2. How does the adviser solicit and retain investors?
3. Are personnel engaging in marketing activities part of a dedicated marketing team?
4. Does compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal (*i.e.*, is premised on a "success" fee)?
5. Are trailing commissions, such as 12b-1 fees involved, or any other transaction-related compensation?
6. Are you otherwise engaged in the business of effecting or facilitating securities transactions?
7. Do you handle the securities or funds of others in connection with securities transactions?

While the determination of broker-dealer status is fact intensive, a "yes" answer to any of these questions indicates that requirements for registration as a broker should be further evaluated with counsel. Some proactive measures firms may take to safeguard against inadvertent registration violations include: creating guidelines for staff and outside consultants on scope of performance, responsibilities, and acceptable behavior for promoting the fund; stipulating compensation structures and standards for use with finders and sales personnel prior to engagement; and formulating a firm-wide policy related to due diligence steps required for employing finders – which should include questioning whether they are affiliated with a registered broker-dealer.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

Author: Robert R. Boeche II, Esq., Associate Attorney; Editor: Michelle L. Jacko, Esq., Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters.

[7] http://www.sec.gov/divisions/marketreg/bdguide.htm#II.