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LITIGATION, FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY, INVESTMENT FUNDS

CLIENT PUBLICATION

April 11, 2013

SEC Lawyer Speaks to Broker-Dealer Registration Status of Private Fund Managers

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Late last week, a senior SEC lawyer encouraged the private equity and hedge fund communities to consider whether certain practices of private fund managers could subject these firms to SEC registration as broker-dealers. David W. Blass, Chief Counsel of the agency's Division of Trading and Markets, raised the issue during an April 5, 2013 speech to the American Bar Association's Trading and Markets subcommittee.

Saying that his remarks followed on SEC staff observations of business practices of newly-registered investment advisers (and offering the customary disclaimer of not speaking for the Commissioners or others on the staff), Mr. Blass reminded the audience that, absent available exemption or relief, persons engaged in the business of effecting transactions for the accounts of others must be registered as brokers. He stated that the test for whether one is acting as a broker is broad, but noted that some of the factors that could be indicative are: 1) marketing securities transactions, which include interests in a private fund; 2) soliciting securities transactions; or 3) handling customer funds and securities.

Warning of the so-called "salesman's stake" in a securities transaction, Mr. Blass reiterated the well-known principle that the existence of transaction-based compensation is a "critical" factor in determining the need for broker-dealer registration. But he also said that even some fund firms whose personnel do not receive transaction-based compensation should be prepared to consider their broker-dealer status. For example, Mr. Blass stated that the existence of a "dedicated marketing department" at a private fund adviser[1] could "strongly indicate that they are in the business of effecting transactions in the private fund, regardless of how the personnel are compensated."

[1] Presumably meaning a marketing department dedicated to selling interests in private funds rather than a marketing department that informs potential clients about investment advisory services such as managed accounts.

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With respect to private equity managers, Mr. Blass then went through a laundry list of fees that some firms receive and that he characterized as being transaction-based. He noted that certain private equity advisers might receive fees in connection with the acquisition, disposition or recapitalization of portfolio companies, and for "purported investment banking" activity, such as the negotiation, marketing and structuring of transactions. He took the view that the combination of receiving success fees and engaging in activities concerning effecting securities transactions appears to cause the adviser also to be a broker. He acknowledged, however, that these practices would not appear to raise broker-dealer concerns if the fees reduce or constitute an additional avenue for payment of advisory fees.

Mr. Blass urged private fund advisers to grapple with these registration issues prior to being visited by SEC examiners and raised a number of questions firms might ask about their practices, such as:

- How the firm sources investors for its funds
- How firm personnel are compensated
- Whether personnel might be viewed primarily as marketers versus having broader responsibilities[2]
- Whether particular revenue streams for the firm might be viewed as providing for transaction-based compensation in connection with securities transactions

He also reminded the audience of the risk of being subject to an enforcement case even for unintentional misconduct, as a private equity fund firm was for paying transaction-based compensation to a consultant who had not been registered as a broker-dealer.[3]

Finally, Mr. Blass acknowledged that both the costs and burdens of operating a registered broker-dealer are meaningful and that "there is a wide array of options available to private fund advisers to raise funds without triggering broker registration concerns." He also invited the industry to consider whether a new regulatory exemption written specifically for private fund advisers is needed or would be helpful.

To summarize, we view aspects of the speech – notably, emphasis on concern with transaction-based compensation – as consistent with industry understanding of these issues and recent judicial and agency decisions, but the tone and emphasis given to private funds cannot be ignored.

[2] We note the general industry view that personnel with marketing duties also should have substantial other duties, which can include portfolio management, investor relations and servicing (focused on a firm's current rather than new fund investors) or executive functions.

[3] If you wish to review further details of that enforcement matter, you may refer to our prior publication entitled SEC Charges Asset Manager for Finder's Broker-Dealer Registration Failure.

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