U.S. Securities and Exchange Commission

A Few Observations in the Private Fund Space

by

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Thank you very much, Dana [Fleischman, Chair of the Trading and Markets Subcommittee] for your kind words and for inviting me to speak with you today.

I have had the great pleasure over the last year or so to work with Dana and other members of the Trading and Markets Subcommittee and other ABA groups on a number of initiatives surrounding one broad and oftentimes tricky question: when is a person required to register with the SEC as a broker-dealer? Not exactly a prime subject for a TED Talk, but this group knows how vitally important it is to settle some of the questions that have been open for a decade or more about who needs to register with the SEC as a broker-dealer.

I and my staff have already begun talking with you about such perennial hits as placement agents, so-called "finders," and business or M&A brokers. Most recently, we have had lengthy discussions with various members of this subcommittee about Rule 15a-6, the rule exempting from registration certain non-U.S. resident persons engaged in business as a broker or dealer entirely outside the U.S. These discussions led the staff to publish responses to frequently asked questions about the rule to address some of the issues that you have told us have been a source of confusion.[1] We view the FAQs as an initial set of staff guidance about issues that commonly arise under Rule 15a-6. They do not break new ground, but I believe they are important to ensuring that regulators and market participants are operating under a common understanding of how the rule works. We are very much open to exploring opportunities for additional guidance through subsequent FAQs.

We also have had broader discussions with many of you about Rule 15a-6, including whether there are opportunities to more fundamentally update the rule, which was adopted in 1989 when the globalization of the securities markets was just emerging. I approach this topic with an open mind, and also a belief that Rule 15a-6 should be complementary to — though not necessarily identical to — the cross-border approach that the SEC may take with respect to the security-based swaps market.

While Rule 15a-6 is a perennial topic, so too are others that we have been discussing with various members and committees of the ABA, as well as

other interested groups. I have in mind the broker-dealer registration requirements as they apply to the group I mentioned earlier — placement agents, finders, and business or M&A brokers. The staff has been considering a wide spectrum of options for certain of these market participants, ranging from potential recommendations for exemptions to working collaboratively with FINRA on a more customized approach for regulation of market participants who perform only limited broker functions. The staff's consideration of this latter approach, which has the potential benefit of removing some barriers to entry, has been greatly facilitated by the work being done for the regulation of funding portals. Introduced by the JOBS Act, funding portals are intended to perform limited functions for crowdfunding offerings. Because their functions are limited (for example, they do not come into possession of customer funds or securities or provide investment advice), funding portals receive lighter regulatory treatment, including being subject to a customized set of rules under FINRA's rulebook (as compared to fully registered broker-dealers) and receiving an exemption from broker registration with the SEC. Needless to say, the staff is continuing to think through the appropriate registration and regulation structure for funding portals, and learning from that experience to see if there are opportunities to extend the approach to other types of brokers whose activities are limited.

Today, I would like to add a new topic of discussion that refers back to our broad theme of broker-dealer registration. The issue arises in the private fund adviser world. *Before I get started on that topic, though, please let me remind you that my remarks represent my own views, and not those of the Commission, any individual Commissioner, or any other members of the staff.*

As you are well aware, private funds have become an increasingly large part of the financial marketplace in the last couple of decades. Their significance was recognized in the Dodd-Frank Act, and related SEC rules, which impose new registration and reporting requirements on private fund advisers. Following suit, the staff is putting an increased examination focus on private fund advisers, both due to the new regulatory requirements and our own observations in the private fund space.

Many private fund advisers are quite rightly coming to terms with the requirements under the Investment Advisers Act of 1940 that are newly applicable to them and are probably focused on recent enforcement actions under that Act and concerns expressed by the SEC's senior enforcement and examination teams.[2] While it is absolutely right and appropriate that private fund advisers devote their resources to complying with the requirements under the Advisers Act, I would like to be sure that the private fund adviser community is not overlooking significant area of concern under the Securities Exchange Act of 1934 — activity that could cause a private fund adviser to be required to register as a broker-dealer.

The reason I focus on the broker-dealer issue in this context is because of some practices that the staff has observed in connection with newly registered private fund advisers. This is an issue that warrants some attention before examiners arrive. To date, the issue has come in two flavors. I will describe these in more detail shortly, but the first flavor (let's call it plain vanilla) involves a fund adviser that pays its personnel transaction-based compensation for selling interests in a fund or that has personnel whose only or primary functions are to sell interest in the fund. In the second flavor (a bit more unusual, say dark chocolate with a subtle infusion of habanero), the private fund adviser, its personnel, or its affiliates receive transaction-based compensation for purported investment banking or other broker activities relating to one or more of the fund's portfolio companies. The staff understands that this second practice is common at advisers of certain types of funds, such as private equity funds that execute a leveraged buyout strategy. I should note that these issues are not unique to advisers to private equity funds or even advisers to private funds. Advisers to other types of funds, including business development

companies, also will want to think through their practices.

Sales of interests in a private fund

In a speech several years ago, the Director of the Division of Investment Management at the time expressed concern that some participants in the private fund industry may be inappropriately claiming to rely on exemptions or interpretive guidance to avoid broker-dealer registration.[3] As this group knows quite well, absent an available exemption or other relief, a person engaged in the business of effecting transactions in securities for the account of others must generally register under Section 15(a) of the Exchange Act as a broker.[4]

The test for broker-dealer registration is broad and depends on various activities a person performs in one or more securities transactions.[5] Some examples of activities, or factors, that might require private fund adviser personnel to register as a broker-dealer include:

- Marketing securities (shares or interests in a private fund) to investors,
- Soliciting or negotiating securities transactions, or
- Handling customer funds and securities.

The importance of each of these activities is heightened where there also is compensation that depends on the outcome or size of the securities transaction — in other words, transaction-based compensation, also referred to as a "salesman's stake" in a securities transaction. The SEC and SEC staff have long viewed receipt of transaction-based compensation is a hallmark of being a broker.[6] This makes sense to me as the broker regulatory structure is built, at least in large part, around managing the conflict of interest arising from a broker acting as a securities salesman, as compared to an investment adviser which traditionally acts as a fiduciary and which should not have that same type of conflict of interest.

With this backdrop, a private fund adviser (or counsel to a private fund adviser) should think through how the adviser goes about obtaining new investors and retaining existing investors. That is not to say that all investment-raising by a private fund adviser results in the adviser being a broker-dealer. We do not look at the world through that type of prism. Based on my own experience, however, I believe that private fund advisers may not be fully aware of all of the activities that could be viewed as soliciting securities transactions, or the implications of compensation methods that are transaction-based.

An example of this area of focus is the recent *Ranieri Partners* enforcement action.[7] Just last month, the SEC settled charges in connection with alleged violations of Section 15(a) of the Exchange Act against Ranieri Partners, which is a New York-based private equity firm, and also with a former senior executive of Ranieri Partners and an independent consultant hired by Ranieri Partners.[8] The Commission's order found that Ranieri Partners paid transaction-based fees to the consultant, who was not registered as a broker, for the purpose of actively soliciting investors for private fund investments. The Commission's cases demonstrate that there are serious consequences for acting as an unregistered broker, even where there are no allegations of fraud. It is important, I believe, for market participants to keep in mind that the willingness for one to act as an unregistered broker can be a strong indicator of other potential misconduct, especially where the unregistered broker-dealer comes into possession of funds and securities.

In order to help private fund advisers think through this a little more, and to give some specific examples, I thought I would run through some

questions private fund advisers might want to ask themselves with respect to activities or services that they may perform. Determining whether a person is a broker-dealer can be fairly fact intensive and these questions are the types we ask ourselves when making that kind of determination. For example, the adviser might want to consider the following:

- How does the adviser solicit and retain investors? I recommend some thinking go into the duties and responsibilities of personnel performing such solicitation or marketing efforts. This is an important consideration because a dedicated sales force of employees working within a "marketing" department may strongly indicates 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? 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.[9]

- Do you 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 (more on this topic below).

Some ask us about the so-called "issuer exemption" in the context of private fund advisers. That exemption, found in Exchange Act Rule 3a4-1, provides a nonexclusive safe harbor under which associated persons of certain issuers can participate in the sale of an issuer's securities in certain limited circumstances without being considered a broker.[10] As you all know, Rule 3a4-1 generally is not used by private fund advisers. Furthermore, and just by way of example, a person must satisfy one of three conditions to claim the issuer exemption from broker-dealer registration:

- the person limits the offering and selling of the issuer's securities only to broker-dealers and other specified types of financial institutions;

- the person performs substantial duties for the issuer other than in connection with transactions in securities, was not a broker-dealer or an associated person of a broker-dealer within the preceding 12 months, and does not participate in selling an offering of securities for any issuer more than once every 12 months; or

- the person limits activities to delivering written communication by means that do not involve oral solicitation by the associated person of a potential purchaser.

It could be difficult for private fund advisers to fall within these conditions.

I am keenly aware that many advisers, particularly smaller advisers, may not be able to afford or be able to either hire a broker-dealer or register as broker-dealers themselves. By raising the issues that I have just described, I am not saying that they need to do that in all circumstances. There is a wide array of options available to private fund advisers to raise funds without triggering broker registration concerns. My purpose is to assist advisers in reviewing their activities to be sure they are aligned with existing legal requirements. I would also be interested in hearing from this group and others whether a broker-dealer registration exemption written specifically for private fund advisers is needed or would be helpful. I have in

mind a potential exemption like the issuer exemption, but one written specifically for private fund advisers. Certainly, the receipt of transaction-based compensation is a problematic practice in this context, but what other parameters might apply if there was an express exemption written specifically for private fund advisers?

Broker-dealer issues arising from private equity fund practices

On a related note, the staff has observed that that advisers to some funds — for example, advisers to private equity funds executing a leverage buyout strategy — may also collect many other fees in addition to advisory fees, some of which call into question whether those advisers are engaging in activities that require broker-dealer registration. Examples include fees the manager 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 described as compensating the private fund adviser or its affiliates or personnel for "investment banking activity," including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions.

Looking back to the earlier analysis of what makes one a broker, this practice appears to involve transaction-based compensation that is linked to the manager effecting a securities transaction. The combination of success fees which cause the adviser to take on a salesman's stake and the activities involved in effecting securities transactions appear, at least on their face, to cause such an adviser to fall within the meaning of the term "broker."

I understand that the practice of charging these transaction fees might be common among some private fund adviser and I am very much open to talking over our broker analysis with interested parties. For example, we have been told that one rationale advisers might put forth for why these activities and payment schemes do not raise broker-dealer status issues is where the payments offset or otherwise reduce the amount of the advisory fee payable by the fund. To the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, one might view the fee as another way to pay the advisory fee, which, in my view, in itself would not appear to raise broker-dealer registration concerns.

Another rationale that has been brought to the staff's attention focuses on the recipient of the fee. Here, the general partner of the fund (where the general partner is also the adviser to the fund or an affiliate of the adviser) directly or indirectly receives the transaction fee. We are told that the general partner should be viewed as the same person as the fund, so there are no transactions for the *account of others*. This explanation does not seem plausible to me — if the general partner and the fund are the same, why is it that the fee is paid to anyone other than the fund. That the fee is paid to someone other than the fund — here the general partner — makes crystal clear to me that, at least for potential broker-dealer status questions, the fund and the general partner are distinct entities with distinct interests.

Others have questioned why the staff would want to require a private equity fund managers to register as a broker-dealer. While certainly an interesting policy question, I approach this issue from another perspective. Unless prepared to register as a broker, a person should not engage in activities that trigger registration. To my knowledge, there is no exemption or other relief available for the activity that I described above. Taking the activity out of the private equity space and applying it in other contexts would leave little question about the need for broker-dealer registration.[11] Investors in the fund, furthermore, may or may not be in a position to monitor the adviser's activity and fees. It does not appear difficult to me for a private equity fund adviser to change its practices so it is not engaging in

activities that raise broker-dealer status questions. Again, the staff is interested in talking these issues over, but I encourage advisers to private funds to think through these practices.

Closing remarks

I raise all these issues to bring them to the attention of private fund advisers and their counsel, so they can grapple with them hopefully in advance of a visit from the SEC's examiners. Also, while some out there might think that acting as an unregistered broker-dealer should be viewed as only a technical violation, I want to take a moment and caution that engaging in these activities without registering can have serious consequences. In addition to being subject to sanctions by the SEC, another possible consequence of acting as an unregistered broker-dealer is the potential right to rescission. In other words, securities transactions intermediated by an inappropriately unregistered broker-dealer could potentially be rendered void.[12] Given the significant consequences of acting as an unregistered broker-dealer and the increased attention being given to this issue by the SEC staff, private fund advisers should consider reviewing their practices to determine whether any activities that may be approaching or crossing the line would require broker-dealer registration.

In closing, I want to thank once again the ABA's Trading and Markets Subcommittee and others at the ABA for their willingness to engage in a fruitful dialogue on a number of issues surrounding broker-dealer registration requirements. With new oversight of private fund advisers comes the opportunity to take proactive steps to avoid problems. These steps can include reviewing the standards for broker-dealer registration and previous staff guidance and to review business activities with these standards in mind. They also can include a dialogue with us about the potential need for relief with appropriate conditions or other parameters. I appreciate the opportunity to share my thoughts on these important issues with you. As I'm sure you are aware, the staff at the SEC is fully committed to our mission of protecting the nation's investors and we view maintaining an ongoing dialogue with market participants as critical to carrying out this mission.

Thank you, and I would be happy to answer any questions you might have.

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[1] The Rule 15a-6 staff FAQs are available at: sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm.

[2] *See*, *e.g.*, Speech, *Private Equity Enforcement Concerns*, Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit (January 23, 2013), available at: sec.gov/news/speech/2013/spch012313bk.htm#P14_514; Speech, *Enforcement Priorities in the Alternative Space*, Bruce Karpati, (December 18, 2012), available at: sec.gov/news/speech/2012/spch121812bk.htm; Speech, *Address at the Private Equity International Private Fund Compliance Forum*, Carlo V. di Florio, Director, SEC's Office of Compliance Inspections and Examinations, available at: http://www.sec.gov/news/speech/2012/spch050212cvd.htm.

[3] Speech, *Keynote Address at the ALI-ABA Compliance Conference*, Andrew J. Donohue, Director, SEC's Division of Investment Management (June 3, 2010), available at: http://www.sec.gov/news/speech/2010/spch060310ajd.htm.

[4] Section 3(a)(4) of the Exchange Act defines a "broker" generally as "any person engaged in the business of effecting transactions in securities for the account of others." A person may be found to be acting as a broker if that person participates in securities transactions "at key points in the chain

of distribution." Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass.), *aff'd,* 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977).

[5] Section 3(a)(5) of the Exchange Act defines "dealer" as "any person engaged in the business of buying and selling securities…for such person's own account through a broker or otherwise." Generally speaking, private fund advisers' activities typically do not cause the adviser to fall within the meaning of the term "dealer."

[6] Although the receipt of compensation in connection with a purchase or sale of securities generally requires, as a practical matter, registration or association with a registered broker-dealer, it is important to understand that the receipt of transaction-based compensation in connection with securities transactions is not a necessary element to require broker-dealer registration. In other words, one can be acting as a broker-dealer without having received transaction-based compensation.

[7] *See* In the Matter of Ranieri Partners LLC and Donald W. Phillips, SEC Release No. 34-69091, Administrative Proceeding File No. 3-15234 (March 8, 2013); *see also* In the Matter of William M. Stephens, SEC Release No. 34-69090, Administrative Proceeding File No. 3-15233.

[8] The Commission ordered Ranieri Partners to pay a civil monetary penalty of $375,000 and the senior executive of the fund to pay a penalty of $75,000. The Commission also barred the independent consultant from the securities industry.

[9] Consider *Ranieri Partners* in this context — the unregistered consultant was compensated a percentage of all capital commitments made to the funds by investors introduced by the consultant.

[10] A provision in Title II of the JOBS Act provides an exemption from broker-dealer registration for so-called "Regulation D portals." Under new Section 4(b) of the Securities Act, a person can offer and sell securities in compliance with Rule 506 of Regulation D under the Securities Act without becoming subject to registration as a broker or dealer where certain conditions are met. Among other things, the person and each person associated with that person may receive no compensation in connection with the purchase or sale of those securities. The prohibition on compensation makes it unlikely that a person outside the venture capital area would be able to rely on the exemption from broker-dealer registration. For more information, including information on forms of compensation, see FAQs published by the Division of Trading and Markets, available at: sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

[11] The practices described may not be unique to private equity fund managers — they may also be prevalent for other funds, including business development companies, in which case the analysis should be the same.

[12] Section 29(b) of the Exchange Act. *See* Reg'l Props., Inc. v. Fin. And Real Estate Consulting Co., 678 F.2d 552 (5th Cir. 1982); *see also,* Eastside Church of Christ v. Nat'l Plan, Inc., 391 F.2d 357 (5th Cir.), cert. denied, 393 U.S. 913 (1968).

http://www.sec.gov/news/speech/2013/spch040513dwg.htm