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SECURITIES AND FUTURES REGULATORY UPDATE

Recent SEC Focus on the Internal Marketing Activities of Private Funds

I. Comments by the SEC on Marketing of Private Funds

Last Friday, April 5, 2013, at an American Bar Association conference in Washington, D.C., David Blass, the Chief Counsel of the Securities and Exchange Commission's (the "SEC") Division of Trading and Markets, expressed concern at the way many private funds market interests in those funds through internal marketing personnel without the involvement of an SEC-registered broker-dealer.[1] As a result, Mr. Blass stated that the SEC was subjecting private fund advisers to an "increased examination focus" with respect to the internal marketing activities of such advisers.

Mr. Blass noted that the SEC no longer views an unregistered broker claim as an "add on" claim to be brought only with another "main" claim, such as an allegation of fraud; rather, the SEC will consider enforcement actions for standalone claims of acting as an unregistered broker, and the SEC's examination staff, through its Office of Compliance Inspections and Examinations, views internal marketing by private funds as a priority exam matter.

Mr. Blass noted that the safe harbor in Rule 3a4-1 under the Securities Exchange Act of 1934 ("Exchange Act") does not, by its terms, cover private fund advisers.[2] In addition, it should be noted that in 2012, as part of the enactment of the Jumpstart Our Business Startups Act, Congress added a new Section 4(b) to the Securities Act of 1933 (the "Securities Act"). Section 4(b) provides, in effect, a safe harbor from broker registration under the Exchange Act with respect to the marketing of securities in private offerings conducted pursuant to Rule 506 of Regulation D under the Securities Act that allows a person to "maintain a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitation, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through other means," provided, however, that no

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[1] Speech, A Few Observations in the Private Fund Space, David W. Blass, Chief Counsel, SEC Division of Trading and Markets (Apr. 5, 2013), available at http://www.sec.gov/news/speech/2013/spch040513dwg.htm.

[2] Rule 3a4-1(a)(4)(ii) provides a non-exclusive safe harbor from the broker registration requirement of Section 15(a)(1) of the Exchange Act with respect to certain "associated persons of an issuer," including employees of a private fund adviser and/or employees of an affiliate of such an adviser who do not receive transaction-based compensation, who primarily perform substantial duties for the issuer unrelated to marketing of the issuer's securities or are intended to primarily perform such substantial duties "at the end of the offering," and who are not subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act. Rule 3a4-1, however, is a very limited safe harbor, and does not contemplate continuous offerings with multiple closings throughout the year. But, by its terms, it is a non-exclusive safe harbor so that technical non-compliance with such safe harbor does not, in and of itself, create a presumption of being an unregistered broker. Many private fund managers attempt to avoid broker registration under the Exchange Act for any such manager and its personnel by trying to fit within the "spirit" of Rule 3a4-1.

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such person receives any "compensation in connection with the purchase or sale of such security," among certain other requirements. In February 2013, the SEC issued Frequently Asked Questions ("FAQs")[3] relating to, among other things, new Section 4(b) of the Securities Act whereby the SEC expressed the view that Congress did not limit the aforesaid limitation on the payment of "compensation" to transaction-based compensation. As such, the SEC noted that it interprets the term "compensation" broadly, to include any direct or indirect economic benefit to the person or any of its associated persons. At the same time, the SEC noted that Congress expressly permitted co-investment in the securities offered on the platform or mechanism. As such, the SEC stated that it does not believe that profits associated with these investments would be impermissible compensation for purposes of Section 4(b) and, as a practical matter, the SEC stated its belief that the prohibition on compensation makes it "unlikely that a person outside the venture capital area" would be able to rely on the aforesaid safe harbor from broker registration.

The SEC further noted in the FAQs that, in some instances, a complex of privately offered funds may have an internal marketing department or use the investor relations department of an affiliated adviser or other entity whose staff is paid a salary to promote, offer, and sell shares of the privately offered funds. The SEC stated that these persons may *not* rely on the safe harbor from broker registration in Section 4(b), as those marketing persons would be impermissibly receiving "compensation" for these purposes.

In light of the foregoing, Mr. Blass expressed the view that the broker registration safe harbor set forth in new Section 4(b) of the Securities Act for private offerings will have little utility to private fund advisers.

Mr. Blass further stated that it is unlikely that the receipt by a person of transaction-based compensation, or a success-based fee, that is tied to the successful consummation of a securities transaction or the amount of securities sold would ever be permissible, as such a compensation arrangement creates a "salesman's stake" in a securities transaction – a conflict of interest that underlies the reason why brokers are generally required to be registered under the Exchange Act. Although Mr. Blass noted that marketing activities by a private fund adviser will not always result in the adviser being subject to broker registration, he did express concern that many private fund advisers have dedicated, internal marketing departments whose personnel are compensated to essentially "solicit and retain" investors. He noted that, although a private fund adviser will generally be registered as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act"), such registration focuses on ensuring that the adviser discharges its duty as a fiduciary, and is not focused upon a marketing role. As such, Mr. Blass said that the argument against separate broker registration because the adviser is already registered with, and regulated by, the SEC under the Advisers Act is not compelling with respect to a determination of whether broker registration under the Exchange Act is mandated.

Noting that the receipt of transaction-based/success-based compensation with likely always be problematic and trigger broker registration, but not all private fund advisers will trigger broker registration in the absence of such a compensation arrangement, Mr. Blass highlighted several factors that a private fund adviser should consider when analyzing the need to register as a broker:

- Does the private fund adviser employ a "dedicated sales force of employees working within a 'marketing' department"? If yes, this factor "strongly indicates" the need for broker registration.
- In contrast, do employees who solicit investors have substantial other responsibilities unrelated to marketing (that is, are the "primary functions" of these employees other than to solicit investors)? If yes, this factor would suggest that broker registration is not necessary. Related to this inquiry, although not specifically addressed by Mr. Blass, is how many separate funds (with separate investment objectives) have been sponsored and marketed, internally, by a fund adviser without the involvement of a registered broker. The greater the number of such separate funds, the

[3] SEC Division of Trading and Markets, Jumpstart Our Business Startups Act Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act (Feb. 5, 2013), http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

greater likelihood that the adviser could be characterized as being engaged in the business of (being compensated for) promoting or sponsoring (that is, "effecting") transactions in multiple fund products, like an investment bank or broker.

How are employees who solicit investors compensated? Do these employees receive bonuses or other types of compensation that are linked to successful investments? As noted above, if the answer is yes, this will likely trigger broker registration. But even if employees do not receive transaction-based/success-based compensation – even if such employees receive only a fixed salary – those employees could nonetheless trigger broker registration if such employees' "primary functions" are to solicit investors. The payment of a fixed salary plus an annual bonus may be permissible, provided that the bonus is not tied to the amount of capital raised by the employee. Mr. Blass noted that SEC examiners may be suspicious if bonuses vary from year-to-year and correlate, positively, to the amount of capital raised by an employee.

Mr. Blass suggested that, if a fund adviser has an internal "investor relations" group whose participants, individually, spend some time, on an ongoing/regular basis, engaged in the solicitation of prospective investors, but whose participants, individually, spend the majority of their time, on an ongoing/regular basis, engaged in investor relations-type activities (such as regular communication with existing investors in the fund to answer questions and to explain proposed changes to or developments in the fund's investment objectives or strategies, or to communicate political, economic or legal/regulatory developments that could impact the operation of the fund), then such an arrangement could be justifiable without triggering broker registration under the Exchange Act. Of course, any such determination would be highly dependent on the particular facts and circumstances.

In this regard, in March 2013, the SEC issued two no-action letters, (i) FundersClub Inc. and FundersClub Management LLC ("FundersClub")[4] and (ii) AngelList LLC and AngelList Advisors LLC ("AngelList"),[5] in which a private fund adviser proposed to solicit investors to invest in privately-offered funds, each of which would be established by the adviser for the purpose of investing in the securities of one or more startup companies. In granting these no-action letters, the SEC said that the adviser could receive a "carried interest" (that is, compensation equal to a percentage of the profits of the investment fund) for its services, where the nature of such services are "traditional advisory and consulting services," but could not receive any transaction-based compensation. With respect to the FundersClub letter, the adviser also noted that, in addition to charging a carried interest, the adviser might also charge an "administrative" fee, but such administrative fee would be used to reimburse third party expenses of the investment fund and would not be paid to the adviser or any of its affiliates or employees.[6]

These letters might suggest that, in the SEC's view, a private fund manager may receive a carried interest, or performance fee, without triggering broker registration (as such a fee is associated with traditional advisory services on the grounds that it incentivizes the adviser to achieve successful future performance of the fund, as opposed to compensating the adviser for sales of interests in such fund), whereas the receipt of a management, administrative or asset-under-management fee (an "advisory fee") by a private fund adviser who, internally, solicits investors might be problematic from a broker registration perspective if such fee is not payable solely to cover bona fide third party expenses.

However, based upon informal discussions with SEC staff, it appears that the SEC would not generally conclude that the receipt by a fund adviser of an advisory fee, in addition to a carried interest, where the fund adviser conducts

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[4] FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar. 26, 2013), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf.

[5] AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter (Mar. 28, 2013), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf.

[6] The FundersClub letter also stated that any portion of the administrative fee remaining in the custody account established by the adviser for these purposes at the time a fund is wound up would be distributed to investors along with the fund's other assets. With respect to the AngelList letter, the SEC noted that the adviser proposed only to receive a carried interest, but not any "commission or management fee as compensation for its advisory services."

internal marketing activities (that is, without the involvement of a broker) triggers broker registration under the Exchange Act, even if such advisory fee is paid to the adviser or any of its affiliates or employees. Thus, the distinction in the letters with respect to the administrative fee appears to simply reflect the differing fact patterns presented by the letters as opposed to suggesting that the outcome depends on the presence of the administrative fee.

Mr. Blass noted that the SEC might be inclined to develop a counterpart to the Rule 3a4-1 safe harbor from broker registration that is designed specifically for private fund advisers, but he did not provide further detail, although he said that the SEC would be open to proposals therefor.

Finally, Mr. Blass cautioned that, notwithstanding the absence of any SEC enforcement initiative with respect to the marketing activities of private fund advisers, securities transactions that are "intermediated by an inappropriately unregistered broker-dealer could potentially be rendered void,"[7] which Mr. Blass characterized as "the significant consequences of acting as an unregistered broker-dealer and the increased attention being given to the issue by the SEC staff."

II. Historical Background

In 2010, Buddy Donohue, the then-Director of the Securities SEC's Division of Investment Management, made several speeches suggesting that the SEC was, at the time, concerned that private fund/issuers were not properly complying with the so-called "issuer exemption" from broker registration set forth in Rule 3a4-1 under the Exchange Act. As noted above, Rule 3a4-1, by its terms, is a non-exclusive safe harbor so that technical non-compliance with such safe harbor does not, in and of itself, create a presumption of being an unregistered broker, and many private fund managers attempt to avoid broker registration for themselves and their personnel by trying to fit within the "spirit" of Rule 3a4-1.

As a result of The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank"), enacted in mid-2010, Congress eliminated the "private adviser" exemption from registration as an investment adviser under the Advisers Act that had been set forth in Section 203(b)(3) thereunder (which established an exemption from registration as an investment adviser for certain advisers that maintained less than 15 clients in any 12-month period and that did not hold themselves out as providing investment advisory services). Accordingly, as a result of Dodd Frank, most large private fund managers were required to register with the SEC as investment advisers and, thus, became subject to SEC examination and inspection.

In more recent years, and in particular since the enactment of Dodd Frank, the SEC appears to have substantially expanded its view of the scope of being a "broker" under the Exchange Act (defined in Section 3(a)(4) thereof generally to mean a person engaged in the business of effecting transactions in securities for the account of others) and, thus, limiting the so-called "finders" exception that was memorialized through the SEC's 1991 Paul Anka no-action letter.[8] That letter permitted a person to simply introduce prospective investors to an issuer – no more – and receive a success-based/transaction-based fee/compensation without triggering broker registration under the Exchange Act. The letter was also generally viewed by the private fund community as providing a basis to lawfully avoid broker registration for internal marketing efforts, especially where no success-based/transaction-based compensation was paid to marketers (which form of compensation was specifically permitted under the Paul Anka letter), in light of the fact that fund advisers were not able to technically comply with Rule 3a4-1 because of the continuous offering nature of their funds, as described above (although, by its terms, the Paul Anka letter could be construed as being limited to acting as a finder for a single issuer in connection with a "one off" transaction).

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[7] See Section 29(b) of the Exchange Act.

[8] Paul Anka, SEC No-Action Letter (Jul. 24, 1991), available at http://www.securities.utah.gov/docs/Anka_Letter.pdf.

Over the last several years, however, the SEC has, in public forums, attempted to discourage persons from relying on the Paul Anka letter suggesting, although never formally stating, that such no-action letter was no longer valid. In 2010, under somewhat similar circumstances as addressed in the Paul Anka letter, the SEC denied a no-action request from a law firm, Brumberg, Mackey & Wall, P.L.C., which sought to introduce prospective investors to issuers in return for success-based compensation.[9] In that letter, the SEC stated that "the Staff believes that the receipt of compensation directly tied to successful investments in [issuer's] securities by investors introduced" thereto by a person "would require broker-dealer registration" for that person.[10]

Historically, the SEC had not been active in bringing standalone enforcement actions for failure to register as a broker; generally such a claim was an "add on" to some additional claim, such as a fraud claim pursuant to Rule 10b-5 under the Exchange Act.

In March 2013, however, the SEC brought two (2) related enforcement actions ("Ranieri Partners") involving an unregistered solicitor/broker who solicited investors for two privately-offered investment funds that were managed by a common fund manager, where the unregistered broker received a success-based/transaction-based fee.[11] Both actions were standalone claims for violations of the broker registration requirement under the Exchange Act and did not involve any other claims, such as an allegation of fraud. The first action was against the unregistered broker, but the second action was against the fund manager which engaged such broker. The SEC's action against the fund manager, which also involved an action against a senior managing partner of the fund manager who "was responsible for coordinating the activities" of the unregistered solicitor to find potential investors for the funds and, thus, for "willfully aiding and abetting" and "causing" the solicitor's violation of Section 15(a)(1) of the Exchange Act, resulted in a cease and desist order against both the fund manager and the senior managing partner, a civil penalty against the fund manager in the amount of $375,000, and a suspension of the senior managing partner from association in a supervisory capacity with any broker-dealer or investment adviser, among certain other persons, for nine (9) months as well as a civil penalty against the senior managing partner in the amount of $75,000.

Historically, private fund managers have tended to view the risk of an SEC enforcement action as "low" when an unregistered broker is used and considered the "real" risk to be potential rescission against the fund by investors pursuant to Section 29(b) of the Exchange Act. Ranieri Partners appears to be the first time that the SEC brought an enforcement action against a *fund manager* (resulting in substantial penalties against both the manager and a senior managing partner thereof).

III. Conclusion

Because many private fund advisers are now registered with the SEC under the Advisers Act, those advisers that do not market their funds through a registered broker, but market through internal personnel, are subject to the heightened scrutiny of the SEC with respect to such advisers' internal marketing activities/practices. While private fund advisers that conduct internal marketing will not necessarily trigger broker registration (notwithstanding the technical

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[9] Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf.

[10] The SEC presaged this position in a prior (2006) denial of no-action involving similar circumstances in John W. Loofbourrow Associates, Inc. See John W. Loofbourrow Associates, Inc., SEC No-Action Letter (Jun. 29, 2006), available at http://www.sec.gov/divisions/marketreg/mr-noaction/loofbourrow062906.htm. However, in 2011, on the other hand, a Florida federal District Court disagreed with the SEC and concluded that a person who, over an extended period of time, introduced prospective investors to an issuer and who received transaction-based compensation therefor was not a broker subject to registration under the Exchange Act. See SEC v. Kramer, 778 F. Supp. 2d. 1320 (M.D. Fla. 2011). Whether or not the SEC appeals the Kramer decision to the Federal Court of Appeals for the 11th Circuit, the decision of the federal District Court would not have precedential value.

[11] In the Matter of Ranieri Partners LLC and Donald W. Phillips, Exchange Act Release No. 69091, Administrative Proceeding File No. 3-15234 (Mar. 8, 2013), available at http://www.sec.gov/litigation/admin/2013/34-69091.pdf; In the Matter of William M. Stephens, Exchange Act Release No. 69090, Administrative Proceeding File No. 3-15233 (Mar. 8, 2013), available at http://www.sec.gov/litigation/admin/2013/34-69090.pdf.

unavailability of the safe harbors in Rule 3a4-1 under the Exchange Act and Section 4(b) of the Securities Act), clearly such advisers should avoid the payment of any transaction-based/success-based compensation to internal marketers or unregistered third party solicitors. But even in the absence of such a compensation structure, a broker registration issue could arise if an adviser has a dedicated marketing staff and/or sponsors or promotes a substantial number of funds with different investment objectives. In addition to the heightened risk of an SEC enforcement action, unregistered brokers face rescission risk from investors (and are subject, potentially, to counterpart State securities or "Blue Sky" laws, including State enforcement). Advisers should, in light of the foregoing, carefully examine their internal marketing activities to determine if the establishment of an SEC-registered broker is warranted.

If you have any questions regarding this update, please contact one of the Sidley lawyers identified below or the Sidley lawyer with whom you usually work.

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