Update on SEC Staff Position on Private Fund Broker-Dealer Issues

On September 26, 2013, David Blass, Chief Counsel of the SEC's Division of Trading and Markets, participated in a Practising Law Institute panel discussion on broker-dealer issues in the private fund industry. He provided an update on the SEC Staff's (the "Staff") thinking since his April, 2013 speech on this topic, in which Blass raised concerns about the broker-dealer status of private fund managers in connection with sales of private fund interests and receipt of deal fees from portfolio company transactions. A link to our Alert on that speech is available here.

Blass Comments on April Speech. Blass said his earlier remarks were part of a larger SEC Staff effort to review the broker-dealer registration requirements and exemptions, and did not reflect any attempt to target the private fund industry. Rather, he was drawing the attention of newly registered private fund investment managers to the broker-dealer registration requirements in advance of SEC examiners raising the issue, and wanted to start a dialogue with the industry to clarify the registration requirements. Blass said he was not trying to make new law or regulations. He noted that he had an open mind on the issues, and that his speech was not connected to the discussion about a uniform fiduciary standard for broker-dealers and investment advisers. He emphasized that the Staff intended to apply a rule of reason to the analysis of broker-dealer requirements in the private fund industry.

Fundraising Issues. As a result of what he characterized as productive discussions between the Staff and the industry on whether fundraising personnel are subject to the broker-dealer registration requirements, Blass said the Staff was now focusing on two issues which arise under SEC Rule 3a4-1, the safe harbor from broker-dealer registration for agents of an issuer. The first is the nature of the non-securities activities needed to qualify for the safe harbor. He noted that typical investor relations activities, such as sending account statements, fielding complaints, and sending other communications were arguably not securities activity. (This appears to be a step back from the position he took in his April speech that actions taken by fund managers to retain investors could be broker-dealer activity.) The second issue concerns permissible compensation for fundraising personnel. While the SEC staff clearly takes the view that the unregistered sales personnel cannot receive commissions, he noted that as Rule 3a4-1 permits sales activity, it would not be fair for the SEC to flatly prohibit compensation for that activity, which could presumably be based on such factors as overall firm profitability, assets under management or firm performance. Mr. Blass noted that the SEC was very busy with various Dodd-Frank and JOBS Act rulemaking initiatives, and that informal Staff guidance was more likely than formal rulemaking on this topic.

Deal Fees. Blass said he focused on this issue in his April speech because SEC examiners had noted the practice of private equity fund sponsors charging commissions to portfolio companies for acquisition and disposition transactions. Some sponsors apparently described the payments as compensation for investment banking activity, which ordinarily requires broker-dealer registration. Blass stated that, although the Staff's thinking on this issue is not as developed as on the fundraising issue, subsequent conversations with sponsors had been helpful. In this context, Blass noted similarities between PE fund sponsors and M&A brokers, which typically facilitate transactions between buyers and sellers of operating business, with the buyer actively involved in the business after the acquisition. He said the Staff was considering registration

relief for these brokers, and that such relief might have favorable implications for private equity fund sponsors. He also noted with approval the practice of many private fund sponsors of disclosing to investors the nature and amount of fees which could be charged to the portfolio company. He suggested that this topic could also be the subject of informal Staff guidance in the future.

If you have questions about either of these issues, please contact your usual Ropes & Gray advisor.