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Milbank Client Alert: Mixed Signals, but Hope, for a Private Adviser Broker-Dealer Exemption

Provisions of the JOBS Act and two recent no-action letters for venture capital advisors initially provide a glimmer of hope that advisors to privately offered funds might not have to register as a broker-dealer when soliciting investors for their funds. A closer examination of the finer details of these materials, however, dashes any such hope, and returns a private fund advisor to the complicated factual analysis of whether it is acting as a "broker" and is therefore required to register as a broker-dealer pursuant to Section 15(a)(1) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Given the serious consequences that follow from acting as a broker-dealer without registering, private fund advisors should carefully assess their conduct and business practices.

Additionally, private fund advisers should be aware of, and strongly consider responding to, an overture by the Chief Counsel in the SEC's Division of Trading and Markets in a recent public speech to evaluate and potentially propose a new exemption from broker-dealer registration requirements specific to private fund advisors.

STATUTORY TEST OF BEING A "BROKER" AND SECTION 15(A) REGISTRATION REQUIREMENT

Section 15(a)(1) of the Exchange Act requires any person that acts as a "broker" or "dealer" of securities to register with the SEC. Section 3(a)(4)(A) of the Exchange Act defines "broker" generally as "any person **engaged in the business** of **effecting transactions in securities** for others." (emphasis added). An adviser to a private investment fund potentially acts as a "broker" in connection with the marketing and placement of fund membership interests with investors.

The tests for these two factors are very fact-specific and are often subjectively applied. The SEC staff views one as "engaged in the business" of effecting securities transactions when there is a "regularity of participation" in such transactions.[1] Effecting transactions on more than a one-off basis often meets this test. The concept of

[1] Mass. Fin. Services, Inc. v. Securities. Investor Protection Corp., 411 F. Supp. 411 (D. Mass. 1976).

"effecting securities transactions", similarly, is broadly interpreted to cover participation "at the key points in the chain of distribution" of securities and includes assisting in structuring a transaction, identifying potential purchasers, soliciting transactions (including advertising), and participating in the order taking or order routing process.[2] Advisers to private funds are typically involved in identifying potential investors and structuring those investors' investments in the fund. Another key factor, and perhaps the most significant factor, is the presence or absence of transaction-based compensation. The rationale for this factor is that the financial incentive created by a commission or other transaction-based compensation creates a "salesman's stake", pursuant to which the marketer, like a broker, has an interest in the transaction succeeding and the limited partner interests being placed. Rule 3a4-1 under the Exchange Act, informally known as the "Issuer's Exemption", is a non-exclusive safe-harbor technically available to employees of an issuer of securities, such as a private investment fund adviser and its personnel. The Issuer's Exemption, however, is limited to personnel engaged in no more than one offering every twelve months. As a practical matter, since private investment funds offer their securities over a period of time that can last for months or even a year, the Issuer's Exemption provides little regulatory cover.

For all of these reasons, an adviser to a private investment fund must engage in a difficult and comprehensive factual analysis, weighing all activities (*e.g.* soliciting investors, regularity of participation, etc.) to determine whether broker-dealer registration is required. Although private investment fund advisors and their employees do not typically receive transaction-based compensation in connection with marketing investors, it can still be very difficult to overcome the "engaged in the business" and "effecting securities transactions" prongs of the statutory test for being a "broker." This, together with the likely unavailability of the Issuer's Exemption, can leave advisers and their employees especially vulnerable.[3]

FALSE HOPE: THE JOBS ACT EXEMPTION FOR PRIVATE PLACEMENTS

In April of 2012, Congress enacted the Jumpstart Our Business Startups Act ("JOBS Act"), with a promising exemption from Section 15(a)'s broker-dealer registrations requirements for sale of securities through private placement. While this exemption initially appears helpful for managers of private investment funds, the SEC staff's

[2] *See MuniAuction, Inc.*, *SEC* No-Action Letter, 2000 WL 291007 (Mar. 13, 2000).

[3] *See, e.g.*, *In re Ranieri Partners LLC and Donald W. Phillips*, SEC Release No. 34-69091, 2013 WL 873219 (Mar. 8, 2013) (fining a private investment firm and its managing partner a total of $450,000 for aiding and abetting violations of the registration requirements of Section 15(a) where an outside consultant received transaction-based compensation and actively solicited investors on behalf of the firm).

recent interpretations of the "compensation" provisions of the exemption (reinforced by certain recent no-action letters) renders it effectively of little value.

1. Exemption Requirements

The JOBS Act adds Section 4(b) to the Securities Act of 1933, as amended (the JOBS Act Exemption"), providing that "no person . . . shall be subject to registration as a broker or dealer pursuant to" Section 15(a) of the Exchange Act solely because the person, in connection with a Regulation D private placement:

- Maintains 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;
- Co-invests in such securities; or
- Provides ancillary services with respect to such securities.[4]

To qualify for the exemption, the person (a) must not receive compensation in connection with the purchase or sale of such security; (b) must not have possession of customer funds or securities in connection with the sale or purchase of such security; and (c) must not be subject to a statutory disqualification.

2. "No Compensation" Requirement Broadly Interpreted

Thus, on its face, the exemption would seem tailor-made for an advisor to a private investment fund. It would allow the advisor to be involved in the sale of the fund interests and even engage in a general solicitation of that offering or sale.[5] The flaw is in the "no compensation" requirement, which the SEC interprets broadly and in a manner that will disqualify most advisers of private investment funds from availing themselves of the exemption.

In February 2013, the SEC Division of Trading and Markets issued a set of Frequently Asked Questions ("FAQs")[6] with respect to the exemption. Questions and Answer Number 5 highlighted the Staff's broad interpretation of "compensation" as used in Section 4(b)(2). It made clear that "compensation," for purposes of the JOBS Act

[4] These services include the provision of due diligence services, so long as such services do not include investment advice or recommendations to issuers or investors (for separate compensation), and the provision of standardized documents to issuers and investors. *See* Securities Act Section 4(b)(3).

[5] The provision permitting a general solicitation will become effective after the SEC adopts rulemaking relation to general solicitation.

[6] Available at http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

Exemption, was not limited to "transaction-based compensation," but rather included any direct or indirect economic benefit related to the sale or purchase of securities. Even salary paid to an employee for marketing securities, would be "compensation" fatal to the exemption, because that salary would be for engaging in activity related to the sale or purchase of securities. (See Question and Answer 8). As many private investment funds seek to market investment in those funds with salaried employees in an internal marketing or investor relations department, this broad reading of "compensation" significantly limits the utility of the exemption for private investment fund advisers.

3. Carried Interest is not Permitted Co-Investing

The SEC Staff's broad interpretation of "compensation" is constrained only by the statutory language of the JOBS Act Exemption, which expressly exempts registration as a broker for any person that "co-invests in" securities offered or sold pursuant to the exemption. In Question and Answer Number 5, the SEC Staff "recognize[d] that Congress expressly permitted co-investment" in such securities and determined that "profits associated with these investments would be [permissible] compensation for purposes of" the JOBS Act Exemption.

Just as the Staff reads "compensation" broadly to limit application of the exemption, it similarly reads "co-investing" in a narrow way that limits the exemption. In two recent No-Action Letters, discussed in more detail below, a venture capital fund adviser was compensated in the form of carried interest. The adviser received an interest in the fund (effectively, it co-invested in the fund without contributing capital for its investment) and, through that interest, was compensated based upon the fund's performance. For tax purposes, this form of compensation is often referred to as "carried interest."

The No-Action letters strongly suggested that "carried interest" would constitute "compensation" that would render the JOBS Act Exemption unavailable. While the SEC Staff has not yet confirmed this interpretation in its Frequently Asked Questions, it has expressly confirmed this interpretation in a telephone call with us. Thus, either the presence of salary compensation for marketing fund interests to prospective investors or simply the presence of a "carried interest" will constitute "compensation" sufficient to prohibit application of the JOBS Act Exemption.

FUNDERSCLUB AND ANGELLIST NO-ACTION LETTERS

The SEC Staff recently granted no-action relief to two advisers who privately offered interests in venture capital funds.[7] Both applicants maintained websites for the purposes of seeking investors for private placements and the organization of private funds. These letters applied the standard "engaged in the business" of "effecting securities transactions" test for being a "broker," as described above.

These letters are notable for two reasons. First, they describe systems that do not actively solicit investors, but rather passively allow prospective venture capital investors to evaluate and invest in a venture capital fund. This makes for an enlightening application of the statutory test for being a "broker," but does not provide much comfort for advisers to other privately offered funds that actively market to investors. Second, they evaluate carried interest as "compensation," but reach two seemingly inconsistent conclusions: that carried interest is "compensation" that renders the JOBS Act Exemption unavailable, but is not "transaction-based compensation" that would render one a "broker" under the statutory test.

Both parties requesting no action proposed to perform due diligence on potential portfolio companies and provide neutral information to potential investors (sometimes only after a direct request for information from the investors). Each investor had to qualify as an accredited investor before gaining access to the websites, which was also required prior to receiving investment related information. Neither firm would handle capital or securities of investors nor solicit investors outside of the member-only websites. Importantly, both applicants stated that no investment advice would be provided to investors prior to the formation of an investment vehicle. Any investment advice would be tied to advising the formed investment funds and would be traditional, post-investment services for the formed investment funds. Each company also planned to register as an Investment Adviser.

The business models called for each company to receive only "carried interest" as compensation and each company would forego commissions and management fees. With each applicant's financial interest directly tied to the success of any potential private fund and not contingent on the completion of any securities transaction, both companies clearly would clearly not be receiving transaction-based compensation. The Staff took particular notice of this fact.

[7] *See FundersClub Inc. and FundersClub Management LLC*, SEC No-Action Letter, 2013 WL 1229456 (Mar. 26, 2013); *AngelList LLC and AngelList Advisors LLC*, SEC No-Action Letter, 2013 WL 1279194 (Mar. 28, 2013).

The No-Action relief in these letters decision primarily rest upon the "passive" conduct proposed by each (*e.g.* limited solicitation, only accredited investor members, no transaction-based compensation, neutral information materials, non-binding indications of interest, investment advisory advice only after an investment, etc.). The take-away is that the passive conduct described does not meet the definition of "broker" in the eyes of the Staff, and provides no guidance or comfort in either the JOBS Act Exemption or elaborating the Issuer's Exemption.

These No-Action letters are useful in that they make a few things clear. First, they reaffirm that carried interest is compensation under the JOBS Act Exemption, and that any person or entity that receives carried interest is likely ineligible. Quixotically, it also follows that carried interest must not be transaction-based compensation, or the two firms would have been receiving transaction-based compensation and have been required to register as brokers. Similarly, if carried interest is compensation prohibited by the JOBS Act Exemption, then it must not constitute co-investing, which is expressly permitted by the statutory exemption under Section 4(b)(1)(B) of the JOBS Act.[8] For these reasons, unless they can avail themselves of the Issuer Exemption or can comfortably determine that they do not fit within the statutory definition of a "broker," private fund advisers are generally subject to Section 15(a)(1)'s registration requirements and the serious consequences of not meeting them.

BEACON ON THE HORIZON

Given the typical conduct of most private fund advisers, the JOBS Act Exemption and No-Action letters do not provide much comfort. Additionally, the continuously active nature of most private fund advisors precludes the availability of the Issuer's Exemption. Taken together, private fund advisers are back right where they started, left to engage in an unclear, fact-intensive analysis of whether they are engaged in the "the business of effecting transactions in securities for others." Yet, there may be a glimmer of hope in the recent public statements of a senior SEC Staff member.

David W. Blass, Chief Counsel at the SEC's Division of Trading and Markets, recently gave a speech that highlighted these very concerns for private fund advisors regarding the registration requirements under Section 15(a)(1).[9] Mr. Blass emphasized the broad application of Section 3(a)(4)(A)'s definition of "broker" and the fact-intensive analysis that one must engage in to determine whether one falls within that definition. He

[8] This is logically difficult to resolve because receiving carried interest for one's services represents sweat equity in the venture, with one's fortunes riding on the success of that venture akin to a co-investment.

[9] David W. Blass, Chief Counsel, U.S. Securities and Exchange Commission, Division of Trading and Markets, Address to the Trading and Markets Subcommittee of the American Bar Association: A Few Observations in the Private Fund Space (Apr. 5, 2013), *available at* http://www.sec.gov/news/speech/2013/spch040513dwg.htm.

encouraged private fund advisers to assess (i) how they "solicit and retain investors," (ii) whether "employees who solicit investors have other responsibilities," (iii) how "personnel who solicit investors [are] compensated," and (iv) whether the adviser "charge[s] a transaction fee in connection with a securities transaction" when engaging in this analysis. All of these questions assess whether a private fund adviser's conduct may require the adviser to register as a broker-dealer.

In the speech, Mr. Blass highlights that most private fund advisers are not eligible for the Issuer's Exemption for the reasons stated above. Nevertheless, he does not believe that "all investment-raising by a private fund adviser results in the adviser being a broker-dealer," necessitating registration under Section 15(a)(1). While recognizing the sometimes prohibitive costs to registering as a broker-dealer, as well as the consequences of not doing so (including rescission of transactions), Mr. Blass publicly invited feedback and suggestions from the industry regarding a private fund adviser exemption to Section 15(a)(1)'s requirements. Mr. Blass specifically and openly sought the industry's views regarding the necessity of any such exemption, saying that he had "in mind a potential exemption like the issuer exemption." While not a guaranteed safe harbor, Mr. Blass's comments foretell some relief may be on the horizon. Now is the time for advisers to private funds to provide a framework for such an exemption.

CONCLUSION

While recent statutes, rules and regulations, and Staff guidance have appeared to offer the private fund community some semblance of relief from broker-dealer registration requirements, there are no true, workable safe harbors. That said, Chief Counsel Blass's recent speech offers the promising opportunity to engage the Staff and help shape an exemption from the potentially onerous burdens that come with registering as a broker-dealer. Private fund advisers should explore all options in order to engage the Staff and beneficially shape any such private fund adviser exemption.

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the contacts in our Financial Institutions Regulation or Alternative Investments Groups.

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