

BROKER-DEALER REGISTRATION

Broker in disguise?

CONTESTANTS:



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THE CHALLENGE:

Can the employees of ABC Capital, a private equity firm and investment advisor to PE Fund I, solicit potential investors for PE Fund II without ABC Capital being required to register as a broker-dealer?

(Editors note: A more complete response to this month's challenge, which addresses deal fees and placement agents, will appear on Privateequitymanager.com)

PEPPER HAMILTON'S ANSWER:

ABC Capital will need to evaluate, together with its counsel, ABC Capital's internal marketing and compensation practices to determine if broker-dealer registration is required. There could be significant consequences to Fund II, ABC Capital and its principals (such as SEC sanctions and investor rescission rights) if ABC Capital is required to be, but is not, so registered.

BROKER-DEALER CONSIDERATIONS

The Securities Exchange Act of 1934 defines a *broker* as "any person engaged in the business of effecting transactions in securities for the account of others" and makes it unlawful for a "broker" to "effect any transactions in, or attempt to induce the purchase and sale of, any security" unless registered as a broker-dealer.

Rule 3a4-1 under the Exchange Act (the so-called "issuer exemption") provides a non-exclusive safe harbor which could permit ABC Capital employees to engage in certain activities without being considered a broker. So long as such personnel are not subject to statutory disqualification, they may (1) offer and sell interests in PE Fund II to certain types of financial institutions (e.g., banks and insurance companies); (2) engage in capital raising activities for PE Fund II *if such persons have substantial job responsibilities for or on behalf*

of PE Fund II other than capital raising and they have not participated in selling an offering of securities for any other issuer (including, for example, PE Fund I) within the prior 12-month period; or (3) limit participation: to preparing and delivering written communications to potential investors so long as they refrain from engaging in any oral solicitation activities, or to performing ministerial and clerical work with respect to PE Fund II's fundraising activities. It should be noted, however, that no employees of ABC Capital who are or were within the prior 12-month period associated with a broker-dealer can come within the Rule 3a-4 safe harbor with respect to PE Fund II. An ABC Capital employee will not fall within the issuer exemption safe harbor if he or she receives any special compensation such as bonuses, commissions or other incentives (e.g., increased carry allocations with respect to PE Fund II) linked to PE Fund II's successful fundraising efforts.

Failure to satisfy the conditions of the safe harbor does not necessarily mean that a private fund adviser or its personnel are "brokers." If it is determined that such persons fall within the definition of a "broker," then ABC Capital should restructure its activities and, if necessary, compensation structure, to avoid broker classification.

Note that the SEC's new rules under the JOBS Act, effective September 23, 2013, lift the ban on issuers engaging in general solicitation activities in private placements in certain circumstances. ABC Capital should also consult with its counsel to explore how compliance with the new rule could help reduce potential broker-dealer exposure. ABC Capital will be able to make PE Fund II's offering materials available to potential investors on an unpassword-protected website after September 22 if PE Fund II files a Form D and sells its interests only to accredited investors. ■