Broker-Dealer and Capital Raising Issues for Private Equity Funds

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Broker-Dealer Basics

• Statutory definition:
  • Engaged in the business of effecting securities transactions

• What activity requires registration as a broker-dealer?
  • Solicitation, negotiation, or execution of securities transactions
    • Applies to privately issued securities as well as publicly traded securities

• Transaction-based compensation
  • SEC is particularly focused on this element
  • Presence of transaction-based compensation tied to a securities transaction is a strong indication that the person receiving the compensation is a broker-dealer
  • Engaging in core broker-dealer activities may require registration even in the absence of transaction-based compensation
Risks for Violating BD Requirements

• Potential enforcement actions by the SEC or states
  • Ranieri case
  • Payment of 1% finders fee to an unlicensed intermediary who introduced investors to a private fund
  • Bar order for the unlicensed intermediary
  • $450,000 in penalties against the fund and its senior officer

• Implications of SEC or state orders under “bad boy” provisions

• Potential rescission rights
  • Need to check state law (e.g., California)
  • Barrington case
  • Unlicensed M&A broker unable to collect its fee because it lacked required license
Recent Developments

• Blass speech
  • A shot across the bow of PE firms
    • Don’t ignore broker-dealer issues … SEC will bring enforcement actions
  • But also an invitation for a dialogue
    • A recognition that current one-size-fits-all model of BD regulation is inappropriate given the wide range of BD business models

• SEC no-action letter for M&A brokers
  • Won’t be fully useful until states get on board
  • Limited to sale of entire company
  • Can’t provide financing or assemble a group of purchasers
  • Current disputes re: related legislation (S. 1923)
    • NASAA objected to removal of bad boy disqualifiers and restrictions on use for shell companies

• Broker-dealer “lite” – FINRA concept release re: corporate finance brokers
Raising Money for PE Funds

• Issuer exemption
  • Issuers are exempt from the broker-dealer requirements when they sell their own securities
  • Applies to issuers and their general partners or promoters
  • Does not apply to employees of the issuer or the GP

• Limited exemption for employees/agents of the issuer
  • SEC Rule 3a4-1
  • Intended to enable employees of issuers who have other, primary responsibilities to participate from time to time in the sale of their employer’s securities
  • Also exempts employees who limit their sales to banks, mutual funds, and certain other institutional investors
  • No transaction-based compensation is permitted
  • Not available to disqualified individuals (persons subject to prior regulatory sanctions)
Problems with 3a4-1 for PE Firms

- Transactional compensation is prohibited
  - Direct or indirect transaction-based compensation is problematic
  - An incentive bonus based on multiple factors may be OK
    - But securities sales must not be a mathematically derived component of the bonus

- May participate in only one offering in a 12-month period
  - Continuous offerings likely fail to meet this test

- Must have responsibilities other than selling securities that are the employee’s primary job duties
  - Other responsibilities must be bona fide
  - Precludes a dedicated salesforce
  - Less clear how to treat IR personnel
Fundraising Alternatives

• Set up a captive broker-dealer
  Takes some up-front time and effort, but over the long run pays off by maintaining full control of the sales process

• Enter into an arrangement with a licensed broker-dealer whereby PE personnel become licensed with that broker and sell through them
  • May be difficult to find quality broker-dealers willing to do this
  • Broker-dealer will require a cut and will be responsible for overseeing the sales efforts, sales literature, etc.

• Engage a broker-dealer to sell
  • Fully outsource the sales function
  • Has appeal to the extent it allows the PE firm to focus on what it does best
  • But entails loss of control of the sales process and loss of related commission revenues
Selling Portfolio Companies

• Sale of a portfolio company in the form of a stock sale or merger could trigger broker-dealer licensing requirements
  • Will not be an issue for asset sales

• Important to consider the PE firm’s role and the manner in which the firm and its personnel are compensated
  • Distinguish advisory fees from transaction-based success fees
  • SEC unlikely to treat the Fund and the GP as one person for these purposes
  • Therefore, payments received by the GP will need to be analyzed
  • Use of a success fee to offset contractually required advisory fees may be OK
Private Offerings

- JOBS Act directed the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D, provided that the securities are sold only to accredited investors and, under Rule 144A offerings, provided that the securities are sold only to persons whom the seller (and any person acting on behalf of the seller) reasonably believes are QIBs.
Private Offerings

• Private offerings have become more “public”
  • In an effort to improve access to capital and minimize liquidity discounts, private offerings and hybrid offering techniques have become more important
  • The SEC’s Office of Risk Fin published a study in February 2012 (“Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption”) that showed that from 2009 to 2011 there was a shift in terms of capital raising from a reliance on public offerings to a reliance on private or hybrid offerings
  • The SEC adopting release also cites increased reliance on Rule 506 offerings
  • The shortened Rule 144 holding period, the popularity of PIPE transactions, and other hybrid offerings all have contributed to the rise of private or targeted offering techniques
  • The JOBS Act changes to the prohibition against general solicitation will contribute even further to making privates less private
Rule 506 Safe Harbor Requirements

• Rule 506(b) is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D

• Requirements of a Rule 506(b) private placement include:
  • No dollar limit on size of transaction
  • Unlimited number of accredited investors and no more than 35 unaccredited investors
  • No general solicitation or advertising
  • Resale limitations
  • Disclosure required for nonaccredited investors
  • Form D filing within 15 days of first sale of securities
  • Good faith effort to comply (Rule 508)

• Currently, no “bad actor” disqualification provisions
Rule 506 Purchasers

• Accredited Investors (Rule 501)
  • Institutional investors such as banks, S&Ls, broker-dealers, insurance companies, investment companies
  • Corporations or trusts with assets in excess of $5 million
    • Not formed for purpose of making the investment (look-through rule)
  • Directors and officers of the issuer
  • Individuals with
    • Income > $200,000 or joint income > $300,000
    • Net worth or joint net worth > $1 million*
  • Entity in which all equity owners are accredited investors

• Nonaccredited investors
  • Sophistication required
  • Alone or with purchaser representative

* Dodd-Frank Act of 2010 amended definition to eliminate ability of individuals to include the equity value of primary residences in calculation of net worth
Relaxation of the Ban on General Solicitation

• The SEC’s final rules implement a bifurcated approach to Rule 506 offerings
  • As proposed, an issuer may still choose to conduct a private offering in reliance on Rule 506(b) without using general solicitation
  • To implement this approach, the SEC adopted a new paragraph (c) in Rule 506, which permits the use of general solicitation, subject to the following conditions:
    • The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
    • All purchasers of securities must be accredited investors, either because they fall within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
    • The conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied
Relaxation of the Ban on General Solicitation (cont’d)

- The final rule does not provide for a safe harbor; however, it does set out a supplemental, nonexclusive list of methods that may be used to satisfy the verification requirement, including:
  - A review of IRS forms for the two most recent years and a written representation regarding the individual’s expectation of attaining the necessary income level for the current year;
  - A review of bank statements, brokerage statements, tax assessments, etc. to assess assets and a consumer report or credit report from at least one consumer reporting agency to assess liabilities;
  - A written confirmation from a registered broker-dealer, RIA, CPA, etc.; or
  - For existing investors (pre-506(c) effective date), a certification
The SEC again confirmed the view that Congress did not intend to eliminate the existing “reasonable belief” standard Rule 501(a) of the Schedule Act or Rule 506 offerings.

- It confirmed that if a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the proposed Rule 506(c) exemption for that offering, provided the issuer, “took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor.”

- The SEC again confirmed that privately offered funds can make a general solicitation under amended Rule 506 without losing the ability to rely on the exclusions from the definition if an “investment company” available under Section 3(c)(1) and 3(c)(7) of the Investment Company Act.

- The SEC reminds funds and their advisers of the application of the anti-fraud provisions.
New Bad Actor Rules

- SEC added a new Section 506(d) to Regulation D
- This new section encompasses disqualification provisions that are substantially similar in their effect to the bad actor disqualification provisions that are currently codified in Rule 262 of Regulation A
- The provisions are applicable only in the context of Rule 506 offerings. The SEC will address bad actor disqualification provisions for crowdfunded offerings and Regulation A+ (3(b)(2)) offerings in the future
Covered Persons

The disqualification provisions apply to the following “covered persons”:

• The issuer and any predecessor of the issuer or affiliated issuer;
• Any director, executive officer, other officer participating in the offering process, general partner, or managing member of the issuer;
• Any beneficial owner of 20 percent or more of any class of the issuer’s voting equity securities, calculated on the basis of voting power;
• Any investment manager to an issuer that is a fund and any director, executive officer, officer participating in the offering, general partner, or managing member of the manager, as well as any director, executive officer, or officer participating in the offering of any such general partner or managing member;
• Any promoter connected with the issuer in any capacity at the time of the sale;
• Any person that has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers in a securities offering; or
• Any director, executive officer, other officer participating in the offering, general partner, or managing member of any compensated solicitor
The rule includes the following categories of disqualifying events:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
  - The CFTC was added to the list of regulatory agencies
  - A definition of “final order” was added to Rule 501
- Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- Certain Commission cease-and-desist orders;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization (SRO);
- Commission stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders
Criminal Convictions

A covered person will be disqualified if that person:

• Has been convicted, within 10 years before the sale (or five years in the case of issuers, their predecessors, and affiliated issuers), of any felony or misdemeanor:
  • In connection with the purchase or sale of any security;
  • Involving the making of any false filing with the Commission; or
  • Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities
Court Injunctions and Restraining Orders

• An offering is disqualified if any covered person:
  • Is subject to any order, judgment, or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:
    A. In connection with the purchase or sale of any security;
    B. Involving the making of any false filing with the Commission; or
    C. Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities
Final Orders of Certain Regulators

• An offering will be disqualified if any covered person:
  • Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:
    
    A. At the time of such sale, bars the person from:
       1. Association with an entity regulated by such commission, authority, agency, or officer;
       2. Engaging in the business of securities, insurance, or banking; or
       3. Engaging in savings association or credit union activities; or
    
    B. Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within 10 years before such sale
Commission Disciplinary Orders

• An offering will be disqualified if any covered person:
  • Is subject to an order of the Commission entered pursuant to section 15(b) or
    15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b) or 78o-4(c)) or
    section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e) or
    (f)) that, at the time of such sale:
      A. Suspends or revokes such person’s registration as a broker, dealer,
         municipal securities dealer, or investment adviser;
      B. Places limitations on the activities, functions, or operations of such person; or
      C. Bars such person from being associated with any entity or from participating
         in the offering of any penny stock
Commission Cease-and-Desist Orders

• This category was added in the final rules
• The offering will be disqualified if any covered person:
  • Is subject to any order of the Commission entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of:
    B. Section 5 of the Securities Act of 1933 (15 U.S.C. 77e)
Suspension or Expulsion from SRO Membership or Association with an SRO Member

- An offering will be disqualified if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade
Stop Orders and Orders Suspending the Regulation A Exemption

• An offering will be disqualified if any covered person has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued
U.S. Postal Service False Representation Orders

• An offering will be disqualified if a covered person is subject to a United States Postal Service false representation order entered within five years before such sale, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations
Measuring Dates

• For purposes of ascertaining compliance, the measuring period begins on the date on which the issuer seeks the exemption

• The SEC measures the bad act from the date of a final order and not from the date of the bad act

• Most important, the SEC will consider only disqualifying events that occur following the effective date of this rule
Reasonable Care Exception

• Consistent with the proposed rule, the final rule contains a reasonable care exception that applies if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person
• Issuer would need to conduct a factual inquiry; the SEC notes that the type of inquiry will depend on the facts and circumstances
Satisfying Reasonable Care Burden

• Issuers will be required to implement new procedures in connection with any Rule 506 offering
  • This may be especially burdensome for private funds that regularly conduct private offerings in reliance on Rule 506

• Issuers may consider:
  • Adding additional questions to D&O questionnaires
  • Requiring placement agents to complete a questionnaire or provide a representation
  • Requiring other participants (that may be covered persons) to complete questionnaires or provide representations
  • For funds or other issuers engaged in continuous or delayed offerings, refreshing or updating their diligence
• The rule permits the SEC to grant waivers upon a showing of good cause
• The rule does not articulate standards for granting waivers
• The adopting release lists various circumstances that might be relevant to a waiver, such as a change of control, a change of supervisory personnel, absence of notice and an opportunity for hearing, and relief from a permanent bar for a person who does not intend to apply to reassociate with a regulated entity
Mandatory Disclosures of Triggering Events Pre-dating Effective Date

• To address the comments relating to the proposed rules, which applied a retrospective approach to disqualifying events, the final rule considers trigger events that occur following the effective date.

• However, the rule requires written disclosure of matters that would have triggered disqualification, except that these actions occurred prior to the effective date of the rule.
  • Disclosures apply to all Rule 506 offerings.
  • Disclosures must be provided “a reasonable time prior to sale”.
  • Relief under Rule 508 will not be available for a failure to provide disclosures.
Solicitation Materials

• Rule 156 under the Securities Act
  • General anti-fraud rule that applies to sales literature used by registered investment companies prohibits use of sales literature that is materially misleading
  • Sales literature may be misleading if it
    • Contains an untrue statement of a material fact
    • Omits to state a material fact necessary in order to make a statement made, in light of the circumstances, not misleading
  • Whether or not a statement is misleading depends on the context in which it is made
  • Rule 156 guidance
    • A statement could be misleading because of
      • Other statements made in connection with the offer or sale
      • The absence of explanations, qualifications or limitations, or other statements necessary or appropriate to make the statement not misleading
      • General economic or financial conditions or circumstances
Solicitation Materials

- Rule 156 guidance
  - Representations about past or future investment performance could be misleading because of statements or omissions made involving a material fact, including when
    - Portrayals of past income, gain, or growth of assets imply net investment results achieved by actual or hypothetical investments that would not be justified under the circumstances
    - Representations, express or implied, about future investment performance including
      - Representations as to security of capital and possible gains or expenses
      - Representations implying that future gain or income may be inferred based on past performance
      - Portrayals of past performance in a manner that implies gains realized in the past may be repeated in the future
Solicitation Materials

• Rule 156 guidance
  • Statements involving material facts about the characteristics or attributes of a fund could be misleading because of
    • Statements about possible benefits connected with or resulting from services to be provided or methods of operation that do not give equal prominence to discussion of risks
    • Exaggerated or unsubstantiated claims about management skill or techniques or effects of government supervision
    • Unwarranted or incompletely explained comparisons to other investment vehicles or indices
  • “Sales literature” is broadly defined
    • Communications among issuers, underwriters, and dealers are included in the definition of sales literature if the information can be reasonably expected to be communication to prospective investors, even if orally
    • Social media