The Operational and Regulatory Risks of Marketing and Fundraising:

Assistance in Raising Assets Can Impose Significant Risks to Your Fund

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For start-up funds or small managers finding investors and raising assets is not an easy task. The use of external tactical assistance to locate potential investors and raise assets can look promising. However, using an individual or firm that is not a registered broker/dealer can create significant risks for the fund.

Candidly, most small hedge funds in their zeal attempt raising assets before they have a comprehensive understanding of the operational issues and regulatory risks of marketing alternative assets. Unfortunately, they both just increased, making it more difficult for smaller funds to raise assets. The SEC has spotlighted broker-dealer registration requirements as an issue in marketing of hedge funds, perhaps in response to The JOBS Act legislation.

In this summer 2013 alert, I provide a brief summary of the issues and risks that may result from the use of an unlicensed individual or firm to raise assets, as well as guidelines for funds considering using professionals to assist in raising assets. I also provide guidance to individuals or firms attempting to safely engage in marketing and raising assets for hedge funds. It is important to note, that the interpretation of the Securities and Exchange Commission (SEC) regulations is broad and difficult to apply. I recommend that you consult with your legal counsel before retaining any individual or firm to assist in fundraising or acting as a fundraiser.

A number of questions arise when managers solicit investors: Are managers then engaged in securities 'brokerage' which requires registration as a broker-dealer? Also, many funds attempt to engage external tactical resources in the form of 3rd party marketers (TPMs). Generally TPMs are FINRA-licensed broker-dealers. However, some individuals and firms representing themselves as TPMs are not registered. (***Note: Only 1 out of every 275 sub $200 million AUM hedge funds, about 40 per year, establishes a relationship with a REGISTERED, QUALIFED and REPUTABLE TPM individual or firm***). There is SEC case history for failure to register as a broker-dealer but much is in situations of fraudulent activity such as Ponzi schemes. However in March 2013 the SEC charged a well-known hedge fund manager with using an external marketing consultant that should have been, but was not, registered as a broker-dealer. It is important to note that no fraud or investor losses were evident in that case.

Potential Risks for Your Fund

Using an unregistered individual or firm to assist with the sale of securities may create a rescission right in favor of the purchasers of the securities, potentially requiring the fund to return the money it received under federal and some states securities laws. Section 29(b) of the Exchange Act provides that every contract made in violation of the Exchange Act, including contracts for which performance under the contract is a violation of any of the Exchange Act provisions, shall be void as to "any persons who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract."

While Section 29(b) creates risk for the individual or firm operating in a fundraising capacity, potentially allowing the fund to claim its obligations to the individual or firm under engagement agreement to be void, the language is broad enough that it can also be interpreted to void the contract for the sale of the securities to investors located through the use of the individual or firm. If investors successfully assert this claim, they would have the right to demand that their investment be rescinded and require the fund to return their monies. This potential rescission right can have a significant negative impact on a funds ability to raise AUM in the future because under federal law the rescission right can be exercised until the later of three years from the date of issuance of the securities or one year from the date of discovery of the violation.

SEC filings require disclosure of compensation paid to individuals or firms in connection with an offering, as do many state blue sky filings. Such disclosure may dissuade future investors from investing and may prevent legal counsel from being able to issue required legal opinions in connection with a subsequent fundraising. In addition, failing to disclose payments made to unregistered individuals or firms in connection with the sale of securities can expose a company to potential liability for fraud under Section 10b-5 of the Securities Act.

Given the overlap of state regulations, similar claims could potentially be brought by investors seeking rescission. Further, there is some risk that the failure to disclose the very fact that an individual or firm is not registered as a broker-dealer might itself be characterized in regulatory enforcement or private litigation as a misleading omission that amounts to fraud

As the SEC steps up its enforcement of regulations requiring registration of broker-dealers, it is also worth noting that funds who engage unregistered individuals and firms may also find themselves subject to SEC action pursuant to Section 20(e) of the Exchange Act for aiding and abetting a violation. In addition, if a private fund manager is newly required to register as an investment adviser under the Dodd-Frank Wall Street Reform and Consumer Protection Act and engages an individual or firm in certain marketing or asset raising capacities, then strict disclosure requirements about the solicitation arrangements will apply pursuant to the Investment Advisers Act of 1940 Rule 206(4)-3.

Finally, by utilizing an external individual or firm, a fund runs the risk of eliminating potential securities registration exemptions under federal and state law, particularly if the fund is not extremely vigilant in monitoring the activities of the individual or firm. Actions by an individual or firm, such as approaching unaccredited investors or engaging in general solicitation, can ultimately prevent the fund from obtaining an exemption under Federal Regulation D or Section 25102 of the California Corporations Code.

Identifying Unregistered Broker-Dealers

Determining whether the individual or firm is considered a broker-dealer under the Exchange Act can be difficult, but a number of factors provide guidance. The Exchange Act defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” This definition is typically interpreted broadly, and includes such activities as providing advice regarding the value of securities, locating issuers, soliciting new clients, assisting in the structuring and negotiation of securities transactions, and disseminating quotes for securities. Section 15(a)(1) of the Exchange Act provides that “[i]t shall be unlawful for any broker or dealer … to induce or attempt to induce the purchase or sale of, any security … unless such broker or dealer is registered” with the SEC. Given the broad nature of the of the broker-dealer definition, some finders may not realize that their activities have triggered a registration requirement. Below are a few questions to contemplate in assessing the risks of retaining external tactical assistance raising assets:

Does the individual or firm receive transaction-based compensation?

Often funds prefer to compensate individuals and firms based on a percentage of assets raised. In addition, funds prefer to pay only if the individual or firm is successful. However, this type of transaction-based compensation creates a substantial likelihood that the individual or firm would be viewed as a broker-dealer and would be required to register because the SEC considers transaction-based compensation to be a key factor in determining if someone is acting as a broker-dealer.

It is important to note that the amount of compensation, either objectively or in relative comparison, is irrelevant for purposes of determining whether registration is required. Therefore the individual or firm can be considered to be “in the business” of effecting transactions (as used in the definition of “broker” above) even if the transaction-based compensation is a small.

Does the individual or firm engage in solicitation of potential investors?

The solicitation of potential investors weighs in favor of requiring registration. However, whether an intermediary is engaged in "solicitation" can be a difficult determination because solicitation can take any number of forms. Generally, a solicitation can be any action that is designed to incentivize or persuade another person to purchase the security. Activities as general as newspaper advertisements or as targeted as individually-addressed e-mails may constitute solicitation. The SEC has recently indicated in a denial of a no-action relief that the introduction of investors "who may have an interest" in a securities investment implies "both 'pre-screening' potential investors to determine their eligibility to purchase the securities, and 'pre-selling' [the] securities to gauge the investors' interest." Both the pre-screening and pre-selling are apparently broker-dealer functions requiring registration in the SEC's view.

Does the individual or firm provide advice or engage in negotiation?

Providing advice, particularly with regard to the value of the securities involved, or assisting the investor in negotiating the terms of the sale of the securities will bring the individual or firm within the definition of a broker-dealer. This may also be the case even if the intermediary is performing a "due diligence" function of providing detailed information on the fund to the investor. For an intermediary's participation to fall reliably outside the definition of a broker-dealer, the intermediary's involvement should not go beyond the "ministerial function of facilitating the exchange of documents or information."

Does the individual or firm have previous securities sales experience or a history of disciplinary action?

The SEC is concerned that persons who have been barred from engaging in the purchase or sale of securities will attempt to evade registration requirements. As such, an individuals prior experience in dealing securities and, in particular, any prior disciplinary action by the SEC, can trigger registration requirements even when other factors listed above are not present.

Risk and Guidelines for External Individual and Firms Marketing/Raising Assets

Individual or firms operating as unregistered broker-dealers may be subject to a number of penalties, the most typical of which is a permanent injunction barring such finder from participating in the purchase or sale of securities. However, the SEC has the power to impose more severe sanctions, such as disgorgement of funds and civil penalties. While historically such harsher penalties have generally been associated only with those cases in which fraud is also present, this is no longer the case. In April 2008, the SEC sanctioned Robert MacGregor, an employee of Duncan Capital who specialized in arranging private investments in public entities, for acting as a broker-dealer without proper registration. The action against MacGregor was brought specifically in response to MacGregor's failure to register as a broker-dealer. The final judgment against MacGregor, absent a finding of fraud, not only barred MacGregor from associating with any broker or dealer for one year, it also required that MacGregor disgorge any "ill-gotten gains" that resulted from the transactions.

Furthermore, as noted above, individual or firms may be unable to collect fees under their engagement agreements with issuers. In 2008, the Supreme Court of New York County in New York denied relief for an unregistered broker-dealer who sued to collect fees owed under a contract with an issuer for brokerage services. The fees owed under the contract were calculated as a percentage of the investment dollars raised with the individual's assistance. The court held that the agreement was void and rescindable because the individual was providing services associated with a broker-dealer, but was not a registered broker.

Summary

Finding investors is difficult and time-consuming, particularly in a hyper-competitive climate. It is important to remember, however, that the long-term success of your fund may be at stake if you choose to engage an unregistered individual or firm to raise assets. As such, funds must be vigilant in vetting whether their employees who solicit investors on their behalf are engaged in activity requiring registration. Managers should review their compensation arrangements to make sure they are not transaction-based compensation' payments. They also should consider the full spectrum of responsibilities of each employee engaged in soliciting investors. In addition, they should review all arrangements with external marketing entities. Transactions in which compensation is provided to an unregistered individual or firm can potentially expose you and your fund to penalties. If you are considering raising assets, seek the advice of experienced counsel before engaging internal or external means to assist in your fundraising activities.

The preceding has been a brief discussion and by no means exhaustive. A full discourse and explanation of legal issues are beyond the scope of this paper. Consultation with experienced legal counsel to seek appropriate specific expertise is highly suggested.

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About Johnson & Company and The Author: Johnson & Company is an Austin,Tx-based consultancy, which provides marketing and fundraising advisory services to alternative asset managers and alternative investment consulting services to investors (institutional and private wealth) as well as consultants, advisors and other key intermediaries.

While our service focus and solutions are for asset managers and investors, we deeply understand that investment bankers, prime brokers, attorneys, accountants, independent administrators, commercial real estate advisors and technology vendors, are all integral components of the eco-system of a successful alternative investment operation. Therefore, we often collaborate and work in partnership with such professionals to assist small funds. Consequently, we welcome inquires from firms and individuals that operate within this sphere to broaden our relationships, augment our knowledge base and bring the highest level of service to our clients.

Bryan K. Johnson is Founder and managing partner and has 20+ years experience within alternative investments. Previous to launching Johnson & Company, he served as Global Head of Marketing and Business Development for the Alternative Investment Group at Moody's Investors Service (MIS), responsible for the deployment of Operational Quality (OQ) Ratings For Hedge Funds. Prior to his tenure with Moody's, he served as chief expert witness for The Attorney General of Texas and The State of Texas in the evaluation of hedge funds and private equity firms as acquirors of the assets of Texas Genco in the multi-billion dollar true-up of Centerpoint Energy (CNP:NYSE)

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