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One Minute Memo®

Private Equity Group and Former Senior Executive Charged by the SEC for Using Unregistered Broker Dealer: Implications for Private Funds and Other Issuers and Their Investors

On March 11, 2013, the Securities and Exchange Commission ("SEC") announced charges against New York-based private equity firm Ranieri Partners, a former senior executive, Donald W. Phillips ("Phillips"), and an unregistered broker, William M. Stephens ("Stephens"), in connection with the solicitation of more than $500 million in capital commitments for private funds managed by the firm.[1] The SEC's orders found that Phillips had aided and abetted the unregistered broker's violations by providing him with key fund documents and information and ignoring red flags indicating that Stephens had gone beyond the limited role of a finder.

Section 15(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") makes it unlawful for a person to effect transactions in, or to induce or attempt to induce the purchase or sale of any security without registering with the SEC as a broker and/or dealer. Section 3(a)(4) of the Exchange Act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." The Exchange Act does not define "effecting transactions" or "engaged in the business." As a result, the determination as to whether a person or entity is acting as a "broker" rather than a "finder" depends on a fact-based analysis taking into account a variety of factors developed by the SEC and federal courts over time.

In a 2001 no-action letter, the SEC staff stated that a person effects transactions in securities "if he or she participates in such transactions 'at key points in the chain of distribution.' Such participation includes, among other activities, assisting an issuer to structure prospective securities transactions, helping an issuer to identify potential purchasers of securities, soliciting securities transactions and participating in the order-taking or order-routing process."[2] Further, the staff noted that factors indicating a person is "engaged in the business" include whether such person (1) receives transaction-related compensation, (2) holds oneself out as a broker by executing trades or assisting in settling securities transactions, (3) participates in the securities business with some degree of regularity, and (4) solicits securities transactions.[3] In recent years, the SEC staff has become, if anything, more restrictive in its views as to what constitutes permissible activities for a person attempting to assert that it is "not engaged in the business of effecting transactions in securities for the account of others." In a 2010 no-action letter where the finder's involvement in the capital raising process was otherwise purportedly limited, the staff observed that the receipt of transaction-based compensation was a "hallmark of broker-dealer activity" and commented that "any person receiving transaction-based compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer."[4]

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1 SEC Press Release 2013-36, SEC Charges Private Equity Firm, Former Executive, and Consultant for Improperly Soliciting Investments (Mar. 11, 2013), available at http://www.sec.gov/news/press/2013/2013-36.htm.
2 BondGlobe, Inc., SEC No-Action Letter (Feb. 6, 2001), citing *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass.) aff'd, 545 F.2d 754 (1st Cir. 1976), cert. denied, 431 U.S. 904 (1977).
3 *Id.*
4 Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (May 17, 2010).

Federal courts have considered similar factors to analyze whether a person falls within the definition of a broker, including whether the person (1) works as an employee of the issuer, (2) receives a commission rather than a salary, (3) sells or earlier sold the securities of another issuer, (4) participates in negotiations between the issuer and an investor, (5) provides either advice or a valuation as to the merit of an investment, and (6) actively (rather than passively) finds investors.[5]

Applying the foregoing factors, the SEC found that from February 2008 through March 2011, Stephens operated as an unregistered broker in violation of Section 15(a) of the Exchange Act. As an independent consultant for Ranieri Partners LLC, Stephens actively solicited investors on behalf of private funds managed by Ranieri Partners' affiliates and, in return, Stephens received transaction-based compensation totaling approximately $2.4 million. According to the SEC's orders, Stephens was actively involved in soliciting investors for Ranieri Partners, including: (1) sending private placement memoranda, subscription documents, and due diligence materials to potential investors; (2) counseling at least one investor to adjust its portfolio allocations to accommodate an investment with Ranieri Partners; (3) providing potential investors with his analysis of Ranieri Partners' funds' strategy and performance track record; and (4) providing potential investors with confidential information relating to the identity of other investors and their capital commitments. By engaging in these activities, the SEC charged that Stephens was engaged in the business of effecting transactions in securities for the account of others without first being registered as a broker-dealer or associated with a registered broker-dealer.

The risks that private equity firms (and other issuers) are exposed to when employing finders (whom the SEC determines are engaging in brokerage activity) include charges by the SEC for causing and/or aiding and abetting violations of the Exchange Act as well as potential private rights of action from investors under either federal or applicable state securities laws seeking to rescind their investment. In this case, the SEC charged Ranieri Partners with causing Stephens' violations of the Exchange Act and charged its then Senior Managing Partner, Phillips, of aiding and abetting Stephens' violations. The SEC found it meaningful that Phillips and Ranieri Partners provided key documents and information related to Ranieri Partners' private equity funds to Stephens and did not exercise appropriate oversight over Stephens' activities or take adequate steps to prevent him from having substantive contacts with potential investors.

In addition, Section 29(b) of the Exchange Act provides that contracts which involve the violation the Exchange Act are void "as regards the rights of any persons who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract." To date, there has been limited applicability of Section 29(b) in the unregistered broker context, and the exact scope of the statute's reach remains unsettled. Arguably, the statute is sufficiently broad to entitle an investor to the return of his or her investment as the purchase contract between the issuer and the investor was part of an illegal arrangement with an unregistered broker.[6] For now, the threat of Section 29(b) appears to have provided a strong incentive for actions involving unregistered broker-dealers to settle, with the issuer and unregistered broker-dealer typically agreeing to return any funds, commissions, fees and expenses to investors. In addition to claims under the Exchange Act, investors may have similar rights of rescission under state securities law in many states.[7] Indeed, claims for rescission under state law based on the participation of an unregistered broker-dealer in a securities offering are not uncommon if the investment is later unsuccessful and plaintiffs' attorneys often look to assert such claims.

The SEC charges in this case reinforce the guidance that issuers, including private funds and their investment managers, should proceed with caution when employing "so called" finders in the fund raising context. The SEC has severely constrained the permissible activities and manner of compensation of finders and more often than not those third parties involved in the capital raising process are likely to be deemed to be "engaged in the business of effecting transactions in securities for the account of others." Moreover, inasmuch as the participation of unregistered broker-dealers in any offering may give rise to possible rights of rescission, auditors asked to audit financial results covering the period of the offering or the balance sheet reflecting the completed offering may have difficulty in issuing unqualified audit opinions, which in turn may have materially adverse consequences for the issuer.[8]

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5 *See SEC v. Kramer*, 778 F. Supp. 2d 1320, 1334 (M.D. Fla. 2011).

6 *See* Mary M. Sjoquist, Report and Recommendations of the Task Force in Private Placement Broker-Dealers, A.B.A. Sec. of Bus. Law (June 20, 2005).

7 Many states also place restrictions on issuers regarding the use of finders, placement agents and brokers vis-à-vis government plans and other government investors.

8 For an extreme example of possible consequences, see Letters from Philip M. Arlen, M.D., President & Chief Executive Officer, Neogenix to Neogenix Shareholders regarding the filing and facts underlying that issuer's sudden bankruptcy filing. www.neogenix.com, and Letter from Philip M. Arlen, M.D., President & Chief Executive Officer, Neogenix to Neogenix Shareholders (Feb. 6, 2012).

Accordingly, private equity firms and other securities issuers should have the proper policies and procedures in place to monitor the activities of any finders they retain and, as will often be the case, when required insist that such finders become affiliated with an SEC-registered broker-dealer. Furthermore, investors in private equity funds and other issuers, including those institutional investors who currently routinely request and obtain "side letter" comfort that no placement agent was utilized to procure their investment, may, in part to guard against the risk of rescission by other investors in the fund, wish to consider broadening the scope of their inquiries and documentation to require the fund manager to represent that no unregistered broker-dealer has been utilized with respect to any investor in the fund.

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