

## BROKER/DEALER REGISTRATION OF HEDGE FUND THIRD PARTY MARKETERS: THE ISSUES

*This article discusses Broker-Dealer (BD) registration of Third Party Marketers (TPMs) or those who engage in the raising of capital on behalf of Hedge Fund managers and the issues involved.*

### **Introduction**

The growth of the third party marketing industry seems to have gone hand in hand with the growth of hedge funds globally. The business has evolved into an industry of its own. Third-party marketers (TPMs) — unaffiliated firms which enter into agreements with managers to find investors for their hedge funds — are increasingly offering more sophisticated and specialized marketing services as they face not only increasing demand for their services, but increasing competition from new firms as well as prime brokerage departments and internal marketing staffs. These services include working with managers on strategy and market positioning, developing market intelligence and identifying prospective investors, arranging meetings to pre-qualify prospective investors in terms of overall suitability, accompanying managers to investor presentations, preparation of marketing materials, follow up with prospective investors, and acting as client liaison throughout the investment period.<sup>1</sup>

The issue of whether or not a TPM acting behalf of hedge funds should or should not register with FINRA and the SEC as a Broker-Dealer (BD) has received much attention as the TPM industry has grown in conjunction with the growth of the hedge fund industry. Multiple issues for a TPM are involved in determining if it is required to register, these include; the structuring of compensation, services performed that may or may not trigger a registration requirement<sup>2</sup>; the types of clients solicited (US or non-US residents); FINRA supervisory requirements; licensing of employees; registration and oversight of employees by a third party associated Broker/Dealer, just to name a few.

Most legal and compliance practitioners encourage TPMs in the hedge fund space to register, some do most don't. According to Donna DiMaria the President of the Third Party Marketers Association (3PM), registration is always recommended to members who seek advice on the issue. Richard Wilson a well known Hedge Fund blogger stated that:

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<sup>1</sup> Hedge Fund Marketing: Pro, Cons and Structuring Agreements with Third-party Marketers, Victor Zimmerman, Curtis Mallet-Prevost, Colt & Mosle LLP, Stamford, Third Quarter 2002.

<sup>2</sup> TPM's apart from raising capital for Hedge Funds also offer services that may not trigger the registration requirement such as developing marketing materials, new product guidance, investor database development, Media relations, request for proposal (RFP) development, event marketing. There are exceptions, but most marketers are evaluated almost exclusively on their ability to raise assets (Investopedia.com, The lucrative World of Third Party Marketing by Richard Wilson)

If you speak with compliance officers and lawyers most will say you should be associated with a broker dealer but several marketers have told me that they have operated without that arrangement in the past and some still do. My position on it is better safe than sorry. If you are taking a serious approach to the business why loose a client because you are not licensed? Some large institutional groups will only work with licensed third party marketers”<sup>3</sup>

## **Definition of a “Broker” & “Dealer”**

In discussing this issue it important that we first determine and define what a “Broker” and a “ Dealer” is.

Section 3(a)(4)(A) of the Securities and Exchange Act of 1934 (“the Act”) <sup>4</sup>generally defines a “broker” broadly as any person engaged in the business of effecting transactions in securities for the account of others.<sup>5</sup> Section 3(a)(5)(A) of the Act generally defines a “dealer” as: any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”<sup>6</sup>

*TPMs who engage in raising capital for hedge funds are clearly not dealers but are they brokers?*

Section 15(a) of the Exchange Act provides that it shall be unlawful for any broker or dealer to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security, unless the broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

The Staff at the SEC has stated that sometimes it is not clear as to whether an entity is a broker. The SEC guidance on the issue provides that individuals and/or entities that act as “finders”, “business brokers,” or engage in finding investors or customers for, making referrals to, or splitting commissions with registered BDs, investment companies (or mutual funds, including hedge funds) or other securities intermediaries; engaging in, or finding investors for, venture capital or “angel” financings, including private placements; or finding investors for “issuers” (entities issuing securities), even in a “consultant” capacity; **“may”** need to register as a broker, depending on a number of factors.<sup>7</sup> These factors include a determination as to what activities are actually being performed.

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<sup>3</sup> Richard Wilson Hedge Fund Blogger <http://hedgefundblogger.com>

<sup>4</sup> The Securities and Exchange Act of 1934

<sup>5</sup> Guide to Broker-Dealer Registration, Division of Market Regulation, U.S. Securities and Exchange Commission December 2005.

<sup>6</sup> Guide to Broker-Dealer Registration, Division of Market Regulation, U.S. Securities and Exchange Commission December 2005.

<sup>7</sup> Ibid.

Here are some of the questions that the SEC Staff suggests you should ask to determine whether you are acting as a broker:

1. Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
2. Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal?
3. Do you receive trailing commissions, such as 12b-1 fees?
4. Do you receive any other transaction-related compensation?
5. Are you otherwise engaged in the business of effecting or facilitating securities transactions?
6. Do you handle the securities or funds of others in connection with securities transactions?

According to the SEC a “yes” answer to any of these questions indicates that you “**may**” need to register as a broker.<sup>8</sup>

### **The Analysis**

In determining whether a person comes within the definition of "broker," the staff has, among other things, focused on whether the person is effecting transactions in securities and whether the person is at least partly engaged in the business of securities transactions or receives commissions or other compensation in connection with transactions in securities ("transaction-based compensation").<sup>9</sup> The Division of Market Regulation at the SEC has previously indicated that the receipt of transaction-related compensation is a key factor in determining whether a person or entity is acting as a BD.

Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of "broker" or "dealer" contained in Sections 3(a)(4) and 3(a)(5), respectively, of the Exchange Act, generally is required to register as a BD under Section 15 of the Exchange Act.

Transaction related compensation is defined as compensation that is dependent upon or related to the outcome or size of the transaction or deal. TPM Compensation is usually structured as a commission only or a moderate retainer while taking a percentage of the fees or assets raised. TPM's will often demand an exclusive engagement with the manager and approximately 20% of all fees. A TPM must therefore answer yes to questions 1 and 2 above posed by the SEC; (a TPM does participate in important parts of a securities transaction as it is involved in the solicitation of the transaction; a TPM does receive compensation which is dependent upon or related to the outcome or size of the transaction or deal).

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<sup>8</sup> Ibid.

<sup>9</sup> Skadden, Arps, Slate, Meager & Flom LLP, Request for No Action on behalf of Welton Street Investments, LLC, June 26, 2006.

The solicitation of potential investors for client hedge funds places a TPM squarely in the realm of performing a “securities based activity” and “effecting transactions in securities” within the definition of a “broker”. TPMs who engage in the business of raising capital for Hedge Funds are acting as placement agents or finders<sup>10</sup>. The compensation received by a TPM’s for its solicitation activities is tied directly to the outcome or size of the funds raised and therefore falls within the definition of “transaction-based compensation”. This combination of acting as a placement agent or finder and receiving compensation that is dependent on the size of the assets raised or in other words “transaction based compensation”, has been determined by the SEC to require registration as a Broker/Dealer.<sup>11</sup>

Brokers” must register with the SEC and join a “self-regulatory organization,” or SRO.

### **Associating with a BD**

NASD Rule 2420 generally prohibits the payment of commissions and fees to entities that operate (or, based on proposed activities, would operate) as unregistered BDs. Many unregistered TPMs have associated themselves with a registered BD. This arrangement takes the form of registering employee individual marketers with the FINRA member through the U-4 process. This arrangement raises a few issues TPM’s seek to avoid a violation of Rule 2420 in this type of arrangement by having the BD receive and pass any compensation received from a Hedge Fund client onto the TPM individual associated with the Broker Dealer, the associated TPM individual would then pass the funds onto the TPM corporate entity. Whether this arrangement may be seen by FINRA as an end-round Rule 2420 is not clear, but an argument could be made and may be made by the regulator that such is the case.

Another issue is supervision. Although BDs do market hedge funds and the practice is growing as evidenced by FINRA adopting guidance on the subject last year notably Notice to Members 03-07, a BD may not grasp the complexities of the TPM business and therein lies a significant compliance risk for them and the TPM registered person. Rules 3030<sup>12</sup> & 3040<sup>13</sup> require FINRA Member Firms to not only supervise the outside

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<sup>10</sup> SEC No Action Letter [Dilworth Capital Management, LLC](#), December 9, 2004

<sup>11</sup> SEC No Action Letter [Dilworth Capital Management, LLC](#), December 9, 2004

<sup>12</sup> **3030. Outside Business Activities of an Associated Person**

No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. Activities subject to the requirements of [Rule 3040](#) shall be exempted from this requirement.

<sup>13</sup> 3040. Private Securities Transactions of an Associated Person

(a) Applicability

No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this Rule.

**(b) Written Notice**

activities of its registered persons but also to record the compensation received on the Firm's books and records. Should a BD choose to register persons involved in the TPM business it would behoove them to familiarize themselves with the TPM business and conduct a thorough review of their own supervisory obligations before filing a single U-4. For example, a BD should be fully aware as to the states in which in the TPM is soliciting investors and verify that the Firm has also registered in those states. Further, a BD's internal controls, including supervision and compliance, must ensure that sales of hedge funds and funds of hedge funds comply with all relevant NASD and SEC rules. Brokers Dealers must include written procedures for supervisory personnel to review compliance with NASD and SEC rules, the accuracy of information gathered, and the appropriateness of the suitability determinations made by their associated persons. Beyond establishing written supervisory procedures, members also must be able to demonstrate adherence to such procedures.<sup>14</sup> TPM's associating with a Broker Dealer is of significant concern to regulators as it involves potential liability to investors if the BD and the TPM does not properly vet the fund and its manager.

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Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

**(c) Transactions for Compensation**

(1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to paragraph (b) shall advise the associated person in writing stating whether the member:

- (A) approves the person's participation in the proposed transaction; or
- (B) disapproves the person's participation in the proposed transaction.

(2) If the member approves a person's participation in a transaction pursuant to paragraph (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

(3) If the member disapproves a person's participation pursuant to paragraph (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.

**(d) Transactions Not for Compensation**

In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to paragraph (b) shall provide the associated person prompt written acknowledgment of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.

**(e) Definitions**

For purposes of this Rule, the following terms shall have the stated meanings:

(1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of [Rule 3050](#), transactions among immediate family members (as defined in [Rule 2790](#)), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.

(2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

<sup>14</sup> FINRA NTM 03-07

## Conclusion

TPM's and their Hedge Fund clients face a myriad of regulatory issues and risks as the industry of marketing hedge funds grows in scope. As the SEC, FINRA and other regulatory bodies give the industry greater and greater regulatory scrutiny it is important that TPMs and their clients adopt a approach of "creating a culture of compliance" in their negotiations and day to day business dealings. If there is an issue as to whether or not to register the approach should always be to take the high road, register and proceed with caution.

### **Authors Information**

*Micah A. Taylor is a regulatory consultant and Partner with Kinetic Partners US LLP, a London based global professional services firm focused exclusively on the investment management and broker dealer industry. Micah is located in the New York office and has over fourteen years of experience in the regulation of the securities industry. Micah assists firms with the operational and regulatory requirements associated with being a FINRA registered Broker-Dealer and/or an SEC Registered Investment adviser. Micah also provides regulatory risk consulting, conducts mock regulatory exams, drafts and tests compliance procedures and controls for both registered entities.*

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