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Skadden

Investment Management Alert

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SEC Charges Private Equity Fund Adviser as an Unregistered Broker

On June 1, 2016, the Securities and Exchange Commission (the "SEC") accepted a settlement offer from a registered investment adviser of private equity funds, and its founder, principal and managing member. The settlement addressed violations of Section 15(a) of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"), regarding prohibitions on unregistered broker activities, and Sections 206(2) and 206(4) of the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), and Rules 206(4)-7 and 206(4)-8 thereunder, regarding fraud and material misstatements by investment advisers.[1]

Receiving Transaction-Based Compensation Without Being Registered as a Broker

This enforcement action has garnered much attention from the private equity industry, as it is the first time the SEC has charged a registered investment adviser for failing to register as a broker due to receiving transaction-based compensation with respect to fund portfolio companies.[2] As is fairly common in industry practice, Blackstreet provided services with respect to the acquisition and disposition of its funds' portfolio companies, which at times involved the purchase and sale of securities, soliciting deals, identifying buyers or sellers, arranging financing, and negotiating and executing transactions. These fees were unquestionably permitted by and disclosed in the governing fund documents, although the adviser was never registered as a broker. The adviser received over $1.8 million of transaction-based compensation for these services. The SEC found these activities to be in violation of the broker-dealer registration requirements of the Exchange Act, and the settlement included disgorgement of the fees along with interest and a civil penalty.

The first warning that the SEC had started to examine fees received by advisers for these types of services came in 2013, when David W. Blass, then Chief Counsel of the SEC's Division of Trading and Markets, gave a speech indicating that private equity advisers may be engaging in activities that require registration as a broker-dealer.[3] Mr.

[1] In the Matter of Blackstreet Capital Management, LLC ("Blackstreet"), SEC Release No 34-77959 (June 1, 2016), available here.

[2] "Broker" is defined in Section 3(a)(4) of the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others."

[3] David W. Blass, Chief Counsel, SEC's Division of Trading and Markets, "A Few Observations in the Private Fund Space" (Apr. 5, 2013), available here. See also, "SEC Staff Warns That Advisers May Be Required to Register as Broker-Dealers," *Skadden, Arps, Slate, Meagher & Flom LLP* (Apr. 22, 2013), available here.

Blass specifically addressed instances where an adviser receives transaction-based compensation for "broker-type" activities relating to the portfolio companies of its fund clients, including fees charged "in connection with the acquisition or disposition (including an initial public offering) of a portfolio company or a recapitalization of the portfolio company" and fees relating to "negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions." In his remarks, Mr. Blass acknowledged that where such transaction fees offset the advisory fee, they could be seen as a method of paying the advisory fee, which in his opinion would not raise a broker-dealer registration concern. However, Mr. Blass also indicated his view that the issuer exemption is not applicable to fund advisers, stating: "That the fee is paid to someone other than the fund — here the general partner — makes crystal clear to me that, at least for potential broker-dealer status questions, the fund and the general partner are distinct entities with distinct interests." He also expressed his view that "[u]nless prepared to register as a broker, a person should not engage in activities that trigger registration" and that it shouldn't be difficult for an adviser "to change its practices so it is not engaging in activities that raise broker-dealer status questions."

Now that the SEC has held an investment adviser accountable for this practice, the question has returned of whether private equity advisers should either stop charging these fees or should fully offset them against the management fee. Recent market trends already have shown such fees increasingly offset, either partially or completely, against the management fee received by the adviser.

In announcing the settlement, Andrew J. Ceresney, Director of the SEC Enforcement Division, stated, "The rules are clear: before a firm provides brokerage services and receives compensation in return, it must be properly registered within the regulatory framework that protects investors and informs our markets," and that "Blackstreet clearly acted as a broker without fulfilling its registration obligations." In light of the Blackstreet enforcement action, investment advisers should review any current or proposed transaction-based fee structures with outside counsel to assess the related broker-dealer regulatory implications.

Other Violations

In addition to the unregistered broker violation, and consistent with other SEC enforcement actions in recent years that have focused on adviser fee and expense practices, conflicts of interest and disclosure thereof, the SEC found that Blackstreet also engaged in the following violations between 2005 and 2012:

- **Charging Undisclosed Fees.** The adviser charged two portfolio companies of one of its funds $450,000 in operating partner oversight fees, which were not authorized or disclosed in the fund's governing documents.
- **Unauthorized Use of Fund Assets.** The adviser used fund assets to make political and charitable contributions and to pay for entertainment expenses, which were not authorized or disclosed in the fund's governing documents.
- **Unauthorized Purchase of Portfolio Company Interests.** The adviser improperly purchased shares in portfolio companies from a departing employee. Pursuant to the agreement whereby the employee had purchased the shares, the shares should have been repurchased by the applicable portfolio companies for the benefit of the funds' limited partners.
- **Improper Acquisition of Fund Interests.** The founder, through an entity he controlled, acquired interests in one of Blackstreet's funds from two limited partners who had defaulted on their commitments (for which he paid only $1 to each defaulting limited partner) instead of causing those limited partners to forfeit their interests back to the fund as required under the fund's governing documents. The founder also purchased the interests of six other limited partners who wished to exit the fund. The founder, acting on behalf of the fund's general partner, then waived his obligation to satisfy future capital calls with respect to the fund interests he had acquired, even though the fund's governing documents required that anyone who acquires another limited partner's interest assume the corresponding obligation to make future capital contributions.
- **Failing to Adopt and Implement Reasonably Designed Compliance Policies and Procedures Designed to Prevent These Violations.**

Pursuant to the settlement agreement, the adviser and the founder will pay disgorgement of over $2.3 million plus interest (over $500,000 of which will be distributed to affected clients) and a civil money penalty of $500,000, and it will cease and desist from committing future violations. The adviser also has agreed to be censured, although it did not admit or deny the charges pursuant to the settlement. The SEC considered certain remedial efforts undertaken by the adviser and the founder in its decision to accept the settlement, such as the adviser's voluntary retention of a compliance consultant in 2012; its decision to stop charging operating partner oversight fees; and the return of fund interests, portfolio company interests and cash (with interest) to the funds.