Client Update

Another Message to Private Fund Sponsors on Broker Registration – This Time from Enforcement

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On Wednesday, June 1, 2016, the U.S. Securities and Exchange Commission (the "SEC") settled an enforcement action against a U.S. private equity firm (the "PE Sponsor") for a number of violations, including acting as an unregistered broker.[1] In its settlement order and public statements, the SEC emphasized that the PE Sponsor had acted as an unregistered broker because it sourced, structured and negotiated the acquisition and disposition of portfolio companies for the funds that it managed and charged the portfolio companies transaction fees for those services. All private equity fund sponsors should carefully review their transaction fee structures in light of this enforcement action.

PRIVATE EQUITY FIRMS AS BROKERS

Since the beginning of the private equity industry in the 1970s, many private equity firms have collected transaction fees from portfolio companies in connection with the acquisition or disposition of portfolio companies by funds closely affiliated with the private equity firm. Typically, the private equity firm would have sourced, negotiated and executed the transaction—sometimes but not always with the involvement of an investment bank or other registered broker-dealer—as a core part of the investment advisory services that the private equity firm provides to the fund.

As we discussed in a prior client update, the issue of whether this practice would result in the private equity sponsor becoming a broker has been on the SEC's radar since at least 2013, when the Chief Counsel of the SEC's Division of Trading and Markets gave a speech (the "TM Speech") raising this issue.[2] At or

[1] In the Matter of Blackstreet Capital Management, LLC, SEC Release Nos. 34-77959, IA-4411 (Jun. 1, 2016).

[2] Client Update: SEC's Division of Trading and Markets Delivers a Message to Private Fund Sponsors about Potential Broker-Dealer Registration Issues (18 April 2013).

about the same time, the SEC's Office of Compliance Inspections and Examinations asked several private equity sponsors to provide explanations of why they were not required to register as brokers based on their receipt of transaction fees. However, the SEC staff has not provided any further public guidance and, until now, there have been no enforcement actions.

The settlement order released Wednesday states that in connection with the acquisition and disposition of portfolio companies or their assets, "some of which involved the purchase or sale of securities," the PE Sponsor "provided brokerage services to and received transaction-based compensation from the portfolio companies" and that this activity caused the PE Sponsor "to be acting as a broker" without having registered as such under Section 15 of the U.S. Securities Exchange Act of 1934. The services that the PE Sponsor provided included "soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions." The settlement order does not go into any further detail concerning the nature of these services or whether the PE Sponsor engaged in any abusive activities in connection with providing these services. The SEC emphasized that the funds' limited partnership agreements ("LPAs") "expressly permitted [the PE Sponsor] to charge transaction or brokerage fees." The significance of this statement is unclear. The settlement order also notes that the PE Sponsor did not retain an investment bank or broker-dealer to provide these brokerage services, but instead performed these services in-house. The settlement order does not clarify whether the presence of an investment bank or broker-dealer in the transaction would have changed the result.

In addition, the order does not address whether the PE Sponsor offset transaction fees against its management fee. In the TM Speech, the then-Chief Counsel of the Division of Trading and Markets stated that "to the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, one might view the fee as another way to pay the advisory fee, which, in my view, in itself would not appear to raise broker-dealer registration concerns." The settlement does not clarify whether the SEC staff continues to hold this view.

OTHER ISSUES ADDRESSED IN THE SETTLEMENT ORDER

The PE Sponsor was also charged with a number of violations under the anti-fraud provisions of the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), largely related to issues that the SEC has focused on in other enforcement

available at http://www.debevoise.com/insights/publications/2013/04/secs-division-of-trading-and-markets-delivers-a-__.

actions involving private fund sponsors. This enforcement action serves as a reminder of the SEC's concerns over conflicts of interest and disclosure.

- *Operating Partner Fees*. The PE Sponsor charged fees to portfolio companies of one fund for providing various employees of the PE Sponsor to perform certain senior-level operating and management services to these companies in circumstances where the companies were having difficulty recruiting suitable talent to work directly for them. The fund's LPA did not expressly address these types of fees or specifically authorize the PE Sponsor to charge these fees to the portfolio companies.
- *Political and Charitable Contributions and Entertainment Expenses*. In several instances the PE Sponsor used fund assets for purposes that were not expressly authorized by the funds' LPAs, including to make political and charitable contributions and to pay for certain entertainment expenses. The SEC noted that the PE Sponsor had provided disclosure that the fund assets had been used to make political and charitable contributions and to pay entertainment expenses; however, the disclosures had not been made until after the limited partners had committed their capital and after the contributions had been made and the expenses incurred. In the case of the entertainment expenses, the PE Sponsor did not take sufficient steps to ensure that the expenses were allocated appropriately among the PE Sponsor and the funds or adequately track or keep records of the entertainment.
- *Conflicted Transactions*. The PE Sponsor provided employees who performed services for portfolio companies with the opportunity to invest alongside the funds in these companies pursuant to agreements that granted the portfolio companies exclusive rights to repurchase the employees' shares at fair market value in the event of the employees' departure or termination. On one occasion, and in violation of these agreements, the PE Sponsor purchased a departing employee's shares "without disclosing its financial interest or obtaining appropriate consent to engage in the transaction."
- *Avoiding Capital Calls*. The principal of the PE Sponsor acquired fund interests from certain limited partners and then directed the fund's general partner (which he also controlled) to waive his obligation to satisfy future capital calls associated with new investments. These acquisitions and subsequent waivers were contrary to the terms of the fund's LPA.
- *Inadequate Policies and Procedures*. The PE Sponsor was found to have failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act as required by Rule 206(4)-7 with respect to the matters described above.

PENALTIES

The sanctions included a censure of the PE Sponsor, a cease and desist order and payments of approximately $3.1 million, including a $500,000 civil penalty, $2.3 million of disgorgement and $300,000 of prejudgment interest. Approximately $500,000 of the disgorgement and prejudgment interest will be paid to one of the PE Sponsor's funds (and its limited partners) that was affected by the alleged violations.

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As noted above, this settlement renews the SEC's focus on transaction fees. All private equity fund sponsors should carefully review their transaction fee structures in light of this enforcement action. In addition, the settlement serves as a useful reminder to review fund disclosures concerning fees and expenses and to obtain appropriate consents before engaging in transactions that present conflicts of interest. We will continue to update you as we receive further information on these important issues.

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Please do not hesitate to contact us with any questions.