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Client Alert

June 13, 2016

SEC Strikes a Harsh Tone on Receipt of Transaction-based Compensation by Private Equity Fund Managers

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On June 1, 2016, the Securities and Exchange Commission (SEC) sent a warning to private equity fund managers who receive transaction-based fees in connection with the purchase and sale of portfolio companies by charging Blackstreet Capital Management (Blackstreet), a private equity fund advisory firm, and its principal, Murry Gunty with, among other things, acting as an unregistered broker-dealer. According to the SEC, Blackstreet received fees, separate and apart from its management fees, for performing "in-house brokerage services" in connection with the acquisition and disposition of portfolio companies for two private equity funds. The fact that Blackstreet Capital fully disclosed the fees did not affect the SEC's conclusion that Blackstreet acted as an unregistered broker-dealer.

Blackstreet and Gunty settled, on a neither-admit-nor-deny basis, with the SEC and agreed to pay more than $3.1 million in disgorgement and civil penalties. Importantly, the $3.1 million settlement also reflects other charges such as failing to disclose other fees and failing to implement reasonably designed compliance policies and procedures to prevent violations of the Investment Advisers Act of 1940 and rules thereunder.

Section 15(a)(1) of the Securities Exchange Act of 1934, as amended (Exchange Act) makes it unlawful for any broker or dealer to use the mails or any other means of interstate commerce to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless that broker or dealer is registered with the SEC in accordance with Section 15(b) of the Exchange Act. "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." Over the last several years, the SEC has included violations of 15(a) in numerous enforcement actions involving offering frauds and other situations involving the offer and sale of securities to retail investors.

In its Order against Blackstreet and Gunty, the SEC concluded that by being involved in the purchase or sale of securities, including soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, executing the transactions and receiving transaction-based compensation, Blackstreet was performing brokerage services without having registered as a broker-dealer and, therefore, willfully violated Section 15(a) of the Exchange Act.

Private equity fund managers have recognized the potential that the SEC would take the position that they are acting as broker-dealers. In 2014, the SEC issued a no-action letter that relieved firms from the requirement to register as a broker-dealer in connection with facilitating a sale of a private company as long as they complied with a number of detailed conditions. The conditions included requirements that the manager must never have possession of customer funds or securities; that upon completion of the M&A transaction, the buyer must have control of the target; and that the manager should not provide financing for the transaction.

The SEC's most recent action in the private equity space emphasizes the SEC's renewed resolve to more strictly enforce non-fraud based violations and to bring Section 15(a) charges in situations beyond traditional transactions with retail investors. In fact, following the settlement, Mr. Robert B. Baker, Assistant Regional Director in the SEC's Enforcement Division's Asset Management Unit, stated "That's the first case of a private-equity adviser violating section 15(a) of the [Exchange Act] for acting as a broker and failing to register as a broker." However, even if Blackstreet had contemplated reliance on the no-action positon cited above and such position was available, it did not comply with at least one of the conditions of the no-action letter because, according to the Order, Blackstreet appears to have been involved in arranging the financing for the transactions. Moreover, while disclosure of the fees was important, the fact that they were disclosed had no significance to the SEC's analysis of whether Blackstreet acted as an unregistered broker dealer.

Fees related to the acquisition and disposition of portfolio companies are not uncommon in the private equity fund context. In light of the SEC's action, private equity fund managers should reconsider whether they need to register as broker dealers, take care to comply with all of the provisions of existing no-action letters, seek no-action relief of their own or take other appropriate steps.

Should you have any questions about this alert, please contact one of the authors listed below or the Drinker Biddle Investment Management Group lawyer with whom you regularly work.

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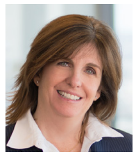

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