SEC targets broker-dealer implications of transaction-based deal fees

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Abstract

Purpose – *To explain a US Securities and Exchange Commission (SEC) enforcement action against a registered investment adviser to private equity funds for allegedly providing brokerage services in connection with the acquisition and disposition of the securities of portfolio companies while not being registered as a broker dealer, making undisclosed use of fund assets, and failing to adopt policies and procedures designed to prevent the alleged violations.*

Design/methodology/approach – *Describes the services provided by the investment adviser, the compensation paid, and the SEC's other bases for enforcement, and draws conclusions for private equity fund advisers.*

Findings – *The SEC has begun pursuing transaction-based compensation paid to private equity fund advisers relating to portfolio company transactions as illegal brokerage commissions. The Commission also continues to target the adviser's undisclosed use of client fund capital, especially in private equity funds.*

Originality/value – *Practical explanation by experienced investment management lawyer.*

Keywords *Investment adviser, US Securities and Exchange Commission (SEC), Private equity fund, Broker-dealer, Brokerage services, Transaction-based compensation*

Paper type *Technical paper*

The Securities and Exchange Commission (SEC) announced on June 1, 2016 that it had brought and settled an enforcement action against Blackstreet Capital Management, LLC (LLC and Gunty, 2016), a registered investment adviser to private equity funds, and its principal for, among other things, "the receipt of transaction-based compensation for the provision of brokerage services in connection with the acquisition and disposition of portfolio companies while not being registered as a broker-dealer". To settle the claims, the investment adviser paid approximately $3.1 million including disgorgement, prejudgment interest and penalties.

Services provided

The SEC claimed that the adviser violated broker-dealer registration requirements when it performed brokerage services on behalf of fund portfolio companies in-house instead of using investment banks and broker-dealers. In particular, the SEC emphasized that the investment adviser performed the following services:

- solicitation of deals;
- identification of buyers or sellers;
- negotiation and structuring of transactions;
- arranging of financing; and
- execution of the transactions.

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Compensation paid

The enforcement action did not expressly address whether the compensation was subject to offset against the management fee paid by the fund client, but it did state that the adviser had received approximately $1.9 million in transaction-based compensation in connection with providing the brokerage services and that the transaction and brokerage fees were expressly permitted in the fund documents. A senior member of the SEC staff has previously stated, "to the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, one might view the [transaction] fee as another way to pay the advisory fee, which, in my view, in itself would not appear to raise broker-dealer registration concerns" (Blass, 2013).

Other conduct

In addition to the unregistered broker-dealer activity, the SEC also included the following as bases for enforcement:

1. undisclosed use of fund assets, such as:
   - portfolio company payments to employees of the adviser for operating partner oversight fees to provide services until suitable portfolio company employees could be retained;
   - political contributions by the advised funds;
   - charitable contributions by the advised funds;
   - payment for a portion of a luxury suite at an arena without retaining adequate records to show personal and business use;
2. the purchase of securities of a fund portfolio company from a departing employee by the principal of the adviser without "disclosing its financial interest or obtaining appropriate consent to engage in the transaction";
3. the undisclosed waiver of the obligation to contribute capital for future drawdowns for limited partner interests in the advised funds acquired by the principal; and
4. the failure to adopt policies and procedures designed to prevent the above violations.

Several of the "undisclosed" fees and expenses were disclosed to investors after the fund had launched, but the SEC viewed such disclosure as ineffective because the disclosure was made after the contribution of capital by the investors and no ability to withdraw was offered. Also, some of the undisclosed uses of fund assets were repaid to the fund with interest.

Conclusion

The SEC will likely look for other cases in which investment advisers have received compensation for what the SEC views as broker-dealer services. Private equity fund advisers should examine their practices and their offset policies. Also, private equity advisers should continue to review the fees and expenses at the fund and portfolio company level, as the SEC and its staff will continue to scrutinize them.

References

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