SEC Cracks Down on Broker-Dealer Registration

Private equity fund advisers are being held accountable for in-house transactions

By Kelli Moll, Eliot Raffkind & Jason Daniel / Akin Gump Strauss Hauer & Feld

The Securities and Exchange Commission (SEC) has begun pursuing transaction-based compensation paid to private equity fund advisers relating to portfolio company transactions as illegal brokerage commissions. It continues to target the advisers' undisclosed use of client fund capital, especially in private equity funds.

The SEC brought and settled an enforcement action against Blackstreet Capital Management, LLC,[1] 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
- Execution of the transactions

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 had 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."[2]

Other Conduct

Along with the unregistered broker-dealer activity, the SEC included the following as bases for enforcement:

- 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
- 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"
- The undisclosed waiver of the obligation to contribute capital for future drawdowns for limited partner interests in the advised funds acquired by the principal
- 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 the disclosure as ineffective because it was made after the investors had contributed capital, 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. In addition, 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.

To review the footnotes to this article, visit http://www.metrocorpcounsel.com

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Internet of Things

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MCC: Is there an example in which some new and unusual Internet of Things information moved a current case forward for a legal team?

Regard: The interest is currently highest in wage and labor, white collar, and antitrust litigations. For example, in on the clock/off the clock litigation, when employees claim that they are working for the benefit of the employer before they clock in or after they clock out, the Internet of Things can help resolve factual questions. When did they arrive on-site? What were they engaged in? Was that beneficial to the employer?

Another example might be in what markets certain devices were distributed and who distributed them. It may relate to market contracts, gray market distribution and retail of goods. Because the goods themselves are smart, we know where they physically are and when. That can be traced to the batch, the lot and the manufacturer.

MCC: What other impact could the IoT have on businesses?

Regard: Up to this point readers may have taken some of my comments to be forward-looking to a future state that hasn't arrived, but this *has* arrived. These devices are in the marketplace now, just not yet in the volumes projected. There is already plenty of litigation that relies heavily on this information to resolve factual issues. Do not think of it as waiting to see what's going to happen in the future with the Internet of Things but catching up to what's already going on.