Simpson Thacher

Memorandum

SEC Charges Private Equity Firm with Acting as Unregistered Broker-Dealer

June 6, 2016

On June 1, 2016, the Securities and Exchange Commission (SEC) announced the settlement of an enforcement action against a private equity firm and its owner, alleging that the firm acted as an unregistered broker-dealer in connection with activities commonly conducted by sponsors of private equity funds.[1] Although several improprieties under the Investment Advisers Act of 1940, as amended, were also alleged and detailed in the Order, the title of the SEC's press release, "SEC: Private Equity Fund Adviser Acted As Unregistered Broker," is indicative of the relative importance of the broker-dealer registration issue, at least with respect to its implications for the private equity industry.[2]

In the settlement order, the SEC noted that the private equity firm acted as an unregistered broker-dealer by "soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing… transactions" on behalf of its portfolio companies. The Order emphasized that the respondents (the firm and one of its principals) did these activities itself, "[r]ather than employing investment banks or broker-dealers," that it collected fees for doing so, and that it did so without registering as a broker-dealer. The Order does not state whether the private equity firm offset the fees it received from portfolio companies for the claimed broker-dealer services against the advisory fees to be received from its funds, in whole or in part.

Without admitting or denying the SEC's allegations, Blackstreet and its owner agreed to pay aggregate disgorgement of $2.339 million, including $504,588 to be distributed to clients impacted by the alleged conduct. The firm and its owner also agreed to pay a $500,000 penalty and $283,737 in interest.

[1] *Blackstreet Capital Mgmt., LLC*, Exchange Act Release No. 77959, Advisers Act Release No. 4411 (June 1, 2016). Blackstreet Capital Management, LLC ("Blackstreet") is a private equity firm located in Chevy Chase, MD.

[2] *See* Press Release, *SEC: Private Equity Fund Adviser Acted as Unregistered Broker* (June 1, 2016).

In outlining the alleged improper conduct, the SEC noted that the activities conducted were fully disclosed to clients, which is distinct from other actions that have recently been brought against private equity and other investment advisers. The alleged violations in prior private equity actions have focused on the adequacy and timing of disclosure to clients because they almost universally involved disclosure violations, while the alleged violation in this case does not require non-disclosure.

We believe that sponsors of private equity funds should take note of the following issues highlighted by the action, beyond the stated facts of the case:

1. This is not a new issue. Then Chief Counsel of the Division of Trading and Markets David Blass, in a speech in April, 2013, raised the question of whether a private fund adviser (or its personnel or affiliates) that receives transaction-based compensation for investment banking or other broker activities relating to one or more of the fund's portfolio companies would need to register as a broker-dealer.[3] Many firms received inquiries from the SEC's Office of Compliance, Inspections and Examinations (OCIE) around the time of Mr. Blass' speech and responded to questions regarding their activities that could be deemed to be of the type provided by broker-dealers in other contexts. Certain firms will recognize the name of one of the key members of the SEC's Enforcement team that handled the Blackstreet matter as one of the OCIE examiners involved in that previous round of inquiries.

2. In January/February of 2014, a no-action letter was issued to so-called "M&A Brokers" that permitted entities and individuals to engage in certain types of activities not dissimilar to the ones at issue in the Blackstreet action, without registration as a broker-dealer.[4] Although several elements of the M&A Brokers no-action letter make it unworkable for private equity sponsors, there was some thought that the SEC might consider a no-action position on similar bases for private equity sponsors, and there were discussions to that effect between the industry and SEC staff. It would be surprising, in light of the Blackstreet proceeding, if such a no-action position were forthcoming or even seriously being contemplated by the SEC staff at the current time.

3. As noted above, there is no mention in the Order of any fee offset for the transaction-based compensation earned by the Blackstreet respondents. In Mr. Blass' speech, he suggested that his personal view was that a complete fee offset would negate any registration concerns. Specifically, he said that "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." If the SEC agreed with that view, however, one would think the fee offset issue would have been mentioned in the Blackstreet Order. Fee

[3] *See* *A Few Observations in the Private Fund Space,* Speech to the American Bar Association, Trading and Markets Subcommittee, David W. Blass, Chief Counsel, SEC Division of Trading and Markets (Apr. 5, 2013).

[4] *See* *M&A Brokers*, SEC No-Action Letter (Jan. 31, 2014 [Revised: Feb. 4, 2014]). *See also*, Simpson Thacher Memorandum, *SEC Issues No-Action Letter Exempting M&A Brokers from Broker-Dealer Registration Requirements in Private M&A Transactions* (Feb.7, 2014).

offsets are a common practice in the industry and a method used by many firms, in light of Mr. Blass' speech, to mitigate the risks associated with activities that could be deemed to be brokerage in nature. We surmise that the omission of a discussion of fee offsets in the Order suggests that there may be some within the SEC who do not subscribe to Mr. Blass' view as to the efficacy of fee offsets in resolving the broker-dealer issues. If that is the case, this would be an unwelcome surprise for many private equity sponsors. That said, normal due process concerns would seem to argue for a clear statement by the SEC contradicting Mr. Blass' earlier comments if it is to pursue enforcement action against a firm that used fee offsets to mitigate its risks in the manner suggested by Mr. Blass' speech.

4. As noted, the order emphasized the lack of another broker-dealer being involved in the transactions at issue. Many private equity sponsors perform the types of activities described in the settlement order with the assistance of a registered broker-dealer. It is not clear following the Blackstreet action to what extent the involvement of a registered broker-dealer would allow a sponsor to receive transaction fees.

Please feel free to reach out to your usual Simpson Thacher contact for further discussion of the implications of this enforcement action.

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