CARTER LEDYARD

our resources

Easy Money – Private Equity Firms Collecting Transaction Fees

March 19, 2018

Client Advisory
March 19, 2018 by Valentino Vasi

For years Private Equity Firms (the general partners and investment advisers that manage and operate Private Equity Funds) have been charging and collecting large sums in transaction fees from portfolio companies as part of the Private Equity Funds' acquisitions and sales of the securities of portfolio companies. The problem is that, generally, negotiating these transactions and collecting these types of fees is considered an investment banking activity requiring registration as a broker-dealer under the Securities Exchange Act of 1934 (the "Exchange Act"). Although some of the larger Private Equity Firms have registered as broker-dealers (or have affiliates that are broker-dealers) many continue to operate as unregistered broker-dealers, risking SEC enforcement actions, sanctions, fines and possibly, rescission of investor purchases.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law on July 21, 2010, created the requirement that certain Private Equity Firms be registered with the Securities and Exchange Commission ("SEC") as investment advisers. As a result, many Private Equity Firms were drawn into the unfamiliar world of federal regulation and inspection.

In October 2012 the SEC's Office of Compliance, Inspections, and Examinations ("OCIE") launched an initiative to get to know these newly-registered investment advisers. OCIE created a specialized unit, the Private Funds Unit, and began to examine Private Equity Firms.

These exams identified a number of deficiencies (which is unsurprising considering regulation was fresh for these newly-registered firms). This led the SEC to embark on further inspections of Private Equity Firms, adding this objective to its annual exam priorities in 2015, 2016 and 2017. OCIE stated in 2015: "Given the high rate of deficiencies that we have observed among advisers to private equity funds in connection with fees and expenses, we will continue to conduct examinations in this area." The SEC specifically noted the practice of Private Equity Firms receiving transaction-based compensation for providing investment banking services to portfolio companies and raised the question of whether such Private Equity Firms should be registered as broker-dealers.

Engaged in the Business – The Definition of Broker-Dealer

Section 3(a)(4) of the Exchange Act states that a "broker" is "any person engaged in the business of effecting transactions in securities for the account of others." Brokers are required to be registered under section 15(a)(1) of the Exchange Act.

The Exchange Act does not define "effecting transactions" or "engaged in the business," but the SEC has taken a very broad view of these terms. The SEC's position, developed through no-action letters and enforcement cases, generally is that being "engaged in the business" can be triggered by one instance of receipt of transaction-based compensation in the sale of securities. Some recent court rulings interpret "engaged in the business" to require something more than receipt of transaction-based compensation. However, it is safe to assume that investment banking activities described above fall within the definition of broker-dealer, at least in the view of the SEC staff.

SEC Staff Actions. On April 5, 2013, David Blass, then Chief Counsel of the SEC's Division of Trading and Markets, spoke to a committee of the American Bar Association. He said that Private Equity Firms that receive, or have employees that receive, fees in connection with the acquisition and sale of securities of portfolio companies may need to be registered as broker-dealers under the Exchange Act. The Private Equity Firm in these instances is acting as a broker, selling for the account of its "customer," the Private Equity Fund. It usually solicits deals, identifies buyers or sellers, negotiates and structures the transactions, arranges financing, executes the transactions, and receives transaction-based compensation for performing these services. These activities and the fees charged are different from management fees that advisers charge a fund.

The BlackStreet Case

On June 1, 2016 the SEC settled an enforcement action against BlackStreet Capital Management LLC ("BCM"), an adviser to and manager of private equity funds, and one of its principals. Among other things, the SEC alleged that BCM operated as an unregistered broker in connection with the buying and selling of portfolio companies. The SEC Order states:

"Rather than employing investment banks or broker-dealers to provide brokerage services with respect to the acquisition and disposition of portfolio companies, some of which involved the purchase or sale of securities, BCM performed these services in-house, including soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions. BCM received at least $1,877,000 in transaction-based compensation in connection with providing these brokerage services."

BCM had fully disclosed to fund investors that it would provide these brokerage services in exchange for a fee, but one cannot disclose away a requirement to register as a broker. Private Equity Firms' management agreements often includes descriptions of activities and fees that define broker-dealers.

Mr. Blass's comments in 2013 and the BCM matter have caused Private Equity Firms to take notice of the issue of whether receipt of transaction fees requires broker-dealer registration. The issue is magnified by the fact that many Private Equity Firms are now subject to SEC jurisdiction and exams. The broker-dealer issue may be low-hanging fruit to an SEC examiner. The range of actions taken by Private Equity Firms has varied greatly from "business as usual" to modification of their business practices to broker-dealer registration.

Options for Private Equity Firms Collecting Transaction-Based Compensation

Business As Usual – Continue to Collect Transaction-Based Fees Without Broker-Dealer Registration

Many Private Equity Funds may think the there is little risk to continuing to act as they always have when it comes to collecting these fees. Some time has passed since the 2016 BCM settlement. There have been no other publicized SEC enforcement actions since then against Private Equity Firms who collect transaction-based fees without being registered as broker-dealers. The BCM matter involved other regulatory issues and, perhaps absent these other regulatory issues, the SEC would not have moved against BCM for acting as an unregistered broker-dealer.

In 2014 the SEC staff considered adopting an exemption or no-action position that would have allowed Private Equity Firms to continue collecting transaction fees without broker-dealer registration. The proposal stalled but it may have reflected a different thought process at the SEC when it comes to Private Equity Firms. In 2013 a whistleblower and former Private Equity Firm executive provided the SEC with evidence of several unnamed Private Equity Firms charging transaction fees in connection with the purchase and sale of portfolio companies without being registered as broker-dealers. We are not aware of any action having been taken by the SEC in response to the whistleblower report.

Modify the Business Model – Offset Transaction Fees

Some Private Equity Firms offset as much as 100% of their transaction fees against management fees and/or carried interest. This may be based, in part, on a belief that if a Private Equity Firm's fund advisory fee is wholly reduced by the transaction-based fees, there might be no broker-dealer registration concerns. The theory is that the Private Equity Firm is then not being compensated for the brokerage services.

It is unclear if this offset against management fees resolves the issue or explains why Private Equity Firms don't just forgo transaction fees and keep the management fee. The offset of transaction fees reduce profits for Private Equity Firms, which may make this option less attractive. However, sometimes they are compelled to offset transaction fees because limited partners are unwilling to pay both management and transaction fees and sometimes "monitoring fees," for consulting and advisory services they presumably provide. In these cases the consideration is not a regulatory one but a business one forced by the limited partners. In other cases Private Equity Firms may believe that optically investors feel good (or not as bad) about paying a transaction fee upfront or at the sale of a portfolio company and seeing reports that state the management fee is waived.

Register as a Broker-Dealer

As stated above, a number of the larger Private Equity Firms have formed broker-dealers. These include Apollo Management, Kohlberg Kravis Roberts, Blackstone Group and TPG Capital.

However, the registration and ongoing compliance, and audit and examination requirements are significant in both cost and resources. Broker-dealers must register with the SEC by filing an application on a Form BD and become a member of a self-regulatory organization, the Financial Industry Regulatory Authority, Inc. ("FINRA"). Broker-dealers may be required to be licensed in the states where they conduct business as a broker-dealer, and certain individuals employed by broker-dealers must also pass qualification exams, such as the Series 7 and Series 63 exams.

Regulatory oversight requires Private Equity Firms to act fairly and holds them to a suitability standard with regard to the transactions they effect. This includes consideration for the best interests of their limited partnership (or limited liability company) investors as well as to the parties to the securities transactions Broker-dealers must also manage other conflicts of interests and comply with regulations designed to protect investors.

The SEC rules governing broker-dealers and those imposed by FINRA cover areas not now addressed by the Investment Advisers Act and its rules. They include more frequent regulatory exams, requirements for annual audits of financial statements, greater legal liabilities, and capital requirements.

No Relief Based on 2014 M&A Broker No-Action Letter

On January 31, 2014, the SEC's Division of Trading and Markets issued the M&A Broker No-Action Letter. The SEC stated that it would not seek enforcement for failing to register as broker-dealers against M&A Brokers if they engaged in limited activities in connection with the purchase or sale of privately-held companies. The company being acquired must be "privately-held" and the buyer must actively operate the acquired business. The letter lists 10 requirements for the M&A Broker effecting the transaction. Two of these 10 requirements usually disqualify a Private Equity Firm.

- The M&A Broker must not have the ability to bind a party to an acquisition transaction.
- The M&A Broker must not have custody, control or possession of funds or securities related to the M&A transaction fee.

The No-Action Letter still has an impact on Private Equity Firms. Nothing in the Letter prohibits an M&A Broker from receiving transaction-based compensation from a Private Equity Firm. Therefore, Private Equity Firms may find more comfort paying transaction-based fees to unaffiliated consultants and finders for referrals of potential acquisition targets. However, Private Equity Firms do not always exercise control of a company purchased (a requirement of the no-action letter) so this something to be careful about. Also, the M&A Broker cannot have helped the Private Equity Firm raise the capital that is being used to purchase the private company.

No Relief Based on the CAB Rules

Since early 2017 there has been an option for certain limited purpose brokers to be become registered as Capital Acquisition Brokers ("CABs"). CABs are FINRA members that engage in limited broker-dealer activities, such as capital raising through certain private placements, including Private Equity Fund portfolio transactions and advice to companies regarding mergers and acquisitions ("M&A"), corporate restructuring and capital raising.

Sometimes referred to as "broker-dealer lite," CABs are not required to have annual compliance meetings or maintain a business continuity plan. A CAB must have an independent audit of its Anti-Money Laundering policies every two years (instead of every year). Review of communications and annual internal inspections by a principal of the firm are not required. The chief executive officer of a CAB is not required to certify annually to the effectiveness of the CAB's supervisory processes. However, CABs are prohibited from certain activities such as engaging in proprietary trading or market-making, carrying or maintaining customer accounts, accepting customer trading orders, and handling customer funds or securities. If the Private Equity Fund is managed by an investment adviser Private Equity Firm, FINRA would most likely consider the Private Equity Firm to be maintaining a customer account and handling customer funds or securities. A general partner Private Equity Firm has an ownership interest in the Private Equity Fund and may be considered to be engaged in proprietary trading.

The CAB Rules may be useful to Private Equity Firms. Private Equity Firms could consider setting up a related separate entity to become a CAB so that this separate entity does not maintain customer accounts or handle customer funds or securities. While less onerous than full registration, operating under the CAB designation still requires a lot of effort, compliance work, and ongoing maintenance. Regulatory exams remain part of the territory.

Conclusion

If they haven't already done so, Private Equity Firms should consider how they collect fees and the options outlined in this article. Get in touch with your Carter Ledyard & Milburn attorney to discuss the matter. Without an exclusion carved out through legislation, a rule change, or a no-action letter Private Equity Firms will continue to collect transaction-based fees at their own peril regardless of whether they consider these fees easy money.

For more information concerning the matters discussed in this publication, please contact Attorney Valentino Vasi (212-238-8877, vasi@clm.com) or your regular Carter Ledyard attorney.
