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Recent PE case rekindles unresolved issue about registering as B-Ds

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That **Blackstreet Capital Management** case from June, in which the **SEC** argued again that a private equity fund adviser receiving transaction-based compensation should register as a broker-dealer, has fired up some who remain unsettled over an issue of regulatory/industry disagreement never resolved.

You may recall that a speech by a now former SEC official cast new light on the issue three years ago (**IA Watch**, May 6, 2013). Nearly one year later, the SEC released a no-action letter that granted flexibility for transaction-based compensation in some M&A deals. Two years ago, **IA Watch** revealed back-room talks between the SEC and PE industry reps aimed at finding agreement on the topic (**IA Watch**, May 26, 2014).

However, those talks ended without success.

The Blackstreet Capital case once again brings the issue to the fore (**IA Watch**, June 2, 2016).

"I can't sit here with a straight face and tell these people to register as broker-dealers without more thoughtful guidance as to how decades of [SEC Division of] Trading and Markets staff interpretations on broker-dealer status under the 'two-part' test should be applied to the unique role of advisers to PE funds," says **Barbara Stettner**, a partner with **Allen & Overy** in Washington, D.C.

Along with B-D registration comes a different regulatory regime and intense compliance duties.

A change in the wind?

That "two-part test" for broker-dealer status requires that the subject be serving as an intermediary and a fiduciary in arranging the purchase or sale of PE fund assets. These are high hurdles for PE fund advisers, says Stettner. She states that the Blackstreet case appears to eviscerate that long established "two-part test."

"It's just thrown big uncertainty across the entire private equity industry," says **Norm Champ**, a partner with **Kirkland & Ellis** in New York, and former director of the SEC's Division of Investment Management. The SEC should issue "more detailed guidance on what the Commission wants," he adds.

Champ recently wrote an opinion piece for the *Wall Street Journal* chastising the agency for setting an important policy stance via enforcement and not through formal regulation.

The SEC declined to comment on the issue to **IA Watch**.

That 2013 speech by then SEC Chief Counsel in the Division of Trading and Markets **David Blass** noted that the "SEC and SEC staff have long viewed receipt of transaction-based compensation" as "a hallmark of being a broker."

What the law says

The legal basis for this view is seen in Exchange Act Section 15(a)(1) (registration and regulation of brokers and dealers).

"I don't agree with Norm Champ that this is new territory," says **Stephen Wink**, a partner with **Latham & Watkins** in New York. "It certainly wasn't a surprise to broker-dealer lawyers" that if you get a fee based on transactions that you should be treated as a B-D, he adds.

But PE fund advocates argue that the private equity model fails to fit within the neat confines of B-D activity, and that given the nature of their business model – to buy and sell portfolio companies – having an instrumental role in these transactions is fundamental.

Back on the burner?

Marc Ponchione, a partner at Allen & Overy, notes that the momentum toward reaching a consensus on the issue among the industry and the SEC slipped away after Blass took a job with the **Investment Company Institute**. "I would like to see that process [of negotiations] started up again," he says.

Champ adds that a paucity of facts within the SEC's settlement with Blackstreet only exacerbates the industry's uncertainty.

"One thing that was very curious in the Blackstreet order was there was no mention of the offset," states Wink. He refers to offsetting the transaction-based compensation against the fund adviser's management fee. In other words, subtracting from the management fee whatever was obtained through the transaction so that it's all a wash for the client.

As we've reported, a fee offset is one solution (**IA Watch**, May 6, 2013).

Multiple sources tell **IA Watch** that the Blackstreet settlement skipped the issue of offset fees because the adviser didn't use an offset. If true, this fact alone could calm the industry's jangled nerves.

The offset should be the "least you should be doing," counsels Wick.

"Without more facts, this [case] appears to be a sloppy application" of Exchange Act section 15 and inconsistent with longstanding guidance and interpretations, reasons Stettner.

But the SEC appears to have little interest in revisiting the topic as a policy issue, leading some to predict more PE fund enforcement actions like Blackstreet's.

Anastasia Rockas, a partner with **Skadden** in New York, offers some final advice. "I would be cautious about charging any fees that could be characterized as broker-dealer-related fees without a full offset" of the PE's management fee, she says. "It's a matter of [your] risk appetite," Rockas adds.

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