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Order Entered Against Private Equity Fund Adviser For Broker-Dealer Activity

Under the notoriously ill-considered Dodd-Frank Wall Street Reform and Consumer Protection Act, previously exempt advisers to private equity funds are subject to Securities and Exchange Commission reporting requirements and examination. Since adoption of that act, the SEC, both informally through speeches and more formally in examinations, has questioned whether an adviser's activities and taking fees in connection with the acquisition or disposition of portfolio companies of the funds the adviser manages requires it to be registered as a broker-dealer under the Securities Exchange Act. Although seemingly resolved, a recent enforcement action appears to raise the issue anew.

On June 1, 2016, a registered investment adviser and its principal consented to an SEC order for acting as an unregistered broker, in violation of the Exchange Act, and for various Investment Advisers Act violations.

According to the SEC's order, the adviser to a pair of private equity funds, in regard to the funds' acquisition and disposition of portfolio companies, solicited deals, identified buyers and sellers, negotiated and structured transactions, arranged financing, and executed the transactions, some of which involved the purchase or sale of securities. In the SEC's view, these activities, for which the adviser took transaction fees pursuant to the funds' limited partnership agreements, constituted the adviser as an unregistered broker, in violation of the Exchange Act.

The SEC also alleged that the adviser violated the Advisers Act by:

- Improperly charging operating partner oversight fees.
- Improperly using fund assets for political and charitable contributions and entertainment.
- Purchasing from an employee portfolio company shares that should have been resold to the fund.
- Purchasing limited partners' interests that should have been resold to the fund.
- Failing to implement internal Advisers Act compliance policies.

Contrasting with the enforcement action, the SEC staff, in 2014, issued no-action relief (i.e., the staff said it would not recommend enforcement action to the SEC) for broker activity in connection with merger and acquisition transactions under the following circumstances:

- The M&A broker does not have authority to bind either party.
- The M&A broker does not provide financing, and, if it assists a party in obtaining financing, complies with Regulation T and other requirements and discloses any compensation arrangements to the client.
- The M&A broker does not handle either funds or securities involved in the transaction.
- The transaction does not involve a public offering, and no party to the transaction is a shell company (other than a business combination related shell company).
- The M&A broker obtains written consent from both parties if it represents both in the transaction.
- The M&A broker does not represent a buyer group that the broker helped organize.
- Upon completion of the transaction, the buyer (or buyer group) controls the target and will actively operate the company; there are no passive buyers.
- Any securities received in the transaction are restricted securities under Rule 144.
- Neither the M&A broker nor any of its officers, directors or employees is barred or suspended from association with a broker-dealer.

The SEC's silence regarding the applicability of the M&A broker no-action letter to the current case raises concerns whether advisers to private equity funds may rely on it. Consequently, PE fund advisers must carefully consider broker-dealer registration issues when charging transaction fees in connection with the acquisition or disposition of a portfolio company.

Three possible ways to avoid SEC enforcement action in connection with this activity may be to:

- Not take transaction fees.
- Engage a third-party registered broker-dealer.
- Establish a captive registered broker-dealer or unregistered entity that is able to comply fully with the M&A no-action letter.

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