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SEC Counsel Hints That Private Equity Managers Must Register as Broker-Dealers

May 6, 2013 – Historically routine practices in private equity investing are likely becoming the target of a significant new regulatory effort by the SEC. As a result, investment advisors may soon become subject to the registration and regulatory rules applicable to broker-dealers.

It is a common and longstanding practice of many private equity managers to receive investment banking-type fees when their funds, or their funds' portfolio companies, engage in securities transactions (for example, in connection with merger and acquisition activities). This practice was subjected to new scrutiny in a speech given early last month to the American Bar Association by David W. Blass, chief counsel in the SEC's Division of Trading and Markets.

According to Mr. Blass, such fees could not logically be distinguished from other types of "transaction-based compensation," the receipt of which has traditionally been considered by the Commission as a "hallmark of being a broker." Therefore, he said, there was no basis under the Securities Exchange Act of 1934 or its rules for fund managers to believe that they were exempt from the broker-dealer registration and enforcement rules if they receive such fees. The SEC's concern, he argued, was with the existence of a "salesman's stake" in a securities transaction, where the transaction-based compensation may provide an incentive to the advisor that raises fiduciary duty issues and conflicts of interest.

While acknowledging how widespread the practice has become among private fund advisors, Mr. Blass stated that "unless prepared to register as a broker, a person should not engage in activities that trigger registration", cautioning that "securities transactions intermediated by an inappropriately unregistered broker-dealer could ultimately be rendered void." Hinting at one possible solution to this potential trap – a solution that is likely unattractive to private fund advisors – he noted that "to the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, 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."

Mr. Blass's comments followed another speech, given earlier in the year by Bruce Karpati, the chief of a Commission enforcement unit, in which Mr. Karpati first implied that the Commission may intend to focus some of its regulatory efforts on the fees traditionally earned by private fund advisors. Last

month's speech were also part of a larger, cautionary discussion that highlighted the risk that fund managers take when fees tied to fundraising success are paid to employees and third parties during the capital-raising process. Specifically, Mr. Blass noted the recent action taken by the Commission against an investment advisor that had retained and compensated a finder who solicited new investors for the investment advisor's funds but who was not a registered broker-dealer. The advisor was fined $375,000 for facilitating the finder's violation of the Exchange Act.

Although Mr. Blass's speech pointed to a broadening of the types of compensation the Commission might consider "transaction-based," the Commission has also recently narrowed its scope as well, ruling in the context of examining two crowdfunding investor portals developed pursuant to the recent JOBS Act that the receipt by a portal affiliate of carried interest would not be considered "transaction-based compensation" and would therefore not expose the affiliated fund manager to broker-dealer registration.

We will continue to monitor additional SEC guidance on broker-dealer registration and related regulatory issues in the private equity industry. In the meantime, if you have questions or would like to discuss broker-dealer registration issues or investment advisor regulation generally, please contact your usual Morrison Cohen attorney, or any one of the following attorneys, for more information.

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