June 8, 2016

SEC Settles with Private Equity Fund Adviser Charged with Acting as an Unregistered Broker

Background

In a case that may reflect a notable change in the SEC's views on broker-dealer registration issues in the private equity industry, a private equity fund adviser agreed to settle SEC charges that it engaged in broker activity and charged brokerage fees without registration, and committed other securities laws violations. On June 1, 2016, Blackstreet Capital Management, LLC ("Blackstreet") was censured, and Blackstreet and its principal owner and managing member Murry N. Gunty agreed to cease and desist from further violations and pay more than $3.1 million to settle the proceeding.

Following an inspection and investigation, the SEC found that Blackstreet performed brokerage services for and received brokerage fees from portfolio companies, instead of using investment banks or registered broker-dealers to provide such services, and that Blackstreet and Mr. Gunty engaged in conflicted transactions, improperly used fund assets and failed to adequately disclose certain fees and expenses that were charged to the funds and/or the portfolio companies. In addition, the SEC determined that Blackstreet failed to adopt and implement reasonably designed compliance policies and procedures to prevent violations of the Investment Advisers Act of 1940 ("Advisers Act") and its rules arising from the alleged improper conduct.

Broker-Dealer Registration

The Securities Exchange Act of 1934 (the "1934 Act") defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." In determining whether a person is a broker, the SEC typically focuses on whether the person receives transaction-based compensation and participates in important parts of a securities transaction, including solicitation, negotiation or execution. According to the SEC order, Blackstreet provided brokerage services and received transaction-based compensation in connection with the acquisition and disposition of portfolio companies, which caused Blackstreet to be acting as a broker. The services included soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions. The settlement included disgorgement of transaction fees of $1,877,000, related prejudgment interest and a civil monetary penalty of $500,000.

The Blackstreet case is the first enforcement action in which the SEC has taken the position that the receipt of portfolio company transaction fees requires a PE adviser to register as a broker-dealer. The case appears to be a departure from previous public comments by the SEC Staff. In 2013, David Blass, then Chief Counsel of the SEC's Division of Trading and Markets, suggested that newly registered PE advisers preparing for their first SEC exam should consider whether any of their activities, including the receipt of transaction fees from portfolio companies, required broker-dealer registration. Blass said that if the fund management fee is "wholly" reduced by the transaction fees, there are no broker-dealer registration concerns, presumably because in that event the PE adviser is not being compensated for the brokerage services.

In public remarks later in 2013, Blass appeared to retreat from his position somewhat, stating that the SEC Staff would apply a rule of reason to the analysis of broker-dealer registration in the private equity industry. He noted similarities between PE advisers and M&A brokers, which typically facilitate transactions between buyers and sellers of operating business, with the buyer actively involved in the business after the acquisition. He said the Staff was considering registration relief for those brokers, and that such relief might have favorable implications for PE advisers. He suggested that this topic could also be the subject of informal Staff guidance in the future.

On January 31, 2014, the SEC's Division of Trading and Markets in fact did issue a no-action letter stating that "M&A Brokers," defined as persons engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of private companies, could, subject to certain conditions, engage in that activity without broker-dealer registration. The letter was a significant departure from the SEC's long-held view that persons receiving transaction-based compensation in connection with acquisition transactions in securities must register. PE advisers do not necessarily fit within the no-action letter's definition of an M&A Broker, and may not satisfy some of the conditions set forth in the letter. Nevertheless, at the time of the M&A Brokers letter, it was thought by some commentators that, in light of the prior remarks by Mr. Blass, the letter might be good news for PE advisers receiving transaction fees from portfolio companies.

During this period, SEC examiners continued to raise the registration issue in examinations of newly registered PE advisers. In that connection, an industry group took the position that PE advisers provide investment advisory services and expertise to their affiliated funds and portfolio companies and do not engage in traditional broker-dealer activity such as widespread solicitation of investors, that receipt of transaction fees alone does not transform an investment adviser into a broker-dealer, that management fee offsets benefit fund investors, that in contrast to brokers which act as intermediaries, PE advisers have a significant economic stake in portfolio companies, and that PE advisers act as owners on behalf of their funds and portfolio companies.

Late in 2014, an SEC staffer commented on the transaction fee issue. He said the perception of the Division of Trading and Markets was that the industry had "self-corrected" to some extent, with the 100% management fee offset in some cases, and with running the fees through affiliated broker-dealers in others. He said the Division was mindful that this was a historic practice in the industry. He thought the best way to address it was through forward-looking guidance via a Q&A or a no-action letter and not through enforcement actions (at least in the absence of other unlawful conduct like bad disclosure and improper expense allocation).

Although the Blackstreet enforcement action does, as noted, include Advisers Act violations, the SEC's press release clearly emphasizes the failure to register and includes the following statement by Andrew J. Ceresney, Director of the SEC Enforcement Division: "The rules are clear: before a firm provides brokerage services and receives compensation in return, it must be properly registered within the regulatory framework that protects investors and informs our markets. Blackstreet clearly acted as a broker without fulfilling its registration obligations."

An SEC administrative proceeding settlement does not have precedential value and of course depends on the facts of the case. However, the order suggests that the SEC now may not see any distinction between the activities of PE advisers and other persons engaged in the business of effecting securities transactions for others and therefore subject to registration. To that extent, prior Staff comments with implications to the contrary should be questioned. It now appears that the SEC may apply traditional broker-dealer analysis to the registration question for PE advisers, which is hard to square with the policy judgment presumably underlying the M&A Brokers no-action letter that brokerage activity in connection with change in control transactions of private companies does not require registration.

Both the SEC press release and order state that Blackstreet received compensation for the broker services provided to its portfolio companies. Notably, the Blackstreet case does not appear to involve failure to disclose such compensation to investors; the order observes that the fund agreements at issue "expressly permitted [Blackstreet] to charge transaction or brokerage fees." The Blackstreet order does not indicate that management fees for the Blackstreet funds were subject to any transaction fee offset. For this reason, the status of prior Staff comments that a 100% management fee offset obviates the need for broker-dealer registration is uncertain. At a minimum, care should be taken that a PE adviser not registered as a broker-dealer is not receiving other forms of compensation for brokerage services rendered to portfolio companies.

The SEC may have been emboldened in pursuing the broker-dealer registration issue with Blackstreet by the explicit reference to brokerage services in the Blackstreet fund agreements, as well as by the seemingly questionable conduct underlying the other securities law violations summarized below. However, in the wake of the Blackstreet action and the absence of any forward-looking guidance from the SEC, PE advisers should carefully review their activities to determine whether registration is required. The risks of failing to register when required include disgorgement of transaction fees, penalties, interest, and censure and cease and desist orders. In addition to these administrative remedies, the SEC can also resort to the courts and seek a permanent or temporary injunction as well as civil penalties. The 1934 Act also imposes liabilities on controlling persons and persons who aid and abet others who violate the 1934 Act. In theory, the SEC could ask the Department of Justice to institute criminal proceedings. As most states have their own statutes requiring broker-dealer registration, state enforcement actions could also result. Finally, a transaction in which an unregistered broker is involved could be subject to rescission in a private action under the 1934 Act or similar state laws.

Other Securities Law Violations

In addition to the unregistered broker-dealer claims, the SEC found that Blackstreet and Mr. Gunty engaged in other violations of securities laws, including:

- Blackstreet charged at least $450,000 in "operating partner oversight fees" to portfolio companies without properly disclosing that it may receive such fees. It is worth noting that the persons performing operating partner services were current employees of Blackstreet and that the portfolio companies paid Blackstreet directly for their services.

- Blackstreet used fund assets to pay for political contributions to a state campaign, charitable contributions and entertainment expenses (including a lease and event tickets), even though such expenditures were not authorized in the funds' governing documents. The SEC further noted that Blackstreet neither sought, nor obtained, appropriate consent for this use of fund assets.

- Blackstreet acquired a departing employee's interest in certain portfolio companies even though the fund's governing documents required the interest to be repurchased by the portfolio companies for the benefit of the funds and its investors. In addition, Blackstreet failed to disclose its own financial interests or obtain appropriate consent to engage in the transaction.

- Mr. Gunty indirectly (through an entity he controlled) acquired fund interests from certain defaulting and selling limited partners despite the fact that the fund's governing documents required the defaulting limited partners to forfeit their interests back to the funds. Following the acquisition, Mr. Gunty caused the fund's general partner (which he also controlled) to waive his obligation to make future capital calls associated with his newly acquired interest.[1] Both the acquisitions and waivers were inconsistent with the terms of the fund's governing documents and the SEC found that Blackstreet's subsequent failure to disclose these waivers rendered the fund's governing documents materially misleading.

- Blackstreet failed to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules arising from the improper use of fund assets, undisclosed receipt of fees and engaging in other transactions that involve conflicts of interest.

The SEC's press release is available here and a copy of the SEC's order is available here.

If you have questions about this issue, please contact your usual Ropes & Gray advisor.

[1] The SEC's order noted that notwithstanding the fact that Mr. Gunty did not participate in the gains resulting from these new investments, the failure to make future capital calls reduced the capital available for investment opportunities, thereby increasing the pro rata share of future capital calls borne by the remaining limited partners.