

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



Christopher J. Bellini

Chair, Private
Equity
Co-
Chair, Capital
Markets &
Securities

cbellini@cozen.com
Phone: (612) 260-9029
Fax: (612) 260-9080

Related Practice Areas

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Background

A recent Securities and Exchange Commission (SEC) settlement order highlights the importance that the SEC has placed on the issue of broker-dealer registration for the private equity industry. On June 1, 2016, the SEC announced the settlement of an enforcement action against a private equity firm and its owner, alleging that the firm acted as an unregistered broker-dealer in connection with activities frequently conducted by private equity sponsors. Pursuant to the order, 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.

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. The SEC also found that Blackstreet and Gunty: (1) engaged in conflicted transactions, (2) improperly used fund assets and (3) failed to adequately disclose certain fees and expenses that were charged to the funds and/or the portfolio companies.¹

Without admitting or denying the SEC's allegations, Blackstreet and Gunty agreed to pay aggregate disgorgement of \$2.339 million, including \$504,588 to be distributed to clients impacted by the alleged conduct, and also agreed to pay a \$500,000 penalty and \$283,737 in interest.

Broker-Dealer Registration

The Securities Exchange Act of 1934 (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's focus is generally 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 acted as an unregistered broker-dealer by "soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing ... transactions" on behalf of its portfolio companies. The order emphasized that Blackstreet did these activities itself, "[r]ather than employing investment banks or broker-dealers," that it collected fees for doing so, and that it did so without registering as a broker-dealer.

The issue of broker dealer registration for private equity funds is hardly new. In 2013, David Blass, then chief counsel of the SEC's Division of Trading and Markets, suggested that newly registered private equity fund 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.² The Blackstreet case, however, is the first enforcement action in which the SEC has taken the position that the receipt of portfolio company transaction fees requires a private equity fund adviser to register as a broker-dealer. In a statement by Andrew J. Ceresney, director of the SEC Enforcement Division, Ceresney noted: "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."

Interestingly, the order does not state whether Blackstreet offset the fees it received from portfolio companies for the claimed broker-dealer services against the advisory fees to be received from its funds it managed, in whole or in part. In Blass's speech, he suggested that his personal view was that a complete fee offset would negate any registration concerns. Specifically, he said that "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.” If the SEC agreed with that view, however, one would expect the fee offset issue to have been mentioned in the order, particularly since fee offsets are a common practice among private equity fund advisers to mitigate the risks associated with activities that could be deemed to be brokerage in nature.

Other Securities Law Violations

In addition to the unregistered broker-dealer claims, the SEC found that Blackstreet and 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.
- 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, 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. 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.

Practical Considerations

While SEC administrative proceeding settlements do not have precedential value, the order suggests that the SEC does not see any distinction between the activities of private equity fund advisers and other persons engaged in the business of effecting securities transactions for others and therefore subject to registration. Accordingly, private equity fund advisers should carefully review their activities to determine whether registration is required. The risks for failure to register when required include disgorgement of transaction fees, penalties, interest, censure, and cease and desist orders.³ It remains to be seen the extent to which the SEC will provide further guidance to the private equity industry, as private equity fund advisers are struggling to evaluate their own activities in light of this enforcement action.

The SEC’s press release is available [here](#) and a copy of the SEC’s order is available [here](#).

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Christopher J. Bellini at (612) 260-9029 or cbellini@cozen.com.

¹ 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.

² See *A Few Observations in the Private Fund Space*, Speech to the American Bar Association, Trading and Markets Subcommittee, David W. Blass, chief counsel, SEC Division of Trading and Markets (Apr. 5, 2013).

³ Additionally, the SEC could 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 and, in theory, the SEC could ask the Department of Justice to institute criminal proceedings. 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.