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Lessons From SEC Sanctions Against Blackstreet

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On June 1, 2016, the U.S. Securities and Exchange Commission issued an administrative order sanctioning Blackstreet Capital Management LLC and Blackstreet's managing member and principal owner, Murry N. Gunty, for acting as an unregistered broker-dealer, as well as engaging in certain conduct that violated the Investment Advisers Act of 1940, as amended. Without admitting or denying the allegations, Blackstreet and Gunty consented to issuance of the order and imposition of the sanctions.[1]

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Background

Blackstreet, a registered investment adviser, is the manager of two private equity funds that invest through leveraged buyouts in companies requiring a "turnaround." Blackstreet disclosed to the fund investors that it would, and the funds' governing documents expressly permit Blackstreet to, charge fees for brokerage services rendered in connection with the acquisition and disposition of portfolio companies (brokerage fees). The SEC found that Blackstreet received at least $1,877,000 in brokerage fees despite the fact that Blackstreet had never been registered with the SEC as a broker. The brokerage services identified in the order included soliciting deals, identifying buyers and sellers, negotiating and structuring transactions, arranging financing and executing transactions.

The SEC also found that Blackstreet (1) improperly charged two portfolio companies operating partner oversight fees, which were not disclosed to fund investors or permitted in the fund's governing documents, (2) improperly used fund assets to make political and charitable contributions and pay for certain entertainment expenses, (3) improperly acquired shares in portfolio companies, and improperly acquired interests in one of the funds from defaulting and exiting investors.

The order requires Blackstreet to disgorge the brokerage fees, as well as certain unrelated and "unauthorized and inadequately disclosed" fees that had been charged to the private equity funds. Together with prejudgment interest and a fine of $500,000, Blackstreet and Gunty are required to pay a total of $3,122,737.

Our Take

Key Lessons Related to the Broker-Dealer Issue

The SEC is serious about requiring managers of private equity funds to conduct brokerage activity through registered broker-dealers.

In April 2013, David Blass, who was then-chief counsel of the SEC's Division of Trading and Markets, gave a highly noted speech in which he warned the private fund industry about the importance of complying with broker-dealer registration requirements.[2] Blass noted that many private equity managers might be violating the broker-dealer registration requirements as a result of the manner in which they were raising money for their funds or the manner in which they were compensated for acquiring and disposing of portfolio companies. While prior enforcement actions have focused on fundraising efforts, this is the first enforcement action of which we are aware in which the SEC sanctions a private equity manager for the manner in which it was compensated for acquiring and selling portfolio companies. Although the respondents in this case are alleged to have committed other violations of the law, it is clear from the SEC's press release[3] that it is sending a message about the importance of complying with the broker-dealer registration requirements.

Broker-dealer registration violations may occur regardless of whether the manager discloses such fees and activities to fund investors.

This action is notable because there were no allegations that investors in the funds were defrauded by the brokerage fees or that receipt of such fees violated Blackstreet's fiduciary duties as an investment adviser due to the fact that Blackstreet apparently fully disclosed the brokerage fees to its investors. Nonetheless, as the SEC has often said, the broker-dealer registration requirements are intended to ensure that participants in the securities industry are subject to proper regulation, and violations of such requirements cannot be cured by disclosure.

Transaction-based fees are a critical element in determining whether or not registration as a broker-dealer is required.

Section 15(a) of the Securities Exchange Act of 1934 requires persons "engaged in the business" of "effecting" securities transactions to register as broker-dealers. The SEC staff has advised that participation in the important parts of a securities transaction, such as solicitation, negotiation and execution, are factors that indicate registration as a broker-dealer may be required. However, most of the enforcement cases brought by the SEC have involved transaction-based compensation in addition to participation in the "important parts" of a securities transaction. Transaction-based compensation consists of commissions or fees that are payable upon the successful completion of a transaction. The SEC has noted that the incentive provided by transaction-based compensation lends itself to the type of potential misconduct that the broker-dealer regulations are intended to prevent.

It is not clear from the order whether the SEC would have alleged violations of the broker-dealer registration provisions had the same services been provided by Blackstreet without the receipt of any transaction-based compensation. In the press release, the director of the SEC's Division of Enforcement stated that: "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." This statement suggests that, in the view of the SEC, the receipt of any compensation for rendering brokerage services will trigger the broker-dealer registration requirements.

Private equity fund managers should review their practices to ensure they are in compliance with broker-dealer registration requirements.

Managers of private equity funds that seek to receive compensation for services rendered in connection with acquisition or disposition of portfolio companies should effect such transactions through a registered broker-dealer. In situations where such an arrangement is not possible, separate fees for the brokerage services should be eliminated. In addition, managers of private equity funds should review the compensation arrangements of their employees who participate in acquisition and disposition activities to ensure that the compensation payable to such employees is not based upon the purchase or sale of securities of portfolio companies.

Advisers Act Lessons From the Order

The order also serves as a reminder of certain areas the SEC staff focuses on during routine examinations, including practices related to the allocation of fees and expenses and conflicts of interest.

Investment advisers should clearly disclose any fees the adviser or its affiliates will receive from portfolio companies and ensure that such fees are permitted by the governing documents of a fund before accepting such fees.

The order alleges that Blackstreet entered into agreements with the portfolio companies pursuant to which various Blackstreet employees were to provide senior-level operating and management services to the portfolio companies in situations where the portfolio companies had difficulty attracting and retaining suitable employees. Blackstreet did not disclose the existence of such to the fund investors nor were such fees permitted by the fund's governing documents of the fund. Moreover, such fees created a conflict of interest between Blackstreet and the fund investors because fund assets were used to compensate Blackstreet and its employees. Moreover, the SEC noted that even though Blackstreet subsequently disclosed the fees to its investors, such disclosure was insufficient to cleanse the conflict of interest because the fund investors had already made capital commitments to the fund and the fees were being charged. As a result, any private fund advisers seeking to receive fees from portfolio companies should ensure that such fees have been fully disclosed to and approved by fund investors prior to the adviser accepting such fees.

Records should be sufficiently detailed to ensure that expenses are properly allocable to a fund.

The order notes that Blackstreet used fund assets to pay for certain entertainment expenses and that respondents did not take sufficient steps to ensure that the costs of such expense were allocated appropriately among Blackstreet and the funds. While the order does not discuss whether any of such expense were allocable to the funds, it is clear that if an investment adviser seeks to allocate entertainment expense to a fund, the adviser should maintain detailed records regarding the business purpose of the expense.

Default and other provisions in a fund's governing documents should be consistently followed in order to ensure investors are treated fairly.

The order also notes that Gunty indirectly acquired interests in one of the funds from two defaulting investors. According to the fund's governing documents, in the event of default, defaulting limited partners were to forfeit all but $1 of their interests in the fund, and the fund's general partner would purchase the remaining $1 interest for $1. The order alleges that Gunty acquired the entire interests from the defaulting investors for himself for $1 (he later transferred the forfeited interests back to the fund).

In addition, Gunty acquired interests in one of the funds from six investors who were seeking to sell their interests in the fund for a negotiated price. The fund's governing documents provide that transferees of another investor assume the investor's obligation to make future capital contributions to the fund. The order alleges that Blackstreet then waived Gunty's obligations to make future capital calls and did not disclose such waivers to the fund investors. The order provides that Gunty's failure to participate in such future capital calls harmed investors because it reduced the capital available for investment opportunities and increased the pro rata share of future capital calls borne by the remaining investors.

While these actions involve conflicts of interest due to Gunty's participation, they also serve as a cautionary tale for managers that elect not to consistently enforce provisions of a fund's governing documents among all investors, as doing so could result in enforcement action. In addition, managers should consider the impact on nondefaulting investors before determining to waive default remedies with respect to a defaulting investor.

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[1] See Securities Exchange Act Release No. 77959, available at: https://www.sec.gov/litigation/admin/2016/34-77959.pdf.

[2] https://www.sec.gov/News/Speech/Detail/Speech/1365171515178

[3] See "SEC: Private Equity Fund Adviser Acted As Unregistered Broker," June 1, 2016, available at: https://www.sec.gov/news/pressrelease/2016-100.html.

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