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SEC Announces Settlement with Adviser Found to Have Acted as an Unregistered Broker and Engaged in Conflicted Transactions

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On June 1, 2016, the SEC announced a settlement with Blackstreet Capital Management, LLC and Murry N. Gunty, Blackstreet's managing member and principal owner. As a registered investment adviser based in Chevy Chase, Maryland, Blackstreet provides investment advisory and management services to two groups of private equity funds (the Blackstreet funds), each in turn sponsored by affiliated Blackstreet Capital general partners. While neither admitting nor denying the SEC's allegations, Blackstreet and Gunty agreed to pay approximately $3.12 million to settle the charges, which consisted of approximately $2.6 million in disgorgement (including pre-judgment interest) and a $500,000 civil monetary penalty.

Based on this finding, private equity fund managers should (i) consider whether the nature of services and compensation related to portfolio company transactions gives rise to an obligation to register as a "broker", (ii) confirm that appropriate disclosure has been made to investors related to conflicted transactions and, regardless, whether investor consent should be sought in such transactions (keeping in mind that "after the fact" disclosure and remediation may mitigate penalties, but is no defense to liability in the eyes of the SEC), and (iii) where certain expenses may appropriately be shared between several funds or between the funds and a management company, ensure that appropriate policies and procedures are in place to monitor and apportion such expenses.

Blackstreet Acted as an Unregistered Broker in Portfolio Company Transactions

Blackstreet was neither registered with the SEC as a broker, nor had it ever been affiliated with a registered broker. The term "Broker" is defined in Section 3(a)(4) of Securities Exchange Act of 1934 as "any person engaged in the business of effecting transactions in securities for the account of others." The Settlement Order (Order) alleged that Blackstreet itself performed brokerage services with respect to the acquisition and disposition of portfolio companies held by the Blackstreet funds, which included soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions themselves, some of which involved the purchase or sale of securities. The respective limited partnership agreements of the Blackstreet funds expressly permitted Blackstreet to charge transaction or brokerage fees, and according to the Order, Blackstreet received at least $1.87 million in transaction-based compensation in connection with these services.

In the press release accompanying the Order, Andrew J. Ceresney, Director of the SEC's Division of Enforcement was quoted as saying "[t]he 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."

Previously, David W. Blass, formerly Chief Counsel of the SEC's Division of Trading and Markets, openly questioned[1] whether transaction fees charged by a private fund manager to a portfolio company "in connection with the acquisition or disposition (including an initial public offering) of a portfolio company or a recapitalization of the portfolio company…for 'investment banking activity,' including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions" should require the fund manager to register as a broker-dealer. [2]

Blass further stated that "[t]o 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." However, the Order does not address whether Blackstreet offset the transaction fees at issue against advisory fees charged to the Blackstreet funds.

Blackstreet and Gunty Engaged in Undisclosed Conflicted Transactions

The Order also alleged that in 2011 and 2012, Blackstreet charged two portfolio companies of one of the Blackstreet funds at least $450,000 in operating partner oversight fees. The applicable Blackstreet fund's governing documents did not expressly authorize Blackstreet to charge oversight fees and the fees were not disclosed to the Blackstreet fund's limited partners until after the LPs committed capital and the fees were already being charged. The Order found that the oversight fees resulted in a conflict of interest between the Blackstreet fund and Blackstreet because the Blackstreet fund's assets were used to compensate Blackstreet and certain Blackstreet employees who provided senior-level operating and management services to these companies.

Blackstreet also provided employees assigned to perform services on behalf of Blackstreet fund portfolio companies with the opportunity to invest alongside the Blackstreet funds and purchase shares in the portfolio companies. These employees signed share purchase agreements that granted the portfolio companies exclusive rights to repurchase the employees' shares at fair market value in the event of the employees' departure or termination. However, in 2010, Blackstreet itself purchased a departing employee's shares in certain portfolio companies held by a Blackstreet fund. The Order found this to be a conflicted transaction because Blackstreet purchased the shares without first disclosing its financial interest to the LPs and obtaining the appropriate consents under the LPA to proceed.

In addition, the LPA for one of the Blackstreet funds permits its general partner to require defaulted LPs of such fund to forfeit to the Blackstreet fund all but one dollar of their interests, whereupon the general partner would then purchase the defaulted partner's remaining interest for one dollar. However, Gunty, through an entity he controlled, acquired interests for himself from two defaulted LPs in their entirety for one dollar each rather than forfeiting all but one dollar of their interests to the Blackstreet fund. The same LPA states that anyone who acquires the interest of an LP assumes that LP's obligation to make future capital contributions. However, when Gundy acquired interests in the Blackstreet fund from six other LPs who were seeking to sell their interests and exit the Blackstreet fund, the Blackstreet fund's general partner, at Gunty's direction, waived Gunty's obligation to satisfy future capital calls on any new investments that would have been associated with the interests he acquired from the two defaulted LPs and purchased from the other six LPs. This reduced the capital available for investment opportunities and increased the pro rata share of future capital calls borne by the remaining LPs. The Order found that Blackstreet's failure to disclose the waivers rendered the LPA's disclosures concerning LPs' obligations to satisfy future capital calls materially misleading.

Blackstreet and GuntyInappropriately Allocated Political, Charitable and Entertainment Expenses

The Order further alleged that in several instances between 2005 and 2012, Blackstreet used assets of both Blackstreet funds for purposes that were not expressly authorized by the Blackstreet funds' LPAs. In particular, Blackstreet allegedly used assets from one Blackstreet fund to make (i) a total of $12,000 in political contributions to a Maryland political candidate's campaigns, and (ii) more than $23,000 in charitable contributions to a variety of charities. Additionally, from 2010 to 2013, Blackstreet allegedly charged each fund one-third of the cost of the lease and event tickets associated with a luxury suite at a professional sports and entertainment arena in Washington, DC. While Blackstreet also paid one-third of the cost, Blackstreet and Gunty did not take sufficient steps to ensure that the costs of the lease and event tickets were allocated appropriately among Blackstreet and the respective Blackstreet funds. Blackstreet and Gunty also did not adequately track or keep records of their usage of the lease or event tickets, including adequate records of personal use.

The Order found that these contributions and expenses were not disclosed by Blackstreet to the LPs until after they had already been made or incurred. Additionally, the Order noted that Blackstreet failed to seek or obtain consents for these expenditures of Blackstreet fund assets. This underscores the SEC's position that expenses charged to private equity funds that are not explicitly permitted by a fund's governing documents must, in advance of the contemplated charge, be both fully disclosed and consented to by the private equity fund's LPs, and/or the fund's advisory committee, if authorized to provide such consent.

Anthony S. Kelly, Chief of the SEC's Division of Enforcement's Asset Management Unit stated in the press release accompanying the Order that "[p]rivate equity fund advisers must manage their funds in accordance with the governing documents…Blackstreet operated outside of the funds' documents by using fund assets to make political and charitable contributions and pay entertainment expenses."

Blackstreet and Gunty Failed to Adopt Appropriate Compliance Policies and Procedures

Finally, the Order alleged that Blackstreet did not adopt or implement any policies and procedures designed to prevent violations of the Investment Advisers Act of 1940 or its rules arising from (i) the improper use of Blackstreet fund assets, (ii) the undisclosed receipt of fees, or (iii) the purchase of LP interests. Furthermore, despite Blackstreet's policies and procedures designating Gunty as Blackstreet's "Designated Supervisor" responsible for ensuring compliance with Blackstreet's policies and procedures and the federal securities laws, Blackstreet failed to adopt and implement any policies and procedures designed to address conflicts of interest arising from Gunty's supervisory role.

Compliance Takeaways

While this action covers several important areas, private fund advisers should note several key takeaways. First, given the prominence of the unregistered broker charge in the Order and public statements, private equity fund managers should consider whether the nature of both the services provided, and compensation received, in connection with portfolio company transactions may bring them within the definition of a broker as applied by the SEC.

Second, private fund advisers in general should confirm that appropriate disclosure has been made to investors with respect to transactions that potentially conflict with the fund, and if appropriate disclosure has not been made prior to an investor's investment in the fund whether the adviser should receive investor consent to the conflicted transaction (or consent of the fund's advisory committee, if authorized by the fund's governing documents). To this point, the SEC has been clear in the context of private equity fund advisers that while "after the fact" disclosure and remediation may mitigate penalties, it is no defense to liability.

Third, where certain expenses, such as entertainment, may appropriately be shared between several funds, or between the funds and a management company or its affiliates, advisers should adopt policies and procedures for tracking the utilization of the benefit received so that proper apportionment may be made. Finally, where an adviser's supervisory or compliance staff may themselves be personally presented with a conflicted situation, advisers should adopt policies and procedures for disclosure and resolution of these circumstances.

[1] Speech, A Few Observations in the Private Fund Space, David W. Blass, Chief Counsel, SEC Division of Trading and Markets (Apr. 5, 2013), available here.

[2] On February 4, 2014, Mr. Blass authored a revised no-action letter on behalf of the SEC's Division of Trading and Markets which allowed relief from the Exchange Act's broker registration requirements for persons and entities meeting the criteria for being classified as an "M&A Broker" and engaged in certain types of transactions. Generally, an "M&A Broker" for purposes of the no action letter is a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company. The relief, however, is contingent upon a number of transaction-specific conditions, including prohibitions against the M&A Broker and its affiliates having custody or control of funds or securities in connection with the transaction, having the ability to bind the parties to the transaction, and providing financing for the transaction. Accordingly, the no-action relief may be of limited use to many private equity firms engaged in these activities and it would appear that the conduct engaged in by Blackstreet was not in compliance with the parameters of this no-action relief.

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