

## SEC Fines Private Equity Adviser for Failing to Register as a Broker-Dealer

***The action may have significant implications for PE advisers performing brokerage services; highlights SEC's focus on advisers receiving transaction-based compensation.***

On June 1, 2016, the Securities and Exchange Commission (SEC) announced a settlement with Blackstreet Capital Management (Blackstreet) and its owner, Murry N. Gunty (Gunty), following an investigation finding that Blackstreet received transaction-based compensation for performing certain brokerage services for funds that Blackstreet managed, without registering as a broker-dealer.<sup>1</sup> Blackstreet performed the services in connection with the purchase and sale of portfolio companies. The settlement marks the first enforcement action against a private equity adviser for violating Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act) by failing to register as a broker-dealer, and, notably, follows more than three years after a speech by David Blass, the former Chief Counsel of the SEC's Division of Trading and Markets, that addressed the potential application of broker-dealer registration requirements under the Exchange Act in connection with services performed by private equity sponsors.<sup>2</sup> The Blackstreet settlement, together with recent comments from current SEC officials, suggests that broker-dealer registration issues for private equity firms remain a significant area of focus for the SEC.

### SEC Findings

The action against Blackstreet stemmed from its provision of "brokerage" services related to the purchase and sale of portfolio companies by the funds it managed. Specifically, the SEC claimed that even though the funds' limited partnership agreements expressly permitted Blackstreet to charge transaction or brokerage fees, Blackstreet violated the broker-dealer registration requirement when it, in connection with the acquisition and disposition of portfolio companies, received transaction-based compensation for, among other things, soliciting deals; identifying buyers and sellers; negotiating and structuring transactions; arranging financing; and executing transactions.<sup>3</sup>

Apart from the broker-dealer registration violation, the SEC also alleged that Blackstreet violated certain provisions of the Investment Advisers Act of 1940 (Advisers Act) as a result of:

- Failing to disclose operating partner oversight fees
- Using fund assets for purposes that were not expressly authorized by the funds' partnership agreements, including for political contributions, charitable contributions and entertainment expenses
- Purchasing shares in portfolio companies owned by a fund without disclosing Blackstreet's financial interest or obtaining appropriate consent to engage in the transaction

- Failing to disclose the waiver of the obligation for the fund's principal to make contributions on capital calls for new investments
- Failing to adopt written policies and procedures to prevent violations of the Advisers Act and the rules thereunder<sup>4</sup>

Without admitting or denying the findings in the Blackstreet Order, Blackstreet and Gunty agreed to pay disgorgement of US\$2,339,000, prejudgment interest of US\$283,737 and a civil money penalty of US\$500,000.<sup>5</sup>

## Conclusion

Significantly, the Blackstreet Order does not indicate whether the transaction-based compensation received (almost US\$2 million in total) was subject to offset against the management fees paid by the funds. In his 2013 remarks, Blass noted that to the extent advisory fees are wholly reduced or offset by a transaction fee, one could view the transaction fee as simply another way to pay the advisory fee, which, in itself, would not appear to raise broker-dealer registration concerns.<sup>6</sup> Our informal understanding is, however, that Blackstreet's fund documents did not provide for an offset of such fees against management fees. Nonetheless, given the Blackstreet Order's silence regarding any offset, whether the SEC's current view remains that a complete offset would obviate the need for a private fund manager to register as a broker-dealer, is an open question.

Also notable, following Blass' remarks, the SEC issued a no-action letter in January 2014 permitting certain "M&A Brokers" to facilitate securities transactions in connection with the purchase and sale of privately held companies, and to receive transaction-based compensation without registering as broker-dealers.<sup>7</sup> While that no-action letter contains a number of conditions that limit its utility for private equity sponsors, some industry participants hoped the letter, coupled with Blass' remarks, signalled a degree of flexibility and willingness by the SEC to afford private equity sponsors similar relief. The Blackstreet Order, however, appears to dash any such hopes, particularly in light of Director of the SEC Enforcement Division Andrew Ceresney's recent statement that "[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."<sup>8</sup> Ceresney's remarks are also a reminder that the SEC does not have to prove intentionality or recklessness to show a violation of the broker-dealer registration provisions. Rather, the agency only needs to prove that a firm meets the definition of a broker-dealer and is not registered in that capacity with the SEC.

While the Blackstreet Order alleged numerous improprieties on the part of Blackstreet and Gunty, the statements in the Blackstreet Press Release clearly highlight the SEC's continued focus on private equity advisers that receive fees that can be deemed "transaction-based compensation" for what the SEC perceives to be broker-dealer activity. Private fund managers should carefully consider all of their fee arrangements in light of these concerns to ensure that their activities do not trigger a requirement to register as a broker-dealer.

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If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

**Nabil Sabki**  
nabil.sabki@lw.com  
+1.312.876.7604  
Chicago

**John J. Sikora Jr.**  
john.sikora@lw.com  
+1.312.876.6580  
Chicago

**Stephen P. Wink**  
stephen.wink@lw.com  
+1.212.906.1229  
New York

**Brett M. Ackerman**  
brett.ackerman@lw.com  
+1.202.637.2109  
Washington, D.C.

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#### **Endnotes**

- <sup>1</sup> In re Blackstreet Capital Management, LLC, and Murry N. Gunty, Administrative Proceeding File No. 3-17267 (June 1, 2016), available at: <https://www.sec.gov/litigation/admin/2016/34-77959.pdf> (the Blackstreet Order).
- <sup>2</sup> See David W. Blass, "A Few Observations in the Private Fund Space" (April 5, 2013), available at: <http://www.sec.gov/news/speech/2013/spch040513dwg.htm> (the Blass Speech).
- <sup>3</sup> Blackstreet Order at p. 5.
- <sup>4</sup> *Id.* at pp. 5-7
- <sup>5</sup> *Id.* at p. 9.
- <sup>6</sup> See Blass Speech.
- <sup>7</sup> See SEC No-Action Letter, dated January 31, 2014 [Revised February, 4, 2014], available at: <http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf>
- <sup>8</sup> SEC Press Release, 2016-100, SEC: Private Equity Fund Adviser Acted As Unregistered Broker (June 1, 2016), available at: <https://www.sec.gov/news/pressrelease/2016-100.html> (Blackstreet Press Release).