SEC to Funds: Watch the Broker-Dealer Activities

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On June 1, 2016, the United States Securities and Exchange Commission (the "SEC") announced and issued an enforcement action (the "Enforcement Action") against Blackstreet Capital Management, LLC ("BCM"), and its founder, Murry Gunty ("Gunty"). The Enforcement Action arose out of actions taken by funds advised by Blackstreet that the SEC alleges required registration by Blackstreet as a broker-dealer. In particular, the SEC noted:

> Although the LPAs expressly permitted BCM to charge transaction or brokerage fees, BCM has never been registered with the Commission as a broker nor has it ever been affiliated with a registered broker. Rather than employing investment banks or broker-dealers to provide brokerage services with respect to the acquisition and disposition of portfolio companies, some of which involved the purchase or sale of securities, BCM performed these services in-house, including soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions. BCM received at least $1,877,000 in transaction-based compensation in connection with providing these brokerage services.

For a number of years, the SEC has focused on regulating non-registered broker-dealer activity by funds and their managers. On April 5, 2013 David Blass delivered a speech to the Trading and Markets Subcommittee of the American Bar Association, Mr. Blass, at the time the chief counsel in the SEC's Division of Trading and Markets, spoke of the need of fund managers to either limit their deal making activities to what was then permitted by the applicable regulations or to register as broker-dealers. Mr. Blass' presentation heralded a number of inspections by the SEC of fund firms engaged in unregistered broker-dealer activities.

However, on January 31, 2014, the SEC issued a No-Action Letter, known as the "M&A Brokers No-Action Letter," that gave some relief to dealmakers that were engaged in M&A activities. Prior M&A Brokers, professionals who were involved in M&A transactions were almost always required to be registered as broker-dealers, a process many found to be expensive and time consuming. However, M&A Brokers opened the door to advisers who could participate in negotiating a transaction and receive transaction-based compensation (always a hallmark of broker-dealer activity), provided that the advisor could meet certain conditions. These conditions included:

- That the transaction involve a change in control of a private company;
- that the adviser not have custody, control, possession of or handle securities issued or exchanged in connection with the transaction;
- that the adviser not be permitted to bind a party to a transaction;
- that the adviser not help finance the transaction; and
- that the buyers actively manage the acquired company after the transaction.

While many practitioners and commentators took the view that M&A Brokers indicated an intent by the SEC to scale back its enforcement actions against funds and their broker-dealer activities, this is clearly not the case. In a speech on May 12, 2016, to the Securities Enforcement

Forum West, Andrew Ceresney, the Director of the Division of Enforcement, noted that the SEC would continue to emphasize the regulation of broker-dealer activity by funds, in large part "[b]ecause it is important to understand that retail investors are significantly invested in private equity." Mr. Ceresney indicated that the SEC would focus its efforts on three topics:

- Advisers that receive undisclosed fees and expenses;
- Advisers that impermissibly shift and misallocate expenses; and
- Advisers that fail to adequately disclose conflicts of interests, including conflicts arising from fee and expense issues.

Given how quickly the Enforcement Action followed this speech, it is clear that the SEC has put unregistered broker-dealer activity by funds clearly in its sights. Among other issues, the SEC found a number of activities that Blackstreet and Gunty had engaged in that took them out of the protections offered by M&A Bankers, in particular that in connection with the acquisition and disposition of portfolio companies or their assets, some of which involved the purchase or sale of securities, BCM provided brokerage services to and received transaction-based compensation from the portfolio companies. This activity caused BCM to be acting as a broker, and BCM had never been registered with the SEC as a broker. The SEC also focused on a number of aspects of the disclosures provided to investors, including whether or not such disclosures were sufficient.

While it is clear that advisers may rely on M&A Bankers when engaging in M&A activity that previously required registration, it is equally clear that the SEC, especially with respect to funds, will be keeping its eye on stringent compliance with the rules.

For more information, please contact a member of our Corporate Practice.