Bloomberg BNA

Securities Regulation & Law Report™

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ENFORCEMENT

BNA Insights: The Perils of Regulation by Prosecution — Lessons From the 'Blackstreet' Case

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Almost seventy years ago, the Supreme Court was asked to consider whether the SEC was required to articulate new principles of law through rule-making rather than adjudication. Since the SEC has the power to use either tool, it was argued that rule-making should be used to prospectively change existing legal standards, while adjudication should be used to punish a person who violates a pre-established legal standard. The Supreme Court rejected this approach, giving the SEC broad discretion to regulate through prosecution rather than rule-making. However, the Supreme Court cautioned that:

> Since the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making powers, it has less reason to rely upon ad hoc adjudication to formulate new standards of conduct . . . . The function of filling in the interstices of the Act should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future.

SEC v. Chenery Corp., 332 U.S. 194 (1947).

Several benefits have been identified of rule-making over adjudication:

1. A rule formulated after rulemaking, ''with its wider notice and broader opportunities for participation[,] is fairer to the class of persons who would be affected by a new 'rule' than'' a rule announced in an adjudication. '' Such broader participation also makes rulemaking more efficient as an information-gathering technique for the agency.''

2. ''Rulemaking is superior to adjudication as a means of making new law because rulemaking is normally prospective while adjudication normally involves prescribing consequences for past conduct or present status.''

3. ''The articulation of a generally applicable rule provides greater clarity to those affected as well as greater uniformity in enforcement.''

4. ''Rulemaking is more efficient from the agency's point of view because its procedures offer more flexibility, at least when the choice is between the notice-and-comment requirements of section 553 of the APA and the formal adjudicatory procedures of sections 554, 556, and 557 of the APA. Two of the most significant elements of this flexibility are the agency's broad control over the procedure for the presentation of information and argument and the agency's freedom to resort to its staff expertise without the inhibitions of separation of functions requirements.''

5. ''Since the agency is better able to control the scope and the pace of a rulemaking proceeding, use of rulemaking to formulate policy gives the agency better control of its agenda and enables it to define

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and to focus on the policy issues without the distractions of individual adjudicative issues'' or the need to wait for issues to arise in a case.

6. ''Rulemaking is also more efficient for the agency because it can result in the adoption of a general principle which can thereafter be applied without reexamination,'' thereby eliminating the need for many case-by-case adjudications.

Richard K. Berg, Re-examining Policy Procedures: The Choice Between Rulemaking and Adjudication, 38 Admin. L. Rev. 149 (1986).

One commentator has noted, however, that there are advantages to adjudication over rule-making:

1. Rulemaking's increasing procedural complexity can be avoided.

2. Modifications can be made more easily.

3. Conflict can be minimized.

4. Adjudicatory decisions can be situation-specific, thus potentially avoiding over-inclusiveness or under-inclusiveness.

Jeffery S. Lubbers, A Guide to Federal Agency Rule-Making (4th ed. 2006).

The Blackstreet Settled Enforcement Case

The SEC's recent settled enforcement action in the Blackstreet case, Admin Pro. 3-17267 (June 1, 2016), illustrates the perils and limitations of regulation by prosecution.

Who Is a Broker-Dealer?

The press release issued by the SEC announcing the Blackstreet case highlighted that a ''Private Equity Fund Adviser Acted As Unregistered Broker.'' SEC Press Release 2016-100 (June 1, 2016). The second paragraph of the press release then prominently stated that:

> An SEC investigation found that Blackstreet Capital Management and Murry N. Gunty performed in-house brokerage services rather than using investment banks or broker-dealers to handle the acquisition and disposition of portfolio companies for a pair of private equity funds they advise. Blackstreet fully disclosed to its funds and their investors that it would provide brokerage services in exchange for a fee, yet the firm failed to comply with the registration requirements to operate as a broker-dealer.

A week after the Blackstreet case, a senior SEC enforcement official confirmed that ''[a]ny private-equity adviser that doesn't have a broker-dealer registration and is earning transaction fees—I'm not saying that's a violation—but it creates a question.'' ''SEC Official Puts Broker-Dealer Issue Back on Private Equity's Radar,'' Wall Street Journal, June 7, 2016. The press release announcing the Blackstreet case and this subsequent statement by an SEC enforcement official created great concern that an enforcement ''crackdown'' on unregistered brokers in the private equity industry is imminent.

The actual settled order in Blackstreet, however, contains virtually no information about why the SEC found that Blackstreet was acting as a broker-dealer. The summary section of the order contains two short sentences on the issue:

> 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. BCM, however, has never been registered with the Commission as a broker.

The order then contains a single brief paragraph discussing the broker-dealer issue:

> Although the L[imited]P[artnership]A[greement]s 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.

Neither the amount of the disgorgement nor the fine bear any apparent relationship to the $1,877,000 figure tied to deal fees.

There appear to have been three reasons why the SEC found the need for broker-dealer registration. First, the firm allegedly disclosed to its investors that it would provide brokerage services for a fee. Second, the adviser allegedly performed the following services, which are allegedly characteristic of brokerage activity: ''soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions.'' Third, the adviser allegedly received transaction-based compensation for performing these services.

The settled order in Blackstreet leaves many questions unanswered and creates great confusion over why the SEC believed Blackstreet needed to be registered as a broker-dealer.

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 defines a ''broker: as ''any person engaged in the business of effecting transactions in securities for the account of others.'' Two elements are generally viewed as necessary to require registration as a broker:

1. The receipt of transaction based compensation; and

2. Engaging in certain activities that are characteristic of effecting transactions in securities.

The Blackstreet case creates ambiguity on each element of the definition.

Although the settled order concludes without analysis that Blackstreet received ''$1,877,000 in transaction-based compensation in connection with providing these brokerage services,'' this observation leaves many ambiguities. First, in the private equity context, so-called ''deal fees'' are in fact advisory fees rather than fees for actually effecting transactions in securities. Moreover, in a 2013 speech, David Blass, then the chief counsel in the SEC's Division of Trading and Markets noted 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,

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which, in my view, in itself would not appear to raise broker-dealer registration concerns.'' ''A Few Observations on the Private Equity Space,'' available at www.sec.gov/News/Speech/Detail/Speech/1365171515178. The Blackstreet case does not mention whether the ''deal fees'' were offset and whether, if that were the case, Mr. Blass's comments remain valid. Finally, since the amount of the disgorgement and fine bear no apparent relationship to the so-called ''deal fees,'' it is unclear why.

With respect to the activities in which Blackstreet allegedly engaged - ''soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions'' – the settled order also leaves great ambiguity. For example, it is difficult to imagine Blackstreet ''executed'' securities transactions in the traditional sense. It is also unclear how some of these activities differed from an advisory function, which would normally be exempt from activity requiring broker registration.

It is also unclear whether the Blackstreet case is intended to limit, or even reverse, no-action relief recently granted by the SEC. On January 31, 2014, in what was widely viewed as a retreat from the focus on broker-dealer issues within the private equity industry, the SEC issued an important no-action letter on this issue. M&A Brokers, SEC no-action letter (pub. avail. Jan. 31, 2014). In this no-action letter, the SEC granted relief from the need for broker-dealer registration where a firm assists in the sale of a private company. Even though the firm would advise the parties on the transaction, participate in the negotiation of the transaction, and receive transaction-based compensation for these efforts, broker-dealer registration was not required. The Blackstreet case simply does not provide sufficient facts to permit any conclusions about the continued vitality of the M&A Brokers no-action letter.

Advisers Act Issues Raised in the Blackstreet Case

Record-Keeping Allegations

Blackstreet was accused of failing to keep adequate records of certain entertainment expenses paid by the funds they managed:

> From 2010 to 2013, BCM charged Fund I and Fund II each one-third of the cost of the lease and event tickets associated with a luxury suite at the Verizon Center in Washington, DC; BCM paid the remaining one-third of the cost. BCM and Gunty did not take sufficient steps to ensure that the costs of the lease and event tickets were allocated appropriately among BCM and the Funds. BCM 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 difficulty with this charge is that the basis for this record-keeping allegation is unclear. The rules under the Investment Advisers Act of 1940 contain extensive record-keeping requirements that are imposed on registered advisers. These rules were adopted over fifty years ago and are widely viewed as out of date and unclear. Whether these rules were implicated by Blackstreet's conduct is unclear, although there is no allegation by the SEC of a violation of the record-keeping rules. If the record-keeping rules were not violated, however, it is unclear why Blacksteet was obligated to maintain records relating to entertainment expenses. If this allegation was intended to shift the burden of proving that entertainment expenses were properly paid to Blackstreet, there appears to be no legal basis for such a burden shifting.

Allegedly Inadequate "After-the-Fact" Disclosures

The Blackstreet order also contains an important allegation about the adequacy of disclosure of certain allegedly improper practices. According to the SEC, Blackstreet disclosed to investors that they were effectively paying certain expenses, but the SEC alleges these disclosures were inadequate because they came too late:

> Although BCM disclosed to the Funds' LPs that fund assets had been used to make political and charitable contributions, and to pay entertainment expenses, the disclosures were not made until after the LPs committed capital and until after the contributions were made and the expenses were incurred. BCM neither sought nor obtained appropriate consent for these expenditures.

This allegation expressly ties the adequacy of disclosures to client consent. According to the SEC, disclosure by an adviser is useless if it comes too late for clients to stop their investments in the fund. This is a strange observation for many reasons. Many disclosures are made after the events occur but are nonetheless viewed as defeating fraud charges. Indeed, the SEC's own rules for amending Form ADV disclosures do not require prospective disclosures, and for good reason. Prospective disclosures may often involve speculative guessing which would only be confusing. After the fact disclosures avoid this vice. In addition, while the Blackstreet case does not provide sufficient information to evaluate whether investors could have objected to questioned payments after the fact, and by their objections could have forced the repayment of disputed fees and expenses, it would be typical that investors would have such power to reverse questioned payments, even accepting the SEC's own connection of the adequacy of disclosure with investor power to block the disputed payments. If this is the case, it is unclear why after the fact disclosure would not defeat a fraud charge. Finally, in the private equity context, where funds operate for many years after investor capital is called, it may be impossible to anticipate every practice at the beginning of the fund. A rule that prohibits any payments that were not disclosed before investor capital is called would thus be unworkable in the private equity context.

* * *

The Blackstreet case creates more ambiguity than it resolves. This case illustrates the virtues of regulation through rule-making and the vices of regulation by prosecution. Having taken the path of regulation by prosecution, it behooves the SEC to clarify the ambiguity it has created.