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KIRKLANDPEN
Private Equity Newsletter

April 15, 2013

SEC Increases Focus on Transaction Fees and Other Broker-Dealer Issues for Private Fund Sponsors

PENpoints

The SEC recently increased its focus on private fund sponsor compliance with broker-dealer registration laws, as highlighted by a recent speech by the Chief Counsel of the SEC Division of Trading and Markets.

Recent Securities and Exchange Commission (SEC) examination, enforcement and regulatory pronouncements demonstrate the SEC's increasing focus on private fund sponsor compliance with broker-dealer registration laws, highlighted by a recent speech[1] (Broker Speech) by the Chief Counsel of the SEC Division of Trading and Markets (Division Chief Counsel) raising concerns about private fund sponsors':

(1) receipt of transaction fees from portfolio companies,

(2) use of unregistered finders in connection with raising private funds, and

(3) sales activities engaged in by personnel in connection with raising funds.

Background. "Broker" is defined under U.S. securities laws as any person engaged in the business of effecting transactions in securities for the account of others.[2] In general, a "broker" must be registered with the SEC and become a member of FINRA, a labor-intensive process taking six months or more and imposing testing and licensing requirements on broker-dealer personnel. Over the years, SEC staff and courts have interpreted this vague definition using facts-and-circumstances analyses with seemingly inconsistent outcomes, resulting in uncertainty over when a person's activities trigger broker status. Many private fund sponsors have taken the positions that:

(1) when selling private fund interests, the sponsor is not "engaged in the business" and/or not acting for the account of others, and

(2) the sponsor's receipt of transaction fees does not trigger broker status.

Increased SEC Focus. SEC staff, however, has now begun to question whether certain private fund sponsors are complying with broker-dealer registration requirements when engaging in these common and long-standing industry practices, noting potential "serious consequences" — including SEC sanctions and voiding of certain transactions — for persons and firms that are not but should be registered as brokers. In the Broker Speech, the Division Chief Counsel encourages PE firms to take "proactive steps" to review existing practices and avoid problems in these areas "hopefully in advance of a visit from the SEC's examiners."

Practices Subject to SEC Focus.

- *Transaction Fees Paid by Portfolio Companies.*[3] In early 2013, SEC examination staff began issuing comment letters and raising concerns in examinations about private fund sponsors' receipt of transaction-based fees from portfolio companies. In the Broker Speech, the Division Chief Counsel expresses concern that investment banking or similar merger and acquisition activities — including negotiating transactions, identifying purchasers or sellers of securities of a portfolio company or structuring transactions — combined with collecting transaction-based or success fees "cause the adviser to take on a salesman's stake and the activities involved in effecting securities transactions appear, at least on their face, to cause such an adviser to fall within the meaning of the term 'broker.'" While the Broker Speech acknowledges the long-standing practice of charging transaction fees to portfolio companies and indicates a willingness to discuss these issues with private fund sponsors, the Division Chief Counsel indicates that he (1) was not aware of any exemption or applicable relief

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from broker-dealer registration for such activities, except potentially in cases where the transaction-based fees wholly offset fund advisory fees, and (2) believes that it is not difficult for a private fund sponsor to change its practices to avoid being deemed a "broker."

- *Payment of Placement Fees to Unregistered "Finders."* The Broker Speech also warns fund sponsors against paying transaction-based fees to finders or consultants that are not registered as broker-dealers absent a valid exemption in connection with an offering of private fund interests. In a 2013 enforcement action[4] — the first enforcement action in the private equity industry under the theory that a fund sponsor is liable for causing its finder's or placement agent's failure to register[5] even where there are no allegations of fraud — the SEC imposed a substantial fine and cease and desist order against the private equity firm and a former principal.
- *Sales Activities of Adviser Personnel*. The Broker Speech also notes that certain practices[6] with respect to fund sponsor personnel could cause the fund sponsor to be considered "engaged in the business" of selling private fund interests, and cautions private fund advisers to ensure that internal investor relations and fund marketing personnel activities comply with existing legal requirements, including compensation practices that ensure no transaction-based compensation is paid to the fund sponsor or its personnel absent broker registration or an available exemption. While many private fund sponsors either do not pay their personnel transaction-based compensation or rely on the Exchange Act's "issuer exemption," under which an issuer and associated persons are not considered to be acting for others within the broker definition, the Broker Speech notes that the exemption's strict requirements — e.g., marketing personnel must perform substantial duties other than in connection with securities transactions — could make it difficult for some private fund adviser personnel to comply. Given these potential difficulties, in the Broker Speech the Division Chief Counsel invited comments on whether the SEC should provide an express exemption written specifically for private fund advisers.

Conclusion. Private fund sponsors should be aware of the SEC's increased focus and evolving views on broker-dealer registration issues relating to transaction fees from portfolio companies and fundraising in both the examination and enforcement context.

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1 *See* http://www.sec.gov/news/speech/2013/spch040513dwg.htm.

2 In the Broker Speech, the Division Chief Counsel notes his view that a fund's general partner has distinct interests from the fund such that the general partner may be "acting for others" within the meaning of the "broker" definition.

3 SEC staff has not to date raised broker-dealer issues with respect to portfolio company monitoring fees and certain other non-transaction related fees (e.g., directors fees).

4 *In the Matter of Ranieri Partners LLC and Donald W. Phillips* (March 8, 2013).

5 Although the Broker Speech did not apply the analysis to what SEC staff referred to as "business or M&A brokers," i.e., finders in the M&A context, it left open the possibility that the SEC could approach such activities by a private fund with the same increased focus.

6 The Broker Speech in particular notes that dedicated marketing departments and the lack of non-sales responsibilities for personnel are potentially problematic.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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President's Budget Proposals Include Changes to Carried Interest Taxation

PENpoints

President's fiscal 2014 budget proposes re-characterizing all income from carried interests as ordinary income.

President Obama's fiscal 2014 budget proposals, released April 10, 2013, include a provision treating 100 percent of carried interest income from an investment partnership as ordinary income. The proposals do not include detailed legislative language, but appear generally similar in scope to past proposed carried interest legislation.

Thus, under the proposal, all income from carried interest allocations, gain from the sale of a carried interest and in-kind distributions on a carried interest, in each case from an investment partnership, would be re-characterized as ordinary income.

The administration indicated a willingness to work with Congress to limit the application of ordinary income re-characterization where income or gain that would otherwise be subject to the proposal (e.g., gain on the sale of a management company partnership interest) includes value attributable to underlying goodwill or other assets not related to the provision of investment services.

The proposal would be effective for tax years ending after December 31, 2013 (e.g., generally January 1, 2014 for calendar year taxpayers).

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PENbriefs

Are All MOEs Created Equal?

With expectations for the rebirth of stock-for-stock deals, after a long period of dominance for all-cash transactions, the term "merger of equals" will likely be used to describe some of these all-equity combinations. While each aspect of a merger of equals deal will fall along a continuum of "equality" for the shareholders of each party, there are a handful of key issues requiring special attention in a merger of equals transaction. See our recent *M&A Update* for a discussion of these and other related issues.

Crown Jewels — Restoring the Luster to Creative Deal Lock-ups?

The "crown jewel" lock-up — an agreement in which a merger target gives the buyer an option to acquire key assets of the target (its "crown jewels") separate and apart from the merger itself — has been showing signs of life in today's deal landscape, albeit in creative forms different from those seen in the crown jewel lock-up's 1980 heydays. To learn more, see our recent *M&A Update*.

Recent Senate Confirmations of Antitrust Regulators

The U.S. Senate recently confirmed nominees to two important antitrust regulatory posts: William J. Baer to serve as Assistant Attorney General in charge of the Department of Justice's Antitrust Division, and Joshua D. Wright to serve as a Commissioner of the Federal Trade Commission. To learn more about these appointments and their impact on antitrust enforcement in the United States, see our recent *Alert*.

Foreign Corrupt Practices Act Guidance Issued by DOJ and SEC

In November, the U.S. Department of Justice and the SEC published *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, a comprehensive guide intended to help companies understand how the government interprets and intends to enforce the FCPA. To learn more about this publication and its impact, see our recent *Alert*.

Seinfeld and Director Compensation: A Decision That Wasn't About Nothing

A recent Delaware court decision found that granting restricted stock to directors pursuant to a stockholder-approved equity plan was an interested party transaction subject to review under the stringent "entire fairness" standard, rather than the deferential business judgment rule, in part because the plan in question lacked "sufficiently defined" limitations on the board's ability to make such grants. To learn more about this case and its impact on a company's equity incentive program, please see our recent *M&A Update*.

PENnotes

PLI's Acquiring or Selling the Privately Held Company
San Francisco
April 30, 2013

The Practising Law Institute will host its "Acquiring or Selling the Privately Held Company 2013" on April 30 in San Francisco. Experienced faculty will walk through all of the steps associated with acquiring and selling a privately held company, whether it is a large independent corporation, a division or subsidiary of a large public company, or a smaller venture capital-backed or family-owned entrepreneurial enterprise. Kirkland partner Eva Davis will speak about the ethics involved in negotiating and documenting transactions. Click here for more information or to register for this event.

PLI's Private Equity Forum (Fourteenth Annual)
New York
July 8-9, 2013

The Practising Law Institute will host its "Private Equity Forum (Fourteenth Annual)" on July 8-9 in New York A distinguished panel of experts will discuss the basics of the private equity practice from fund formation to private equity M&A. Kirkland partner John O'Neil will participate in a panel discussion about the regulatory issues that must be considered when raising a private equity fund. Click here for more information or to register for this event.

33rd Annual Ray Garrett Jr. Corporate and Securities Law Institute
Chicago, IL
May 2-3, 2013

The Ray Garrett Jr. Corporate and Securities Law Institute is the pre-eminent securities law conference in the Midwest. It is the only Midwest conference that brings together senior officials from the Securities and Exchange Commission and leading securities practitioners. Kirkland partner F. Scott Falk and Kirkland partner Keith S. Crow are members of the Executive Committee. F. Scott Falk will chair a session on "Avoiding Pitfalls in M&A Transactions." For more information or to register, click here.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, real estate, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012 and 2013 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best Private Equity Firm in the United States" at *World Finance*'s 2012 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011 and 2012* and has consistently received top rankings among law firms in Private Equity by Chambers & Partners, *The Legal 500*, the Practical Law Company and *IFLR*, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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