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KIRKLANDPEN
Private Equity Newsletter

March 12, 2014

SEC Issues Broker-Dealer Registration Relief for Private M&A Brokers

PENpoints

A recent SEC no-action letter gives private fund managers more flexibility to use an unregistered M&A Broker, in part by reducing the risk of aiding and abetting liability for a third party's securities law violations.

As discussed in a prior *KirklandPEN*, the SEC staff recently raised a variety of broker-dealer registration concerns relating to private fund managers,[1] including: (1) receipt of transaction fees from portfolio companies; (2) use of unregistered finders in connection with raising private funds;[2] and (3) sales activities of manager personnel in connection with raising funds from limited partners.

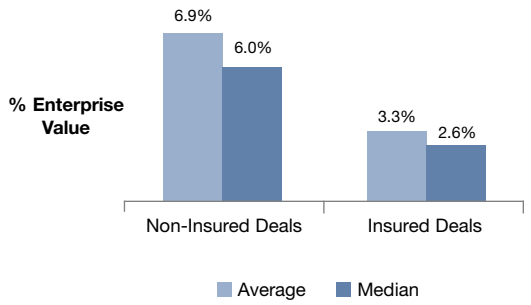
However, the SEC staff recently issued a favorable no-action letter permitting certain "M&A Brokers" to facilitate mergers, acquisitions, business sales and business combinations (collectively, M&A Transactions) between a seller and buyer of a privately held company[3] without registering as a broker-dealer under the Securities Exchange Act of 1934.[4]

While not explicitly addressing the three SEC-identified concerns, the no-action relief provides greater flexibility to a private fund manager using an unregistered M&A Broker, in part by reducing the risk of liability for aiding and abetting a third party's securities law violations. Industry participants continue to dialogue with the SEC staff on the outstanding areas of concern with the hope that all or some of those topics will be addressed in the near term.

Background. The SEC historically requires an intermediary to register as a broker-dealer under the Exchange Act if such intermediary (1) advises buyers and/or sellers regarding private-company M&A Transactions involving securities (e.g., transactions structured as stock purchases rather than asset sales) and (2) receives transaction-based compensation (e.g., a percentage of the transaction value). Over the years, the SEC issued limited relief for certain deal finders or business brokers, but such relief contained various difficult-to-meet conditions and/or had limited utility.

PENstats

Escrow Size: Deals With & Without Buy-Side Rep & Warranty Insurance



This chart shows the size of indemnity escrows for deals with and without a buy-side representation and warranty insurance policy closed in the last 18 months. The chart was generated from data in CTRAN, Kirkland's proprietary database of more than 875 private-target M&A transactions closed since 2008 in which Kirkland represented a transaction party.

The recent M&A Broker no-action letter provides that an unregistered intermediary may effect a securities transaction solely (a) in connection with the transfer of ownership and control of a privately held company (whether through a securities transaction or asset sale) and (b) to a buyer or a buyer group not organized by the M&A Broker that will actively operate the acquired business. Permitted activities under the no-action letter include (1) advertising a privately held company for

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sale with information such as the description of the business, general location and price range, (2) involvement in negotiating the terms of the sale between or among the parties, (3) advice to either party about the value of the securities, and (4) advice regarding the structure of the transaction or form of consideration.

Conditions for Relief. The no-action relief permits an M&A Broker to facilitate an M&A Transaction for a privately held company without regard to the size of the transaction or target company, subject to the following conditions:

- M&A Broker will not have (1) the ability to bind a party to an M&A Transaction or (2) custody, control, possession of or otherwise handle funds or securities in connection with the M&A Transaction;
- M&A Broker will facilitate an M&A Transaction with a buyer group (e.g., in a private equity club deal) only if the group is formed without the M&A Broker's assistance;
- Any buyer or buyer group will not be passive and instead will control[5] and actively operate the company or business;
- M&A Broker will not provide financing for an M&A Transaction directly or through an affiliate (but may assist in arranging financing through an unaffiliated third party);
- M&A Transaction must not involve a public offering and must comply with an applicable exemption from Securities Act of 1933 registration;
- M&A Broker can represent both the buyer and seller only if M&A Broker provides clear written disclosure to the parties and obtains written consent to the dual representation; and
- M&A Broker and any of its officers, directors or employees will not have been suspended or barred from association with a broker-dealer by the SEC, any state or any self-regulatory organization.

Effect on Private Fund Sponsors. While the no-action letter does not address the SEC staff's broker-dealer concern over a private fund manager's receipt of transaction-based compensation, it does provide relief for a private fund manager seeking to use an unregistered deal finder if the conditions of the no-action letter can be met.

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1 *See* April 2013 speech by David Blass, Chief Counsel of the SEC Division of Trading and Markets.

2 *See, e.g., In the Matter of Ranieri Partners LLC and Donald W. Phillips* (March 8, 2013), where the SEC settled charges against a private fund manager, a former executive and an unregistered individual "finder" engaged for the solicitation of more than $500 million in capital commitments. The case was particularly noteworthy for being the first in the private equity industry to find a sponsor liable for a third-party placement agent's failure to register, even absent fraud allegations.

3 The SEC staff defines a "privately held company" as "a company that does not have any class of securities registered, or required to be registered, with the [SEC] under Section 12 of the Exchange Act, or with respect to which the company files, or is required to file, periodic information, documents, or reports under Section 15(d) of the Exchange Act." Any privately held company that is the subject of the relief would be an operating company (or a holding company of an operating company) that is a going concern and not a "shell" company with no or nominal operations or assets.

4 M&A Brokers still need to consider applicable state broker-dealer registration or licensing requirements, which are not addressed by the SEC relief.

5 The necessary control will be presumed to exist if, upon completion of the transaction, the buyer or buyer group has (1) the right to vote 25 percent or more of a class of voting securities, (2) the power to sell or direct the sale of 25 percent or more of a class of voting securities, or (3) in the case of a partnership or limited liability company, has the right to receive upon dissolution or has contributed 25 percent or more of the capital.

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

Scott A. Moehrke, P.C.
http://www.kirkland.com/smoehrke
+1 312-862-2199

Kevin R. Bettsteller
http://www.kirkland.com/kbettsteller
+1 312-862-2228

SEC Provides Industry-Favorable "Bad Actor" Rule Interpretations

PENpoints

The SEC staff recently released interpretations of the so-called "bad actor" rule which may lessen its impact on private fund sponsors.

The SEC's "bad actor" rule under the Securities Act of 1933, discussed in a previous *KirklandPEN* (the Rule), disqualifies a private fund or other issuer from relying on the Regulation D Rule 506 private placement safe harbor if the issuer or certain affiliated persons committed or were connected to a list of bad acts. Since the Rule's September 2013 effective date, the SEC staff has released interpretations of the Rule,[1] certain of which may substantially lessen issuers' diligence obligations and limit the effect of penalties. Key recent interpretations are below.

- **Scope of Disqualifying Affiliates Narrowed**. The Rule provides that "affiliated issuer" bad acts may disqualify an issuer's Rule 506 private placement, which leads to concerns that a portfolio company disqualifying event could disqualify the fund itself (and other fund portfolio companies) from relying on Rule 506. The staff, however, has narrowly construed "affiliated issuer" to include only affiliates of the issuer that are issuing securities in the same or an "integrated" offering — an unlikely event when a private fund (including its parallel funds) is raising money — so portfolio company disqualifying events generally should not disqualify the fund's (or other portfolio companies') private placement exemption.

- **Non-U.S. Disqualifying Events Disregarded**. The staff stated that actions taken in jurisdictions other than the United States, such as convictions, court orders or injunctions in a non-U.S. court, or orders issued by non-U.S. regulatory authorities, will not trigger bad actor disqualification.

- **Placement Agent Terminations May Limit Bad Actor Penalties**. If a disqualifying event occurs with respect to a placement agent or one of its covered control persons while an issuer's offering is ongoing, the staff permits an issuer to continue to rely on Rule 506 for that offering if (1) the issuer terminates its engagement with the placement agent and does not compensate the placement agent for future sales in that offering or (2) the placement agent's problematic covered affiliated person is terminated or prohibited from performing roles at the placement agent covered by the Rule.

Key Upcoming Filing Dates for Private Equity Managers

- **March 31**. Annual Form ADV update.
- **April 30**. Form PF filing deadline for private equity advisers.
- **May 15**. 1st Quarter update for Form 13F filers.

All dates assume December 31 fiscal year-end.

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1 *See* http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

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

Josh Westerholm
http://www.kirkland.com/jwesterholm
+1 312-862-2007

Corey Zarse
http://www.kirkland.com/czarse
+1 312-862-2033

SEC Clarifies Scope of "Knowledgeable Employee"

PENpoints

A recent SEC no-action letter gave a generally broader and more favorable interpretation of "knowledgeable employee" for purposes of investing in a private fund.

A private fund sponsor that offers its qualifying personnel the opportunity to invest in or alongside its funds generally relies on the Investment Company Act's "knowledgeable employee" definition to permit such investments. Under the Investment Company Act, "knowledgeable employees" need not meet the qualified purchaser tests otherwise required of investors in funds exempt under §3(c)(7) of the Investment Company Act, and need not be counted against the 100-investor limit applicable to funds exempt under §3(c)(1).

The knowledgeable employee definition includes two categories of natural persons: (1) executive officers (i.e., a president, any vice president in charge of a principal business unit and any other officer or other person who performs a policy-making function),[1] directors, trustees, general partners, advisory board members and/or any persons serving in a similar capacity; and (2) employees who have participated in investment activities for the sponsor, certain affiliates or other companies for at least the last 12 months.

In a recent no-action letter,[2] the SEC provided relief that is generally broader and more favorable than previous SEC interpretations. Although the SEC emphasized that the ability to qualify as a knowledgeable employee is based on facts and circumstances, the letter included the following notable items:

- **Employees Participating in Investment Activities.** The SEC expanded previous interpretations by stating that "employees participating in investment activities" may include tax professionals and attorneys who regularly analyze investment structures in a manner material to investment decisions (as opposed to personnel that prepare tax filings or negotiate agreements that evidence investment decisions). The letter also expanded previous SEC interpretations by stating that analysts who research only portions of a private fund's portfolio can qualify as knowledgeable employees, where previous guidance required such analysts to have researched "all potential portfolio investments."
- **Executive Officer/Principal Business Unit.** The SEC indicated that the knowledgeable employee definition provides flexibility in assessing whether a business unit is "principal," noting in particular that a sponsor may have several principal business units. As examples, the SEC agreed that principal business units could include (1) an investor relations department that conducts substantive portfolio reviews with investors and responds to substantive due diligence inquiries, as opposed to merely arranging meetings and performing other relatively administrative tasks, and (2) an IT department where IT is an important element of the investment process.
- **Policy-Making Function.** The letter describes a substance-over-form approach in the SEC's determination of which employees have a policy-making function. Accordingly, an employee need not have a senior-level management title or sole responsibility for policy-making in order to perform a policy-making function. Instead, regular involvement in the development and adoption of a sponsor's policies, whether individually or as a member of a policy-making committee or group, will suffice. As an example, the SEC agreed that an active member of a valuation committee could be a knowledgeable employee, although the SEC distinguished as non-policy-making those individuals who merely observe proceedings or merely provide information to committee decision-makers.

The SEC's guidance should provide many private fund sponsors more latitude and increased comfort in determining which of their employees qualify as knowledgeable employees.

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1 For a private fund sponsor, this may include managing directors, principals or persons with similar titles.

2 Managed Funds Association, February 6, 2014.

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

Josh Westerholm
http://www.kirkland.com/jwesterholm
+1 312-862-2007

Ryan P. Swan
http://www.kirkland.com/rswan
+1 312-862-2221

PENbriefs

SEC Bars Chinese Units of Big Four Accounting Firms

In January 2014, an SEC administrative law judge barred the Chinese units of the "Big Four" accounting firms from auditing businesses that do business in the United States because they refused to turn over certain documents to SEC investigators on the ground that doing so would violate Chinese law. Although the decision does not go into effect immediately, and the firms intend to appeal, if upheld the decision could have a negative impact on Chinese companies that use Big Four firms to audit financial statements used in SEC filings, as well as U.S. companies with significant operations in China. To learn more, see our recent *Alert*.

Revised Hart-Scott-Rodino Act Thresholds Announced

The Federal Trade Commission recently announced revisions to the HSR filing thresholds. The new thresholds are set forth in our recent *Alert*.

Temporary Suspension of Iran Sanctions Is Limited and Leaves in Place Sanctions that Apply to U.S. Persons

U.S. officials recently announced a temporary suspension — for a six-month period ending July 20, 2014 — of Iran sanctions in exchange for Iran's commitment to place meaningful limits on its nuclear program. The suspension, however, leaves in place sanctions that apply to U.S. persons and their owned or controlled non-U.S. affiliates, as well as sanctions targeting important sectors of Iran's economy. Accordingly, the Iran sanctions landscape has not changed for U.S. companies and their owned or controlled non-U.S. affiliates. To learn more, see our recent *Alert*.

PENnotes

Kellogg Private Equity & Venture Capital Conference
Chicago, IL
April 23, 2014

This year's conference will focus on the unique challenges of middle-market PE investing and the dynamics of early-stage VC investing. Kirkland partner Brian Van Klompenberg will moderate the "Innovative Approaches to Growth Equity Investing" panel. Kirkland is also a sponsor of the event. For more information, click here.

34th Annual Ray Garrett Jr. Corporate and Securities Law Institute
Chicago, IL
May 1-2, 2014

The Ray Garrett Jr. Corporate and Securities Law Institute is the pre-eminent securities law conference in the Midwest. Kirkland partner R. Scott Falk will chair a session on "When the Challenge Goes Public." For more information or to register, click here.

Beijing
Kirkland & Ellis International LLP
29th Floor, China World Office 2
No. 1 Jian Guo Men Wai Avenue
Beijing 100004
P.R. China
+8610 5737 9300
+8610 5737 9301 fax

Chicago
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong
Kirkland & Ellis
26th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London
Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles
Kirkland & Ellis LLP
333 South Hope Street
Los Angeles, CA 90071
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich
Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto
Kirkland & Ellis LLP
3330 Hillview Avenue
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco
Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Shanghai
Kirkland & Ellis
International LLP
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

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, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its pre-eminent 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 M&A Firm" and "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.

In 2012 and 2013, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, UK, Asia-Pacific and globally. 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, 2012 and 2013*, and has consistently received top rankings among law firms in Private Equity by 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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EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
+1 (312) 862-3356