KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

June 3, 2016

Private Fund Manager Settles SEC Enforcement Case for Acting as Unregistered Broker

PENpoints

The SEC recently announced its first enforcement action alleging that a private equity fund manager acted as an unregistered broker-dealer.

On June 1, 2016, the Securities and Exchange Commission (SEC) entered into a consent order[1] with a private equity fund manager (Manager) settling, among other matters, allegations that the Manager provided brokerage services in connection with the acquisition and disposition of portfolio companies, and received transaction-based compensation for such services, without registering as a broker-dealer. This is the first enforcement action alleging that a private fund manager acted as an unregistered broker-dealer for purchases and sales of portfolio companies and may indicate a renewed focus on broker-dealer registration issues in the private equity context.

The public announcement of this settlement follows a lengthy hiatus in public commentary from the SEC staff on this topic after it was first raised in 2013.[2] Most private equity managers have acted in the longstanding belief that their activities and compensation in the context of portfolio company transactions did not create a broker-dealer registration requirement, primarily on the basis that the activities for which they were compensated fell outside the scope of regulated activity.

As to "unregistered broker-dealer activity," the consent order set forth the following:

- In lieu of employing investment banks or broker-dealers, the Manager performed brokerage services in-house.
- With respect to the purchase and sale of portfolio company securities, the Manager solicited deals, identified buyers or sellers, negotiated and structured transactions, arranged financing and executed transactions.
- The Manager received transaction-based compensation in connection with providing such services.

The Securities Exchange Act of 1934 defines a "broker" as "any person engaged in the business of effecting transactions in securities for the accounts of others" and makes it unlawful for any broker to effect transactions in, or induce the purchase or sale of, any security, without being registered as a broker-dealer. The subject funds' limited partnership agreements expressly permitted the Manager to charge transaction or brokerage fees. Nevertheless, the SEC found that the Manager had violated the Exchange Act because the Manager never registered as a broker-dealer.

To avoid the time and cost of contesting the allegations, the Manager (without admitting or denying the

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1 See Press Release and Consent Order, June 1, 2016.

2 See *Kirkland PEN*: "SEC Increases Focus on Transaction Fees and Other Broker-Dealer Issues for Private Fund Sponsors" (April 15, 2013).

findings) agreed to disgorge $2.3 million, of which it appears approximately $1.9 million is attributable to transaction fees received, plus pay prejudgment interest and a $500,000 civil penalty.[3]

The settlement order contains very little detail regarding the circumstances under which the transaction-based compensation was paid – e.g., whether the Manager's transaction-based fee offset its management fee – and is silent as to whether the result might have been different had, e.g., an investment bank been retained on any transaction on which the Manager collected a fee. It is possible that the SEC would consider such factors when evaluating a similar case. Accordingly, a private fund manager receiving transaction fees should consult with counsel, and should evaluate the impact of the SEC's renewed focus on these issues on its transaction fee practices.

3 The disgorgement and penalty included amounts that were attributable to all of the violations cited by the settlement order.

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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Divorce, Wall Street Style

PENpoints

Most of the recent terminated M&A transactions can be traced to a few macro trends — changes in tax law, increased antitrust enforcement and developing economic conditions.

Taking a page from the Hollywood tabloids, recent deal press has been overtaken by a stream of reported breakups, real or speculated. With *The Wall Street Journal* citing broken deal values in excess of $300 billion so far in 2016, we take a closer look at the M&A environment to look for any macro trends that may be contributing to these record numbers.

While the lion's share of recent M&A activity has been in the public-company space, these trends can also affect a private equity firm selling to a large strategic buyer or looking to acquire a public company in a take-private transaction.

Looking at selected signed transactions that terminated for reasons other than for a superior offer[1] since June 2015 (see our chart, which will be updated on a rolling basis), three secular trends emerge as key drivers of the increase in breakups:

Changes in Tax Law. In reaction to the spate of so-called inversion transactions over the last few years, the IRS and Treasury have released a series of rules and regulations intended to deter, or at least make less appealing, these moves by U.S. companies. The most recent tax release in early April included new rules seemingly targeted at one high-profile deal — Pfizer/Allergan. The tactic worked, with the parties terminating their planned merger just two days later under the terms of their agreement which had anticipated, and included a framework, to unwind the deal if tax laws were changed and impacted certain anticipated tax benefits. Recent tax pronouncements also included proposed regulations addressing intercompany debt that would impact common tax planning generally applicable to U.S. and non-U.S. multinationals and that can be expected to reduce certain of the tax benefits of inversion transactions. These modifications seem to have caught up with the CF Industries/OCI transaction and the Terex/Konecranes combination, a transaction that was also complicated by a post-announcement topping bid for Terex. In the Terex deal the merger agreement did not include a pre-wired framework to terminate the transaction in the event of a change in tax law, leaving the parties to negotiate a bespoke mutual separation whereby Konecranes would instead acquire Terex's material handling and port solutions unit.

More Aggressive Antitrust Reviews. The termination of a number of other transactions is attributable to a more robust review of deals by antitrust authorities, reflected in the recent increase in litigated merger challenges. In the past 17 months, the Federal Trade Commission and the Department of Justice have sued to prevent eight mergers, with success in blocking some high-profile transactions including the Office Depot/Staples and US Foods/Sysco mergers and GE's sale of its appliance business to Electrolux. In addition, the review of more controversial combinations by the antitrust authorities is taking longer, often with more extensive remedies being sought. This more aggressive posture on remedies ultimately doomed the Baker Hughes/Halliburton and Bumble Bee/Chicken of the Sea mergers. While it is difficult to generalize to all situations, factors cited as driving this more robust regulatory posture include beefed-up litigation resources at the antitrust agencies, authorities being emboldened by this being the last year of the current Administration, and the reality that many of the blocked deals represented attempts at further consolidation in already concentrated industries.

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1 Many of the "busted" transactions featured in the headlines are either unsolicited offers that are subsequently withdrawn or deals or offers that are withdrawn due to a topping bid. Because these "withdrawn" deals are part of the ordinary churn of the M&A market, particularly one that may have hit peak activity and value levels, we do not address them here.

Economic Conditions. A number of transactions appear to have fallen victim to the economic slowdown, particularly in corners of the energy industry that have been especially hard hit (e.g., Kayne Anderson/Ares Management), and others may be on a similar path (e.g., Energy Transfer Equity/Williams). While the impact has not been as widespread as the 2007 credit crisis which impacted a broader cross-section of deals, especially those involving leverage, these troubled energy deals highlight the potential risks when deals are struck at particular points in the commodity/industry cycle.[2]

2 These trends may also explain some of the withdrawn unsolicited offers for reasons other than competing offers (we summarize a selection of these withdrawn unsolicited offers in this chart). For example, Canadian Pacific's unsolicited offer for Norfolk Southern was met with negative commentary from regulators and industry participants, ultimately resulting in its withdrawal. Similarly, Honeywell withdrew its unsolicited offer for United Technologies in the face of skepticism by the target on the prospects for antitrust approval.

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PENbriefs

U.S. Department of the Treasury Again Relaxes Burmese Sanctions

The U.S. government recently authorized transactions that enable U.S. companies to expand trade and other business with Burma (aka Myanmar), while also announcing new sanctions targeting specific Burmese companies. This approach is consistent with the U.S. government's policy to use sanctions to "incentivize further democratic reforms" in Burma while also maintaining pressure on targeted parties and particularly the military. To learn more, see our recent *Alert*.

SEC Issues Guidance on Non-GAAP Financial Measures

The U.S. Securities and Exchange Commission recently updated its Compliance & Disclosure Interpretations (CD&Is) on the use of non-GAAP financial measures in SEC filings, earnings releases and other public disclosures. Notably, the SEC has significantly expanded its guidance on what is required to comply with the existing SEC rule requiring GAAP measures to be shown with equal or greater prominence. Management and audit committees should take this opportunity to re-examine how their companies calculate and present non-GAAP financial measures, and be reminded that they should not consider the prohibited practices noted in the C&DIs as exhaustive. To learn more, see our recent *Alert*.

PENbriefs

An Unexpected Intersection of Deal-Related Indemnification and D&O Advancement

Purchase agreements in many private company transactions contain some form of two seemingly unrelated provisions: (1) an agreement by the sellers to indemnify the buyer for certain losses arising out of breaches of representations and warranties made by the sellers and (2) an agreement by the buyer to maintain or assume the rights of former directors and officers of the target contained in the target's organizational documents to indemnification and advancement of expenses for actions taken prior to closing. A recent Delaware court decision shows how these two distinct provisions can intersect in an unexpected way, resulting in what may appear to be a somewhat circular outcome.

In that case, the court found that former officers of the target, who also served as representatives of the sellers, were entitled to advancement of their litigation expenses (under the second type of provision above) in defending a claim for indemnification for breaches of representations made to the buyer about the target business (under the first type). Parties may wish to address this potential issue by including an "anti-circularity" provision stating that where the buyer seeks indemnification from sellers for breaches of the purchase agreement, no seller may seek indemnification, advancement or contribution from the target (now owned by the buyer) under any statutory, organizational document or contractual theory. To learn more, see our recent *Alert*.

Federal Trade Secrets Bill Poised to Become Law

The U.S. Defend Trade Secrets Act (DTSA) recently became law. Differences in trade secret law among the various U.S. states has created uncertainties for companies that operate in multiple states. The DTSA is intended to create some consistency across the states by giving trade secret plaintiffs access to federal courts under certain circumstances. To learn more, see our recent *Alert*.

Corporate Team Led by Achim Herfs Joins Kirkland

Kirkland & Ellis International LLP is pleased to announce that Dr. Achim Herfs, Dr. Anna Schwander and Dr. Benjamin Leyendecker-Langner have joined the Firm. They will further strengthen the existing corporate and restructuring practice with a focus on M&A and capital markets transactions. Achim, Anna and Benjamin joined Kirkland from Hengeler Mueller. Click here for more information.

PENnotes

Kayo Women's Energy Investment Conference
Houston, Texas
June 6-7, 2016

Kirkland is a sponsor of this year's event, which will cover topics including portfolio management during volatility, restructuring and opportunities for private capital, what's next in cleantech, and GP/LP communications. Kirkland partner Mary Kogut will serve as a panelist and partner Anna Rotman will deliver the closing keynote address. Click here for more information.

SuperReturn U.S. 2016
Boston, Massachusetts
June 6-9, 2016

Kirkland is a sponsor of SuperReturn U.S. 2016, which is the largest annual meeting of private equity and venture capital professionals. Kirkland partner Aaron Schlaphoff will speak on the "CCO Response to the SEC Update" panel. Click here for more information.

IBA 15th Annual International Mergers & Acquisitions Conference
New York, New York
June 7-8, 2016

Kirkland is a sponsor of this year's event, which will bring together practitioners from around the globe to discuss the latest developments and hot topics in international M&A law, including foreign investment controls, stockholder activism, cross-border M&A and private equity. Click here for more information.

PLI 17th Annual Private Equity Forum
New York, New York
June 29-30, 2016

This annual event is designed to provide an understanding of the business and legal issues related to private equity investment, including recent regulatory and enforcement developments, compliance programs and ethical issues. Kirkland partner Andrew Wright will speak on "How to Market Private Equity Funds on a Global Basis." Click here for more information.

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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 preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last five years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland & Ellis was named "Law Firm of the Year" in Mergers and Acquisitions Law by U.S. News Media Group and Best Lawyers in their 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "Law Firm of the Year in North America: Fund Formation" at Private Equity International's 2013 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012-2015, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, 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 2011-2015*, 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," 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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