Independent Sponsor Economics and Transaction-Based Compensation Under Broker-Dealer Regulations

By Thomas F. Lamprecht

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Independent sponsors, like their private equity firm brethren, may be breathing a sigh of relief at indications that the SEC will be focusing more on protecting retail investors and less on scrutiny of the private equity industry. Under the leadership of former SEC Chair Mary Jo White, the SEC actively pursued the private equity industry for so-called “hidden fees” and weak disclosures, including the much publicized enforcement action against Blackstreet Capital Management. In the Blackstreet case, the private equity firm settled charges that it engaged in brokerage activity and charged fees without registering as a broker-dealer and committed other securities law violations. In contrast, according to a recent article by The Wall Street Journal, Peter Driscoll, the acting director, Office of Compliance Inspections and Examinations, is quoted as saying with respect to the private equity industry, “I think we’ve hit that area pretty hard. Generally we are going to focus more on retail investors.”

Despite this potential change in focus of SEC resources, the SEC will always continue to actively solicit complaints and tips, so independent sponsors should continue to ensure their compliance with broker-dealer regulations and avoid a race to the bottom.

Following the Blackstreet case, many independent sponsors wondered for the first time whether their activities required that they register as a broker-dealer. Concern was warranted given the ambiguity that the case created in the eyes of many commentators. Section 15(a) of the Securities Exchange Act of 1934 makes it unlawful for a person to make use of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security, unless registered as a broker-dealer. “Broker” is defined in Section 3(a)(4) of the Exchange Act as “any person engaged in the business of effecting transactions in securities for the account of others.” In case law and no-action letters, receipt of transaction-based compensation (i.e., fees or other compensation that is contingent upon the success of a securities transaction) has been a focus of the SEC in determining whether a person should register as a broker-dealer. Transaction-based compensation includes success fees, as well as commissions, premiums charged, or discounts granted or any other fee that is contingent upon the completion of a specific securities transaction. Generally, independent sponsors earn compensation in three ways during the life cycle of a portfolio company investment: (i) a fee upon consummation of an acquisition or disposition of the portfolio company (a “Closing Fee”), (ii) an ongoing management fee during ownership of the portfolio company (a “Management Fee”), and (iii) a “promote” or “carried interest” in which the independent sponsor receives a percentage of the profits earned upon a liquidity event in connection with the portfolio company (“Carried Interest”). With respect to broker-dealer registration, the analysis with respect to Management Fees and Carried Interest is relatively straightforward, but Closing Fees are a much more fact specific and nuanced analysis.

One no-action letter that will not provide independent sponsors with relief is the so-called “Private M&A Broker Letter.” On January 31, 2014, the SEC issued a no-action letter concluding that, even though a firm is engaged in certain activities in connection with the purchase or sale of a private company, such firm did not need to register as a broker-dealer. However, relief under this no-action letter is available for independent sponsors because, among other requirements, an M&A Broker cannot bind any party to the M&A transaction or provide financing in connection with the M&A transaction or provide financing in connection with the M&A transaction, which are both hallmarks of an independent sponsor’s activities.

3 An M&A Broker is defined in the no-action letter as “a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company.”
MANAGEMENT FEE

Upon acquiring a portfolio company, an independent sponsor will typically enter into a management or advisory services agreement with the portfolio company, pursuant to which the independent sponsor provides ongoing management, advisory and consulting services in exchange for compensation. During the life of the investment, the independent sponsor will have representatives that advise on corporate strategy, personnel decisions, equity and/or debt financings and other business matters, as well as serve on the board or other governing body of the portfolio company. The compensation amount is usually calculated as a percentage of EBITDA, subject to a floor and a cap (e.g., 5 percent of EBITDA, but no less than $250,000 and no more than $450,000). Management Fees do not raise broker-dealer concerns because (i) the services are not characteristic of effecting transactions in securities and (ii) the compensation is for services related to the operation of the portfolio company’s business and not “transaction-based” compensation. Nevertheless, the management or advisory services agreement will sometimes provide for payment of a fee in connection with an add-on acquisition, which should be analyzed in the same manner as a Closing Fee (as discussed below).

CARRIED INTEREST

Carried Interest enables an independent sponsor to participate in the profits generated from an investment in a portfolio company. Carried Interest ensures that the financial interests of the independent sponsor are fully aligned with those of its capital providers, because the independent sponsor will only receive compensation if value is created for such capital providers. Given that Carried Interest principally motivates a professional’s desire to become an independent sponsor, Carried Interest is often heavily negotiated between the independent sponsor and its capital providers, resulting in sometimes complex tiered structures (e.g., after an independent sponsor’s capital providers receive a return on invested capital, plus an 8 percent preferred return; first, the independent sponsor would be entitled to a catch-up until the independent sponsor received 10 percent of subsequent profits distributed; second, the capital providers are entitled to 90 percent of profits and the independent sponsor 10 percent until the capital providers receive a 1.5x return; and thereafter, 80 percent of profits to the capital providers and 20 percent of profits to the independent sponsor). The SEC has granted no-action relief to advisers who receive contingent consideration (i.e., Carried Interest) for services that are traditional advisory and consulting services, and not transaction-based compensation. Similarly, an independent sponsor who earns Carried Interest in exchange for managing a portfolio company over the investment life cycle is not receiving transaction-based compensation. The value of the Carried Interest is solely based on appreciation in the portfolio company created by the independent sponsor through management of the business, not execution of a securities transaction. For this reason, Carried Interest has not been the focus of SEC enforcement actions for unregistered broker-dealers.

CLOSING FEE

Upon consummation of an acquisition or disposition of a portfolio company, an independent sponsor will often negotiate with its capital providers for a Closing Fee. Closing Fees vary widely among transactions and frequently are not actually paid because the independent sponsor will “roll” or waive all or a portion of the Closing Fee otherwise payable in cash into equity in the portfolio company (often a security junior to the preferred security of the capital provider). Whether or not consideration is paid in cash, or the independent sponsor receives equity in the investment vehicle, the structure of the transaction, timing and nature of the independent sponsor’s services, use of an M&A Broker and any rollover must be closely analyzed to assess whether the independent sponsor is receiving transaction-based compensation that may give rise to broker-dealer registration concerns. Some of the considerations relevant for such analysis include the following:

- **Asset Transaction vs. Equity Transaction** – Many independent sponsors execute transactions in the lower middle market, and many transactions in that size range are structured as an asset purchase. If a transaction is structured as a purchase of assets (and not the securities of the target company), no broker-dealer issues would arise in connection with a Closing Fee paid upon consummation of the asset purchase, because there is no transaction in securities occurring (assuming, of course, that the assets of the target company are not themselves securities).
- **Acquisition** – In connection with the acquisition of a portfolio company, a Closing Fee may be a form of reimbursement for the independent sponsor’s time and expense in sourcing, conducting due diligence, negotiating the transaction and creating a business plan. In many instances, the amounts payable as a Closing Fee are for services similar to those for which the independent sponsor may be paid a Management Fee after the closing of a transaction, and may be an advance payment for such services.
- **Disposition** – In connection with the sale or other disposition of a portfolio company, a Closing Fee may be compensation for the additional time in managing a business undergoing a sale process, or a prepayment for post-closing management of purchase price adjustments and indemnification obligations under the definitive transaction agreement. An independent sponsor will often serve as a “representative” of the unitholders incurring significant time and expense.

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4 See FundsClub Inc. and FundsClub Managements LLC, SEC No-Action Letter (Mar. 26, 2013).
in winding down the investment vehicle without the ability to be paid for such services because the sale proceeds have been distributed. As a result, a Closing Fee may be advance consideration for those efforts.

- **Use of an M&A Broker** – If an independent sponsor is using an M&A Broker on a transaction, the independent sponsor certainly has a credible argument that it is not performing a brokerage function. The use of an M&A Broker by an independent sponsor is far more likely to occur in a disposition of a portfolio company, but some independent sponsors have used buy-side M&A Brokers. Fees payable to the M&A Broker by the independent sponsor would likely be transaction-based compensation for the M&A Broker.

- **Frequency of Transactions** – Unlike a private equity firm that may close numerous transactions in the course of a year, a successful independent sponsor may close one or two. The definition of broker described above includes a “person engaged in the business of effecting transactions in securities.” Although the SEC has said that even a single transaction may be enough to meet the “in the business” element, this authority is not well supported. With fewer transactions, an independent sponsor has a better chance of prevailing on a “not in the business” argument than a private equity firm.

- **Rollover** – As mentioned above, independent sponsors often “roll” or waive a portion of the Closing Fee in exchange for an equity interest in the portfolio company. Instead of such an arrangement, some independent sponsors contribute an intangible asset (such as a business plan or signed letter of intent) to the investment vehicle in exchange for an equity interest, or create the investment vehicle in the early stages, conduct all activities through the investment vehicle, and then have the investment vehicle raise equity and debt financing to consummate the transaction. As a result, upon consummation of the transaction, the independent sponsor retains an equity interest in the investment vehicle that owns the portfolio company. In these examples, the independent sponsor is at risk that the equity it receives or retains may never have value, or any initial value in the equity may be lost during the course of the investment, and such equity is different than transaction-based compensation paid to a broker.

As described above, the facts and circumstances of a Closing Fee need to be carefully discussed between an independent sponsor and knowledgeable legal counsel to ensure the purpose of the Closing Fee, and services in exchange for such Closing Fee, are properly documented and disclosed to the capital providers in order to avoid a Closing Fee being deemed transaction-based compensation. In addition, an independent sponsor may wish to explore the broker-dealer registration process and ongoing obligations related to such registration. If you have questions about the subject matter of this article, please contact the author of this article or a member of the Katten team with whom you work.

### Summary Table

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<th>Closing Fee</th>
<th>Management Fee</th>
<th>Carried Interest</th>
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<tbody>
<tr>
<td><strong>Amount</strong></td>
<td>Vary widely</td>
<td>Typically around 5 percent of EBITDA</td>
<td>Typically 10 percent that ratchets up to 20 percent</td>
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<tr>
<td></td>
<td></td>
<td>subject to a cap and floor</td>
<td>based on return thresholds</td>
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<td><strong>Timing</strong></td>
<td>Paid upon the closing of an</td>
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<td>Paid pursuant to the distribution “waterfall” upon a</td>
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<td></td>
<td>acquisition or disposition of</td>
<td>investment</td>
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<td></td>
<td>a portfolio company</td>
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<td>**Broker-Dealer</td>
<td>Facts and circumstances</td>
<td>Compensation in exchange for management,</td>
<td>Contingent consideration based on appreciation in</td>
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<td>Consideration</td>
<td>analysis to determine if</td>
<td>advisory and consulting services, and</td>
<td>value of a portfolio company, and not generally</td>
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<tr>
<td></td>
<td>transaction-based compensation</td>
<td>not generally considered transaction-based compensation</td>
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