SEC Enforcement Case Summary
Undisclosed Conflicts of Interest from Activist Consulting Agreements

On September 30, 2024, the SEC charged registered investment adviser, Macellum Advisors, LP, that advised a series of single-security pooled investment vehicles (the "Funds" or "Macellum Funds") with failing to disclose payments Macellum affiliates received from third party investment advisers and the resulting conflicts of interest. Macellum pursues an activist strategy where its Funds build large equity positions in public companies that Macellum perceives to be undervalued, and Macellum seeks to drive price appreciation by actively engaging with boards and management teams. According to the SEC order, as part of its activist strategy, after a suitable investment is identified, Macellum seeks to acquire a sufficient number of shares of the company stock to negotiate changes with current management, or, if necessary, launch a proxy contest to achieve the desired outcome. Macellum forms a single-security focused Fund – that is, a fund that invests only in the equity securities of a single target company – and then raises capital for the Fund so that it can acquire a significant position in the target company's equity securities.

Macellum sought to amass a significant position in each target company to facilitate more votes that would increase the likelihood of its activist campaign being successful. Accordingly, in each of its activist campaigns, in addition to the Macellum Fund's investment, Macellum also entered into arrangements with one or more outside investors – typically unaffiliated investment advisers that are larger and better capitalized than the relevant Macellum Fund (each an "Outside Entity") – to also invest in the Macellum campaign. The Outside Entity typically invested its clients' assets in the target company's securities directly rather than through a Macellum Fund. Macellum and the relevant Outside Entity or Entities entered into what Macellum termed a "Consulting Agreement" through which the Outside Entity agreed to pay one or more Macellum affiliates a performance-based fee to compensate Macellum for its idea generation, leadership of the activist strategy, and expenditure of time, capital and resources in service of the campaign. The performance fee generally equated to 10% of the Outside Entity's profits from the campaign, but in some cases the fee was as much as 55% of profits.

The terms of the Consulting Agreements varied from deal to deal, but the agreements typically required the Outside Entity to coordinate with Macellum, through a jointly engaged broker, on the purchase of the target company stock to ensure it was done on a pro-rata basis with the relevant Fund, and further required the parties to coordinate in connection with the exit from their respective positions. According to Macellum, these provisions were specifically included to mitigate the conflicts of interest created by the Consulting Agreements, and to ensure the parties acted in a coordinated way with respect to their investments such that neither party could sell without notice to or consent of the other party. However, in some cases, Macellum and the Outside Entity either did not formally execute the Consulting Agreement or did not memorialize the Consulting Agreement in writing.

While Macellum stated in Fund formation documents and various disclosures documents that it "may" or "could" engage in outside activities and other conflicted transactions, the SEC faulted the firm for not specifically disclosing the extensive Consulting Agreements it entered into, or compensation received from the Outside Entities in connection with its activist campaigns. In addition, the firm was faulted for not adequately addressing the risks and conflicts raised by the Consulting Agreements and ensuring that such agreements were always executed and memorialized.

This case reminds us that general disclosures about potential conflicts of interest are not sufficient to fully and fairly disclose specific known conflicts. Moreover, compliance policies and procedures should specifically address bespoke practices undertaken by firms to address risks and conflicts that are unique to its business practices and ensure such procedures are followed consistently. Due to the firm's cooperation and prompt remedial action taken, the penalty in the case was limited to $75,000.

See Summary – https://www.sec.gov/enforcement-litigation/administrative-proceedings/ia-6731-s