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Who Foots the Bill? SEC Cracks Down on Operating Partner Reimbursement Disclosures

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The SEC has been active in the private equity space recently after being relatively quiet for some time. A recent enforcement action serves as a reminder for fund sponsors that regulators are continuing to look at fund sponsors' practices relating to "operating partners," particularly in the context of disclosures to limited partners.

The SEC has long focused on conflicts of interest and disclosures relating to practices that involve compensation to the adviser or related parties. Most recently, a private equity sponsor agreed to a settlement alleging a failure to adequately disclose how its in-house group of operating partners was compensated for its services. The SEC found that instead of covering such costs through the sponsor's management fee, the firm had billed portfolio companies for its operating partners' services related to business improvements without "fully or fairly" disclosing the practice to, or obtaining consent from, its limited partners.

The SEC alleged that the practice was not adequately disclosed in the applicable limited partnership agreement. While the adviser did state in its 2014 form ADV brochure that the firm "may" be reimbursed for costs related to services provided to portfolio companies "under specific circumstances," the SEC found that disclosure lacking. The settlement order alleged that the sponsor "routinely provide[d] such services, that it did, in fact, receive reimbursements from portfolio companies for such services, and that the reimbursement rates were designed to recoup most (but not all) of the firm's costs of maintaining its operations group." Along with an SEC censure, the sponsor agreed to a civil monetary penalty, disgorgement, and prejudgment interest for its failure to disclose.

In the absence of full disclosure, the SEC may view reimbursements to advisers for items such as operating partner services as additional compensation, ultimately paid by the fund (through its portfolio companies). For years, the SEC has been signaling that it is focused on disclosure and expense allocations relating to operating partners. Since former Director of OCIE Andrew Bowden gave a speech titled Spreading Sunshine in Private Equity in May 2014, OCIE supervisors have noted concern about operating partners who function as sponsor employees but whose services are expensed directly or indirectly to the fund rather than paid by the adviser. Based on this recent settlement, we can likely expect to see continued SEC scrutiny on fund managers' historical practices and disclosure.

We have added this order to our database tracking SEC enforcement actions involving private equity advisers, available here.

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