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Operating Partners and/or Captive Consultants: Recent SEC Action and Six Takeaways

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On April 22, 2020, the U.S. Securities and Exchange Commission (the "Commission") issued a settled order finding that a middle-market private equity fund adviser failed to adequately disclose that costs relating to an internal "Operations Group" would be charged to the portfolio companies of the adviser's fund. In addition to finding a violation of Section 206(2) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), the negligence-based anti-fraud provision, the adviser agreed to pay disgorgement of $1.7 million and a civil penalty of $200,000.[1]

The order states that, although the applicable fund documents described certain fees that would be charged to portfolio companies, including "monitoring fees" and "consulting fees," the documents failed to discuss any operations group costs or describe with any specificity any other relevant fees that would be charged by the adviser to the portfolio companies of the fund and not be subject to management fee offset. Furthermore, the Commission found to be inadequate language that was subsequently added to the adviser's Form ADV disclosure brochure describing potential costs relating to adviser personnel that "may"[2] be charged to portfolio companies of the fund. The order is consistent with prior settlement orders where the Commission found disclosures inadequate for costs relating to in-house services[3] and captive consulting groups.[4]

Operating partner arrangements come in a variety of forms, and it is important to distinguish captive consulting groups from other arrangements. The recent order describes the operating partners as an "in-house 'Operations Group'" and provides other facts that distinguish it from many third-party consultant arrangements, including that it was held out to investors as being in-house, that it serviced the adviser's entire portfolio and that it charged fees designed to cover costs.[5] While the order does not address third-party consultant arrangements, by including such distinguishing facts in its order the Commission suggests that those facts are relevant to its evaluation of the adequacy of disclosure. While third-party consultant arrangements may receive somewhat less scrutiny, even those types of arrangements can present meaningful conflicts or other issues that merit specific disclosure.[6]

Given the Commission's focus on operating partners and the variety of conflicts presented by operating partners, we encourage clients to discuss with counsel and consider the following general takeaways.

1. Determine if the operating partners will be viewed as third-party consultants or as an in-house, captive consulting group. Ensuring independence and limiting the use of operating partners may be appropriate depending on disclosure and other factors and may reduce regulatory risk.
2. Ensure that disclosure is adequate in view of the arrangement (specifically evaluating what costs are disclosed and can be fairly charged to funds and portfolio companies) and consider if periodic reporting of costs to investors is

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sufficiently comprehensive. Broad disclosures such as references to "monitoring fees" or "consulting fees" may be viewed as inadequate by the Commission. In particular, the more "captive" the operating partners arrangement is, the more extensive and specific the disclosure regarding the arrangement should be.

3. Consider what compliance controls are appropriate given the arrangement. Even if the operating partners are not "supervised persons" of the adviser under the Advisers Act, it may be appropriate to subject them to certain compliance controls consistent with an adviser's responsibility to prevent the misuse of material, nonpublic information.
4. Evaluate broker-dealer registration issues, if the arrangement includes the potential for transaction-based compensation.
5. Generally consider other conflicts and issues presented by the arrangement and how they should be addressed (disclosure, consent, additional controls).
6. Where costs of internal operating partners are allocated among portfolio companies or between portfolio companies and the adviser, it is important to maintain contemporaneous documentation to support the allocations.

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[1] Monomoy Capital Management, L.P., Administrative Order No. 3-19764, the U.S. Securities and Exchange Commission (April 22, 2020) available at https://www.sec.gov/litigation/admin/2020/ia-5485.pdf.

[2] Notably, the Commission has expressed its dislike of the use of "may" in certain disclosures relating to conflicts of interest. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, the U.S. Securities and Exchange Commission (July 12, 2019), available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf ("Similarly, disclosure that an adviser 'may' have a particular conflict, without more, is not adequate when the conflict actually exists.").

[3] In 2015, the Commission found that an adviser violated Section 206(2) of the Advisers Act for failing to adequately disclose costs relating to legal and compliance services provided by in-house personnel charged by the adviser. *See* Cherokee Investment Partners, LLC and Cherokee Advisers, LLC, Administrative Order No. 3-16945, the U.S. Securities and Exchange Commission (November 5 2015) available at https://www.sec.gov/litigation/admin/2015/ia-4258.pdf.

[4] In 2018, the Commission announced settlement with an adviser concerning the way in which it allocated compensation-related expenses for employees of an internal operating partner group. *See* NB Alternatives Advisers LLC, Administrative Order No. 3-18935, the U.S. Securities and Exchange Commission (December 17, 2018) available at https://www.sec.gov/litigation/admin/2018/ia-5079.pdf.

[5] The order cites the following statements from the adviser's advertising materials: "an extensive in-house operational and financial restructuring team that drives business improvement throughout the [adviser's] portfolio." "The operations team is led by two operating partners…. The operating partners currently supervise a team of five portfolio company employees and 12 contractors who lead business improvement and lean manufacturing programs throughout the [adviser's] portfolio."

[6] On December 13, 2018, the Commissioner announced a settlement with an adviser for its failure to disclose certain in-house employee costs and arrangements with third-party consultants that gave rise to actual or potential conflicts of interest. Notably, the arrangement with the third-party consultant included a personal loan between the consultant and a senior person at the adviser. *See* Yucaipa Master Manager, LLC, Administrative Order No. 3-18930, the U.S. Securities and Exchange Commission

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(December 113, 2018) available at https://www.sec.gov/litigation/admin/2018/ia-5074.pdf.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Investment Funds or Securities Enforcement practice groups, or the following authors:

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