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Kirkland AIM

Two SEC Settlements Involving Private Equity Operations Groups, In-House Charges and Service Provider Conflicts

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The Securities and Exchange Commission (SEC) recently entered into two settlements with private equity managers related to lack of disclosure regarding operations groups, costs of in-house personnel and conflicts relating to consulting service providers.

As described in one [consent order](#):

- the manager sponsored private equity funds that invested in minority ownership positions in other private fund sponsors;
- the manager created a “business services platform” (i.e., an operations group) to provide operational consulting services to the alternative investment firms in which its private equity funds invested, which services included client development, talent management, operational advisory services and sourcing new investors for these alternative investment firms;
- the governing documents of the manager’s funds provided that the manager would bear all costs of its investment professionals, but the funds would bear the costs of the operations group up to a stated cap per fund;
- although the SEC did not allege that the cap was exceeded, it objected to the manager’s practice of allocating the full cost of operations group employees to the funds, where a percentage of the employees’ time was spent performing services for the manager instead of the firms in which its private equity funds invested. These services included capital raising for the manager’s funds and deal sourcing of new investments for the manager’s funds; and

- the manager agreed to disgorge approximately \$2.4 million including interest, and pay a civil money of \$375,000.

According to the [other consent order](#):

- the manager used in-house personnel to prepare its private equity funds' tax returns and charged a portion of their costs to the funds. Although the funds' governing documents authorized the funds to bear tax return preparation costs, the SEC believed disclosure to be inadequate in light of a broad provision in the funds' governing documents that the funds' manager and general partner would bear the costs of "normal operating overhead," including salaries, compensation and benefits of manager employees;
- the manager also regularly used two consulting firms to assist with sourcing and consulting on portfolio company investments. Deal sourcing expenses were a manager expense under the funds' governing documents, but were charged in certain instances to the funds, and the SEC also alleged that the manager did not adequately track or allocate consulting expenses between the manager and its funds (or among funds), causing some funds to bear expenses on behalf of another fund, the manager or its principal;
- the manager also failed to disclose conflicts¹ related to the consulting firm relationships: in one instance, the manager's principal had agreed to personally loan \$215,000 to a consulting firm's principal, accelerating payments from one of the funds to pay off the loan; in another, the manager's principal made a personal investment in a consulting firm in exchange for a share of its profits. Related fees from the consulting firm were not offset in accordance with the relevant fund's offering documents; and
- the manager reimbursed the funds approximately \$940,000, disgorged approximately \$1.9 million including interest, paid \$1 million as a civil money penalty and agreed to retain an independent compliance consultant.

These settlements reflect the SEC's ongoing focus on private fund manager expense practices and conflicts in light of disclosures made to investors and the terms of fund governing documents.

1. The governing documents of the manager's funds had broad advisory board provisions requiring disclosure to, and possibly approval of, any conflict involving the manager and the funds. [↪](#)

If you have any questions about the matters addressed in this *Kirkland AIM*, please contact the following Kirkland attorneys or your regular Kirkland contact.

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Suggested Reading

- 12 February 2019 Kirkland Seminar Brave Girls, Not Perfect Book Launch – Women in PE Event
- 13 December 2018 & 18 December 2018 Kirkland Seminar Tax Incentives of Investing in Opportunity Zones
- 12 December 2018 Press Release Kirkland Advises Windjammer Capital on Formation of \$870 Million Fifth Fund

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