Alchemy Accelerated: Private Equity Pre-Commitment Fee Disclosure

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This article summarizes a recent SEC Administrative Proceeding against THL Managers V, LLC and THL Managers VII, LLC (collectively, "THL"), Boston based private equity managers.[1] The SEC found that THL (i) provided inadequate pre-commitment disclosure of certain accelerated fees received from portfolio companies; (ii) failed to obtain fund advisory committee consent as a result of the potential conflict of interest posed by negotiating and receiving accelerated fees; and (iii) had inadequate policies and procedures to deal with the accelerated fees.

THL Managers V, LLC and THL Manager VI, LLC are Boston based private equity managers (collectively, "THL"). THL has been managing private equity since 1974. THL manages the Thomas H. Lee Equity Fund V, L.P. ("Fund V") and the Thomas H. Lee Equity Fund VI, L.P. ("Fund VI" and together with Fund V, collectively, the "Funds"). Fund V was formed in 2000 and raised nearly $6 billion; Fund VI was formed in 2006 and raised nearly $8 billion. Each Fund's limited partnership agreement ("LPA") establishes a limited partner advisory committee ("LPAC") to approve potential conflicts of interest relating to, among other things, transactions with portfolio companies.

The Funds have a typical compensation structure that includes carried interest and a management fee. In addition, each LPA provides that THL may (i) receive customary transaction fees ("Transaction Fees") and (ii) may enter into management or consulting agreements with Fund portfolio companies. As a result, THL entered into consulting and advisory agreements ("Monitoring Agreements") with Fund portfolio companies and received a fee ("Consulting Fee") for providing such services. Upon either the sale or initial public offering ("IPO") of the portfolio company the Monitoring Agreement provided for an acceleration to THL of the net present value of the periodic fees ("Accelerated Fees") that would have been paid over the typically ten-year term of the relevant Monitoring Agreement.

Management fees were partially offset by Transaction Fees and Consulting Fees. Accelerated Fees offset management fees in the same way.

Just under 80% of Fund VI investors knew about the existence of Accelerated Fees through a side letter prior to committing capital to Fund VI; all Fund investors received a semi-annual report that included the amount of Accelerated Fees paid to THL. The portfolio companies that were subject to a sale or IPO also

[1] Investment Adviser Release No. 4952 June 29, 2018 *In the Matter of THL Managers V, LLC and THL Managers VI, LLC.* See https://www.sec.gov/litigation/admin/2018/ia-4952.pdf.

disclosed Accelerated Fees in filings with the SEC. Commencing in 2014, THL disclosed the possibility of receiving Accelerated Fees in its Form ADV, well after the Fund investors committed capital.

First, as to the 20% of Fund VI investors and all of Fund V investors, the SEC found that THL provided inadequate pre-commitment disclosure concerning Accelerated Fees in violation of Advisers Act Section 206(4) and Rule 206(4)-8. This violation was not cured by subsequent disclosures in Form ADV, in financial reports or other SEC filings by the portfolio companies.

The SEC also cited THL for failure to obtain consent and approval from the Funds' LPAC, as was required, prior to negotiating and accepting Accelerated Fees, which posed at least a potential conflict of interest. This failure was a violation of Advisers Act Section 206(2) and a negligent breach of its fiduciary duty to the Funds.

Finally, the SEC found THL's policies and procedures lacking as a result of its practice of receiving Accelerated Fees in violation of Advisers Act Section 206(4) and Rule 206(4)-7.

The SEC praised THL for its cooperation and prompt responses and demanded payment of $5 million in disgorgement and prejudgment interest and a civil money payment of $1.5 million.

This case is instructive in that it may not be intuitively obvious to fund managers that the timing of a disclosed fee (Consulting Fee) would change the very nature of that fee such that it is now, in the eyes of the SEC, a completely new and distinct category of fees (Accelerated Fee) that requires separate and distinct disclosure prior to investor commitment. Likewise, it may not be obvious that that the acceleration of a disclosed Consulting fee that is shared with investors to offset management fees (as is the case in THC) creates a conflict of interest that requires LPAC review and approval.

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