March 14, 2019

The Honorable Carolyn Maloney
Chairman
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga
Ranking Member
Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
U.S. House of Representatives
Washington, D.C. 20515

Re: March 14, 2019 Hearing Entitled "Putting Investors First? Examining the SEC's Best Interest Rule"[1]

Dear Madam Chair and Ranking Member Huizenga:

I am writing on behalf of the Institutional Limited Partners Association (ILPA) to express our appreciation for holding the above referenced hearing and to provide you with our views on the impact on private equity fund advisers ("PE Advisers") and their investors, of the *Proposed Interpretation Regarding Standard of Conduct for Investment Advisers*[2], a component of the Best Interest Rule, which we understand may be discussed at the hearing. We would respectfully request that this letter be made a part of the hearing record.

ILPA is the voice of institutional investors invested in the private equity ("PE") asset class, known as Limited Partners ("LPs"). Our 500+ member institutions represent over $2 trillion in PE assets under management and include U.S. and global public and private pension funds, insurance companies, university endowments, charitable foundations, family offices, and sovereign wealth funds, all of which invest in the U.S.

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[1] Hearings, United States House of Representatives, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets (March 14, 2019), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402388

[2] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, SEC Rel. IA-4889, File No. S7-09-18 (Apr. 18, 2018). ("Proposed Interpretation")

PE market.[3] LPs provide the capital that fuels private equity and venture capital investment, generating economic growth and job creation, across America and around the world. In addition to providing this critical capital for economic growth, LPs are the trusted financial stewards investing the assets of average Americans in a class of investments consistently providing high investment returns so that they may enjoy financial security and comfort. Limited partner beneficiaries include teachers, first responders, students receiving university scholarships, and charity recipients, among others.

Strong fiduciary duties are the foundation of the relationship between LPs and the PE Advisers they invest with. These duties of care, loyalty, and good faith foster the trust that gives investors confidence to invest with investment managers, particularly in private markets; markets that by their very nature exhibit less transparency. Unfortunately, LPs are facing significant resistance in their efforts to retain meaningful fiduciary protections while investing in the PE market, ultimately raising the risk of harm to beneficiaries. The loss of certain fiduciary protections is magnified due to the illiquid nature of these investments, which often last for 10-15 years in duration. Addressing these challenges will require both action by the SEC while finalizing their Proposed Interpretation, and legislative solutions in Congress to address the reduction of fiduciary duties in the investment contracts of PE Advisers.

The primary sources of fiduciary obligations owed by PE Advisers to LPs are found in two places: the Investment Advisers Act of 1940 ("Advisers Act") and those included in the investment contract between the LP and the PE Adviser, generally governed under the laws of the state of Delaware.[4] ILPA believes that the SEC could and should improve their final Proposed Interpretation in a variety of ways, which are outlined below. ILPA also encourages Congress to take action to address the problem of federally registered PE Advisers reducing or eliminating their fiduciary duties under their investment contracts with investors. Addressing these issues will only become more critical should retail investors gain the ability to invest in PE, as we understand is being evaluated by the Commission.[5]

Overview of Fiduciary Duties under the Advisers Act & ILPA's Suggested Improvements to the SEC's Proposed Interpretation:

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[3]As an illustration of the members we represent, the ILPA Board of Directors includes representatives from: Guardian Life Insurance Company, Teacher Retirement System of Texas, Oregon State Treasury, Washington State Investment Board, California State Teachers Retirement System (CalSTRS), Tufts University Investment Office, and the Alaska Permanent Fund Corporation, among others: https://ilpa.org/who-we-are/board-of-directors/

[4] Most private equity funds in which U.S. LPs invest are formed under the Limited Liability Company and Limited Partnership laws of the State of Delaware. *See* Michael Hong, *Fiduciary Duties under the Advisers Act vs. Delaware Law,* LAW360, April 7, 2017, *available at:* https://www.law360.com/articles/896627/fiduciary-duties-under-the-advisers-act-vs-delaware-law

[5] "Mr. Clayton said the SEC is now weighing a major overhaul of rules intended to protect mom-and-pop investors, with the goal of opening up new options for them." Dave Michaels, *SEC Chairman Wants to Let More Main Street Investors in on Private Deals,* WALL STREET JOURNAL, August 30, 2018.

As members of this Subcommittee are likely aware, the Advisers Act fiduciary obligations of investment advisers are not expressly stated in the statute passed in 1940, but instead were interpreted to exist under the anti-fraud provisions of the law (by the U.S. Supreme Court in the case *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180 (1963). This case (and subsequent case law) set out that investment advisers, including those advising private equity funds, have both a duty of loyalty (i.e. they must act in the best interest of their investors), and a duty of care (i.e. they must not act negligently in their duties).[6] Most importantly for LPs, the fiduciary duties under the Advisers Act are **only** enforceable by the SEC, and only apply to the fund as a whole, not the individual LPs within it.[7] LPs are most concerned with the provisions in the Proposed Interpretation that discuss the duty of loyalty and the obligations of the PE Advisers to disclose conflicts of interest and achieve "informed consent" from the investors. We encourage the Commission to do more to make clear the obligations of PE Advisers.

This duty of loyalty is particularly critical to LPs, given the increased diversity of GP services that has accompanied the growth and maturation of this asset class. As the private equity industry has grown, many GPs have dramatically expanded their business lines, effectively becoming large asset managers. The increased scale and breadth of PE Advisers' activities, as well as the varying types of clients and funds they advise, has resulted in a concurrent rise in potential and actual conflicts of interest[8], and therefore greater risk of breaching their duty of loyalty.

Since 2014, there have been at least 18 SEC enforcement actions against private fund advisers that were found to have breached their fiduciary duties.[9] Many of these

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[6] "An investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty." *See* Proposed Interpretation at P. 7.

[7] *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006).

[8] "Conflicts of interest are a particularly important challenge for large financial institutions and asset managers with complex structures. Due to these firms' extensive affiliations and the dynamic nature of their businesses, conflicts are constantly arising and changing." *See* Michael Sakala and Daniel New, *Managing conflicts of interest in the alternative investment industry,* Ernst & Young, September 2013, *available at:* https://www.ey.com/Publication/vwLUAssets/EY_-_Conflicts_of_interest_in_alternative_investment/$FILE/EY-conflicts-of-interest.pdf

[9] The cases where private fund advisers were found to have breached their fiduciary duties by the SEC include: *In the Matter of THL Managers V, LLC and THL Managers VI, LLC* (June 29, 2018) (Failed to disclose accelerated monitoring fees); *In the Matter of Aisling Capital, LLC* (June 29, 2018) (Failed to offset consulting fees charged to investors); *In the Matter of WCAS Management Corp. (*April 24, 2018) (Failed to disclose conflicts of interest between adviser & clients); *In the Matter of TPG Capital Advisers, LLC,* (December 21, 2017) (Failed to disclose accelerated monitoring fees); *In the Matter of Capital Dynamics, Inc.,* (August 16, 2017) (Inappropriately charged management expenses to the fund/investors); *In the Matter of SLRA Inc., as successor to Liquid Realty Advisors III, LLC and Scott M. Landress,* (February 7, 2017) (Failure to disclose fees and expenses); *In the Matter of Centre Partners Management, LLC* (January 1, 2017)(Failure to disclose potential conflicts of interest and omission of material facts); *In the Matter of New Silk Route Advisors, LP* (December 14, 2016)(failure to obtain LPAC consent for co-investments); *In the Matter of Apollo Management V, VI, VII and Apollo Commodities Mgmt, LP.* (August 23, 2016) (Failure to disclose accelerated monitoring fees, failing to disclose accrued allocation of accrued interest from a loan would benefit only one fund); *In the Matter of JH Partners, LLC* (November 23, 2015) (Favoring one client over another, failure to disclose conflicts of interest, failure to obtain consent from LPAC on investments outside LPA coverage); *In the Matter of Cherokee Investment*

enforcement actions were against well-known and significant PE Advisers, managing billions of dollars in assets. Most of these actions highlighted the breach of the duty of loyalty, and most significantly the *failure to disclose* either real or potential conflicts of interest or inappropriately charged fees & expenses. While these actions are believed to have deterred other advisers from engaging in similar breaches of fiduciary duty, they have also resulted in a "mountain" of disclosures in the limited partnership agreements ("LPAs") and Private Placement Memorandums ("PPMs") drafted by investment advisers. These complex and opaque documents do not present these disclosures in a standardized way, and often fail to ensure that LPs are clearly informed about the various conflicts that an adviser has or may have, or the fees and expenses that will be charged. As a result, it is often difficult for an LP, even a sophisticated LP, to truly give informed consent when confronted with written LPA terms and PPM disclosures that are broad, opaque, voluminous, inclusive of comprehensive possibilities or potential conflicts that are not thought to be relevant, complex, and sometimes contradicted by the oral statements of the investment adviser.

ILPA has suggested several specific and targeted improvements that should be made to the final Proposed Interpretation in letters sent to the SEC on November 21, 2018[10], and in a follow-up letter signed by 35 of the largest institutional investors in the United States on February 12, 2019.[11] The goal of these suggestions was to improve the disclosure received by investors and ensure they are truly giving informed consent to the PE Adviser. These suggestions included:

- Private fund advisers should be required to explicitly and clearly disclose the standard of care under both state law and the Advisers Act owed to LPs and the fund.

Partners, LLC and Cherokee Advisers, LLC, (November 5, 2015) (Failure to disclose funds would be charged for GP legal and compliance expenses); *In the Matter of Fenway Partners, LLC et. al., (*November 3, 2015) (Failure to disclose conflicts of interest regarding use of outside consultants and application of fee offsets); *In the Matter of Blackstone Management Partners LLC, III and IV,* (October 7, 2015) (Failure to disclose accelerated monitoring fees, failure to disclose disparate legal fee discount between GP and Fund); *In the Matter of Guggenheim Partners Investment Management, LLC* (August 10, 2015) (Failure to disclose that an executive received a loan to personally participate in a Guggenheim acquisition, inadvertently billing a client for management fees on non-managed assets); *In the Matter of Kohlberg Kravis Roberts & Co, LP, (*June 29, 2015)(Failing to allocate broken deal expenses to co-investors rather than fund); *In the Matter of Alpha Titans LLC et. al.,* (April 29, 2015) (Using fund assets to pay expenses without clear authorization in the LPA); *In the Matter of BlackRock Advisors, LLC,* (April 20, 2015) (Failing to disclose conflict of interest involving the outside business activity of a portfolio manager); *In the Matter of Lincolnshire Management*, *Inc.,* (September 22, 2014) (Failing to follow expense allocation policy in LPA).

[10] Follow up letter from the Institutional Limited Partners Association to the Securities & Exchange Commission regarding the "*Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18",* November 21, 2018.

[11] *Institutional Investor Letter on Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18",* February 12, 2019.

- The SEC should clearly state that the standard of care owed to the clients of private fund advisers under the Advisers Act is a "negligence" standard.

- "Pre-clearance" of conflicts of interest should be limited, and specific details of each conflict must be presented to the LPs to receive true "informed consent."

- The SEC should indicate that for private fund advisers, having a Limited Partner Advisory Committee (LPAC) is best practice, and all perceived conflicts should be presented to the committee for resolution.

- The SEC should provide more clarity surrounding hedge clauses, including the limits of their scope, and the facts and circumstances in which they can be used.

- The SEC should issue a statement indicating that any settlements of an enforcement action with a private fund adviser will be conditioned upon that adviser itself assuming those costs (including attorneys fees), rather than seeking indemnification from investors.

We ask members of the Subcommittee to encourage the Commission to make these changes to ensure that investors truly can give "informed consent" to actual and prospective conflicts of interest that would otherwise violate a PE Adviser's fiduciary obligation.

Overview of Fiduciary Obligations under the Investment Contract with PE Advisers

The contractual fiduciary obligations under the Delaware limited partnership and LLC laws are slightly different than those under the Advisers Act, but currently more critical to LPs. In 2004, the Delaware legislature enacted laws that permitted General Partners and LLC Managing Members[12] to disclaim their fiduciary duties of care, loyalty and good faith owed to LPs and LLC members.[13] Prior to 2004, Delaware, where many partnerships and LLCs are domiciled, required fundamentally the same fiduciary duty obligations for PE Advisers as those under the Advisers Act. After 2004, PE Advisers were permitted to contract away their duties of care and loyalty under Delaware law. "By contractually waiving fiduciary obligations, a fund manager 'has almost no extracontractual constraints on it'…the limited partners are left to rely upon the 'implied covenant of good faith and fair dealing, which is explicitly protected within the Delaware statutes, but seldom found by the Delaware courts as a source of protection."[14]

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[12] Under partnership or LLC laws, the PE Adviser is structured into serving as the General Partner or Managing Member of the LLC, directing the investment activities of the private equity fund, while the Limited Partners or LPs are the passive investors in the fund.

[13] Courtney Nowell, Matthew Cohen and Brooke LoCoCo, *A Call to Duty: Waivers of Fiduciary Duty under Delaware Law,* Squire Patton Boggs, Vol. 22, No. 7, July 2015, *available at:* www.squirepattonboggs.com/~/media/files/insights/publications/2015/07/a-call-to-duty-waivers-of-fiduciary-duty-under-delaware-law/a_call_to_duty_waivers_fiduciary_duty_under_delaware_law.pdf

[14] *Id.* at 2.

Fiduciary duties under Delaware law, if they have not been contracted away under the LLC agreement or LPA, apply to the fund as a whole, and each individual LP. They also are enforceable in court by the LPs and provide a remedy in the case of breach by PE Advisers.

Given that the Advisers Act duties can only be applied in an SEC enforcement action, only apply to the fund as a whole (rather than the individual investors), and usually do not result in a financial recovery of the full LP losses if they are triggered, they are generally less protective than those found in the investment contract under Delaware law. Unfortunately, federally registered PE Advisers with fiduciary duties under the Advisers Act are permitted to contract away those same exact duties under their investment contracts with their investors. This is becoming an increased concern due to market trends.

<u>PE Advisers Are Actively Reducing Their Fiduciary Obligations in Their Investment Contracts with Investors</u>

Federally-registered PE Advisers are increasingly reducing or diminishing their fiduciary obligations to their investors under Delaware law. While the impact of the change in Delaware law permitting this to occur was not immediately felt in the private equity marketplace due to the Great Recession, as the market has rebounded, the legal terms have becoming immensely more challenging. This has been exacerbated by the current fundraising environment, which is characterized by unprecedented fund raising levels and speed, where GPs have significant leverage in negotiations, and many LPs, particularly public pensions, are forced to deploy capital under disadvantaged terms in order to achieve allocations in the sorts of high performing funds that will help them to attain certain actuarial performance thresholds necessary to meet their pension and other disbursement requirements.[15] LPs, including even the nation's largest public pensions, with correspondingly reduced leverage in negotiations, have continued to face a market where they are forced to accept these reductions in the applicability of basic duties of fairness, loyalty and good faith owed to them by the investment advisers they invest with. This was evidenced in an October 2018 poll of over 80 LP organizations conducted by ILPA, in which 69% of LP organizations indicated they had been faced with reduced fiduciary duties in the LPAs they were required to sign to invest, with 54% seeing an increased frequency in reduced fiduciary duties in LPAs. Out of the 89 LP organizations responding to the poll, 42% of LP organizations had been forced to walk away from an investment because these duties could not be restored in negotiation.

[15] "While many in the industry anticipated 2017 would be another strong year for private equity fundraising, I suspect few would have predicted that 2017 would witness the largest amount of capital ($453 bn) raised in any year." *See* Christopher Elvin, *Private Equity in 2018,* 2018 Preqin Global Private Equity & Venture Capital Report, 15, *available at:* http://docs.preqin.com/reports/2018-Preqin-Global-Private-Equity-Report-Sample-Pages.pdf

Some of the largest LPs have been forced to walk away from investment opportunities because the PE adviser was requiring them to accept terms permitting the manager to think of its own interests (i.e., permitting the manager to act in its "sole discretion") before the interests of the institutions providing the PE Advisers with their capital. As the poll evidences, the ability of LPs to retain basic protections has been substantially undermined in recent years. This challenge is magnified for U.S. public pension plans. Their ongoing commitments to PE are critical in order to generate sufficient investment returns for beneficiaries, but they may be unable to invest with managers that have reduced or eliminated their fiduciary duties due to their own fiduciary obligations to pensioners. This results in capital being left out of the marketplace and harms the ability of pensioners to achieve the returns they need.

We believe Congress should take action to ensure that these federally registered PE Advisers are not able to avoid their full fiduciary obligations by reducing or eliminating them in their investment contracts with LPs. The Advisers Act could be amended to prevent federally registered PE Advisers from contracting to a lower fiduciary standard than that in the Advisers Act in their investment contracts. Taking this action will ensure there are basic, minimum standards in the asset class that require PE Advisers to truly act in the best interest of their investors.

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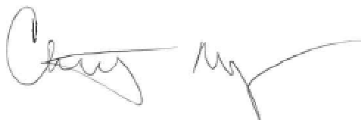
If we can answer any questions or provide additional information that would be helpful to you or the Subcommittee, please do not hesitate to contact me at (202) 871-9367 or chayes@ilpa.org.

Sincerely,



Christopher Hayes
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