September 22, 2021

Honorable Gary Gensler
Chair

U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Dear Chair Gensler,

We greatly appreciated the opportunity to meet with you and your senior staff on May 18, 2021 to discuss needed investor protection reforms in the private funds marketplace. We also appreciated your testimony on May 26, 2021, in the House Appropriations Subcommittee on Financial Services & General Government, as well as in the Senate Banking Committee on September 14, 2021, where you indicated your concern regarding fee and expense transparency and erosion of fiduciary duties in the private funds marketplace. Your views strongly align with the rulemaking reforms we have encouraged the SEC to pursue, and we look forward to working with you and the Commission staff to advance these and other important reforms and encourage you to add these items to the SEC's rulemaking agenda.

At our May 18, 2021 meeting, you raised concerns about the cost associated with access to the private equity asset class for investors, as well as inefficiencies in the market that have caused limited competition on pricing and cost. We would like to provide additional information that will highlight challenges in the market and reforms that will address not only the costs of accessing the market but also limit the downside risk of investing in these funds for investors. There are several factors that influence the pricing and cost inefficiencies in this market. Some of these factors are related to traditional supply and demand dynamics that cannot be easily remedied through regulatory action. However, other factors could be addressed through targeted rulemaking action by the SEC.

These include: (1) information asymmetry in the negotiation process for private fund terms and economics; (2) a lack of cost and performance transparency in the asset class; and, (3) federal and state law changes that have removed downside risk protection, which is exacerbated by the expansion of conflicts of interest in the industry.

I. Information Asymmetry in Investment Negotiations

The multilateral negotiation process to invest in a private fund does not take place on a level playing field where both parties, the general partner (GP), and each limited partner (LP) investing in the fund have equal access to information, nor do they have equal financial resources to obtain legal counsel. Despite legal counsel being allocated as a fund expense, and thereby being paid for by a private fund's LP, legal counsel forming the fund: (1) expressly represents the GP in negotiations and waives any obligations to act as counsel on behalf of the fund; (2) are typically hired without a cost-competitive process by the GP; (3) have access to additional information based on their negotiations with all fund investors that is not accessible to the individual LPs; and (4) have access to information on previous concessions LPs have made across their client base of multiple GP organizations. Each of these factors contributes to an imbalance in private fund negotiations and has also led to a significant increase in organizational expenses; put simply, LPs are effectively paying to negotiate fund terms against themselves.

Moreover, the increased concentration of fund formation work among a small number of large law firms has created the ability for those law firms to share information across their platform to improve their negotiation outcomes for their GP clients to the detriment of LPs. There is also an incentive for those law firms to fail to concede certain negotiation points that might be acceptable to the GP to preserve the product that they are selling to their GP clients: their form limited partnership agreement (LPA). By contrast, there is little incentive for an individual LP to utilize limited negotiating capital to address issues such as excessive organizational expenses, which are socialized and shared pro rata, as opposed to issues that disproportionately impact that LP, resulting in a collective action problem. Even where LPs seek to overcome this disincentive, perceived antitrust risk prevents LPs and their counsel from collectively sharing similar negotiation information, particularly of an economic nature, when negotiating to enter the same funds, placing them at an information disadvantage in the process. Many LPs, particularly public pension plans, also have cost pressure limiting their ability to engage external counsel, which are not compensated as a fund expense, but are out of their organization's general legal budget. As a result, fund organizational expenses (which pay fund formation counsel for the GP) have grown significantly. ILPA's 2021 Report on Fund Terms[1] indicates that these expenses have grown 123% since 2011, even when side letter and MFN process negotiations have increasingly been carved out of organizational expense caps.

The imbalance in negotiations due to these structural concerns ultimately results in unnecessary additional costs to LPs and less efficient negotiation outcomes in the industry. LPs encourage the SEC to consider certain actions within its power to address the imbalance by:

1. Requiring private fund advisers to pay for the legal costs of fund formation, rather than the fund, to avoid a conflict of interest, or at minimum requiring private fund advisers to conduct a cost-competitive process to select external legal counsel for fund formation.

2. Requiring that private fund advisers share ongoing information about the concessions other LPs are receiving in fund term negotiations.

II. Lack of Cost Transparency

While private equity is an expensive asset class, LPs are sophisticated investors and have made a calculation that prospective net returns are sufficiently attractive to warrant investment. Generally, the supply and demand dynamic in the market[2] makes it difficult for LPs to lower the cost of investment and adjust the economic terms, beyond select LPs of substantial scale that may receive co-investment rights[3] to lower their overall fee profile. Data from ILPA's research suggests that most funds charge a 2% management fee and a 20% performance fee, after the achievement of an 8% preferred return paid to

[1] ILPA will be releasing a report on trends in private fund terms in October 2021, based on data from an ILPA survey and anonymized and aggregated LPA data from an ILPA technology partner, Colmore. This data is accompanied by commentary by K&L Gates LLP. All references below regarding the findings of the report are labeled as ILPA Fund Terms Report 2021.

[2] ILPA's members continue to increase their allocations to private funds to meet their requirements for risk-adjusted returns, diversification, and access to small and emerging growth companies unavailable in the public markets. America's public pension plans have continued to increase their allocations to private markets, which they generally access through funds, given those plans' strong reliance on investment returns to meet their obligations to beneficiaries, including state and local government employees, teachers and first responders. Given the need to access the highest performing funds, regularly deploy capital, growing global competition for allocations, and a small pipeline of new, proven private fund managers coming to market, demand exceeds supply in the marketplace.

[3] Co-investors often invest in the private equity fund, but also can invest additional capital alongside the GP in particular portfolio companies at a no-fee basis, thereby lowering the overall cost of investment.

LPs.[4] LPs are occasionally able to realize management fees of 1.5% in larger funds (i.e., AUM over USD 3.0 billion), although growing fund sizes often result in higher fees in absolute dollar terms.[5]

The complexity of fee disclosures in the LPA also creates specific challenges, as the bright line costs of a 2% management fee rarely change, but an increasing number of items previously covered by the management fee, such as traditional adviser responsibilities and staff, are now partnership expenses.[6] This was likely accelerated by the SEC's efforts to examine the industry as more fees shifted from a "gray area" to being applied as a partnership expense. 25% of LPs in ILPA's recent fund terms report[7] found that GP administration costs, including in-house legal and accounting staff, as well as computer software, were being shifted from the management fee to be paid as a partnership expense. Other expenses, such as deal sourcing costs (including private jet travel), the salaries of advisers and affiliates, and regulatory filings and compliance, also continue to be shifted outside the coverage of the management fee, suggesting the management fee is transforming into a GP profit center, as opposed to its traditional use to "keep the lights on." As a result, LPs must constantly push back on various charges moving from the manager side of the ledger to the fund.

This complexity of fees and expenses charged to the fund is magnified by the fees charged by the manager to the portfolio companies, thereby impacting the overall return profile of these companies at exit and providing additional revenue streams for the manager. Many LPs have resorted to negotiating fee offsets to address this "leakage", but that has dramatically raised the difficulty of tracking and validating that the fees charged are both charged correctly in practice based on the LPA and potentially offset by reductions in the management fee.

The SEC has highlighted the issue of inappropriately charged fees and expenses since regulating the private fund industry, beginning in 2014 with the Sunshine Speech.[8] In every speech or risk alert regarding the private fund industry since that time, the SEC has indicated that inappropriate charging of fees and expenses on investors is a significant finding.[9] For example, in the most recent June 2020 Risk Alert, the SEC highlighted that "*Advisers charged private fund clients for expenses that were not permitted by the relevant fund operating agreements, such as adviser-related expenses like salaries of adviser personnel, compliance, regulatory filings, and office expenses, thereby causing investors to overpay expenses*."[10] The SEC has the power to address this issue through required disclosures under the Advisers Act.

ILPA worked together with LPs and select GPs, to develop a solution for this validation issue through the creation of the ILPA Fee Template in 2016. The template provides a standardized way for managers to report their cash flows to LPs. Despite growth in adoption, the Fee Template's transparency is only available to those LPs that have the negotiating leverage to receive it. The need for fee transparency has been magnified by state laws in California and Texas that require public pensions to receive this

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[4] ILPA Fund Terms Report, 2021.

[5] ILPA Fund Terms Report, 2021.

[6] ILPA Fund Terms Report, 2021.

[7] ILPA Fund Terms Report, 2021.

[8] Spreading Sunshine in Private Equity., U.S. Securities & Exchange Commission (May 6, 2014), *available at*: https://www.sec.gov/news/speech/2014--spch05062014ab.html

[9] Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement, U.S. Securities & Exchange Commission (May 12, 2016), *available at:* https://www.sec.gov/news/speech/private-equity-enforcement.html

[10]Observations from Examinations of Investment Advisers Managing Private Funds, U.S. Securities & Exchange Commission (June 23, 2020), *available at:* https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf

reporting, limiting their investment options to those GPs that are willing to provide it.[11] While ILPA supports fee transparency, we believe these state laws limit the options of smaller public pensions in those states and believe there should be required reporting from the manager to all investors in the fund, avoiding the need to negotiate this critical validation tool on an individual basis.

LPs encourage the SEC to:

1. Create a new rule under Section 206 of the Advisers Act to require private fund advisers to report all direct and indirect fees, expenses, and fee offsets applied in connection with the adviser or its affiliates. This new rule should be *principles based*, to ensure flexibility to adjust to market changes through issued staff guidance and SEC examination direction on private fund advisers, without the need for SEC rulemaking to continually update a form or SEC-created template. We believe the industry will ultimately coalesce around an industry standard (likely the ILPA Fee Template) to meet the obligations required under this principles-based rule and would encourage the SEC not to introduce another fee template into the market.

2. Issue guidance on what should be covered by a private fund management fee, as opposed to expenses charged to the fund, to address the continued cost-shifting in the marketplace.

III. Erosion of Downside Risk Protections and Increased Conflicts of Interest

As ILPA has highlighted extensively, we are concerned about the erosion of fiduciary duties in LPAs for private funds domiciled under Delaware or Cayman law. Delaware (2004) and Cayman (2014) laws changed to permit the duty of loyalty and duty of care to be contracted away in investment partnership contracts.[12] This has resulted in a significant loss of downside risk protection for LPs, as was stressed in a 2014 academic paper by the recent Delaware Chief Justice, Leo Strine:

> "[a]mong the hallmarks of [alternative investment contracts] are broad waivers of all fiduciary duties, including duty of loyalty. Traditionally, the duty of loyalty provided the most meaningful protection to passive investors in corporations and partnerships. Yet at the same time the alternative entity agreements eliminate this bedrock protection, they also fully utilize the expansive contractual freedom authorized by alternative entity statutes to grant managerial discretion…. [t]he practical alternatives for skeptical investors are often stark: invest without adequate protection against self-dealing or avoid the asset class together."[13]

These state law changes have been magnified by changes in federal law, notably the decision in *Goldstein v. SEC* which originally prevented the SEC from applying an interpretation that would consider LPs within a private fund as "clients" of the investment adviser under the Investment Advisers Act of 1940, and thereby being owed an individual fiduciary duty by the private fund adviser.[14] This decision at the time effectively prevented the registration of private fund advisers and ensured no private right of action for LPs under the Advisers Act, forcing them to rely on the SEC for remedies or that designated under the contractual arrangements with the GP, typically a limited partnership agreement. Further changes, which were essentially codified into the 2019 SEC's interpretation of the investment adviser standard of

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[11] California Assembly Bill 2833 (2016); Texas Senate Bill 322 (2019).

[12] DEL CODE ANN. Title 6, §§ 17-1101(d), 18-1101(c); *The Exempted Limited Partnership Law, 2014,* Cayman Islands (Law 5 of 2014, July 2, 2014).

[13] Leo E. Strine Jr. and J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom,* Harvard University John M. Olin Center for Law, Economics and Business, Discussion Paper No. 789, P. 3, August 2014.

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

care, permitted advisers to also limit their liability in investment contracts with their clients.[15] At the state level, these legal changes resulted in the reduction of fiduciary obligations in the LPA, not always explicitly stated, but diffused throughout the document. These changes closed the possiblity of recourse under the Advisers Act, resulting in LPs being more reliant on the SEC to police bad actors. While litigation is rare in the private fund industry, these provisions would set strong guardrails around bad behavior in addition to the SEC's examination and enforcement powers.

Concurrent with fiduciary obligations being reduced, the complexity and the size of the private fund industry has grown, resulting in more potential conflicts of interest that must be managed. As a recent Deloitte article highlighted,

> "[p]rivate equity has unique and inherent [conflicts of interest] for a number of reasons. For example, potential conflicts may include how the manager handles issues arising from controlling investments in a portfolio company from which they receive fees; how fees and expenses are allocated to private equity funds versus the management company; and the process of how the private equity firm may direct its portfolio companies to use service providers, buy products or influence financial reporting… [these] conflicts differ from hedge funds and mutual funds since private equity firms have a higher level of control over their portfolio companies compared to the continued arms-length investments of the other types of managers."[16]

The SEC has indicated repeatedly in its risk alerts that inadequately disclosed conflicts persist in the private equity industry,[17] and the growth of large platforms in the space with multiple funds and strategies – as well as new structures for co-investment, sales of management company interests and a thriving secondaries and fund restructurings market – have all raised the likelihood of conflicts of interest that must be addressed. The loss of fiduciary duty protection has magnified these growing risks and limited self-help mechanisms for LPs. Furthermore, since there is no requirement to have an independent board of directors in private funds, as in registered funds, there is no independent voice to address and resolve these conflicts of interest.

The SEC could take action to address this in a variety of ways, depending on how it aggressive it would like to be, including by taking the following actions:

1. Explicitly preempt state partnership law in connection with federally registered investment advisers by holding that SEC registered private fund advisers are not permitted to contract to a lower standard in their limited partnership agreements.

2. Provide additional rulemaking and guidance from the Division of Investment Management on how private fund advisers manage their conflicts of interest, with a specific focus on requiring certain conflicts to be mitigated as opposed to merely disclosed.

Regarding the first approach, the SEC could apply a new rule preventing an SEC registered private fund adviser from contracting away their obligations under state law in the LPA, finding it incongruent with the obligations under the Advisers Act. This would effectively seek to preempt the provisions in the LPA.

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[15] Heitman Capital Management No-Action Letter (2007).

[16] Deloitte Center for Financial Services Analysis, *Private Equity Growth in Transition,* (2016) at 13, *available at:* https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-fsi-private-equity-growth-in-transition.pdf

[17] U.S. Securities & Exchange Commission*,* Risk Alert, OCIE, *Observations from Examinations of Investment Advisers Managing Private Funds* (June 2020).

However, the SEC has in the past been sensitive not to explicitly preempt state law, and ultimately, we understand this represents a policy question for the Commission.

Second, the SEC could consider new rulemaking and guidance that would enhance disclosures and require mitigation of specific conflicts of interest with private fund advisers, without directly addressing the broader fiduciary duty itself. ILPA suggests the following items as a starting point, with the SEC reviewing its examination program for areas where these issues are ripe to be addressed:

- Private fund advisers should be required to disclose publicly in Form ADV the standard of care that they have to LPs under the LPA in each private fund they advise. The standard should apply equally to all investors in each fund vehicle, and the disclosure should indicate what duties the adviser believes it owes to LPs in clear language.

- The SEC should prevent "pre-clearance" of conflicts of interest where the private fund adviser seeks to disclose all anticipated conflicts at the time the LPA is signed. The private fund adviser should be required to have a certain level of clarity around the conflicts and seek true "informed consent" to proceed, by a certain LP minimum vote threshold, or else seek to mitigate the conflict.

- The SEC should indicate that each private fund should have a Limited Partner Advisory Committee (LPAC) with certain information and resource rights for the LPs, to provide feedback on conflicts. Certain levels of conflict could be approved by the LPAC, with others requiring a vote of LPs.

- The SEC should require a minimum amount of notice, as well as fulsome information for certain conflicted transactions, including fund restructurings and continuation funds, in line with the ILPA guidance.[18]

- The SEC should provide greater guidance and clarity around the conflicts surrounding cross-trades, GP stake sales, co-investments, private fund adviser interest in recommended investments and the financial relationships between clients, affiliates, and the adviser.

- The SEC should require GPs to provide deficiency letters and other feedback from regulatory investigations, including that from the SEC to all their investors.

- The SEC should require greater disclosure of fund-level leverage and of how the private fund adviser utilizes it.

- The SEC should not agree to allow private fund advisers that settle SEC enforcement actions to seek indemnification for their penalties and legal costs under the fund agreement, as a condition of settlement.

ILPA appreciates the opportunity to continue to serve as a resource to the Commission in the areas noted herein. We believe the steps described above will materially enhance the functioning of the private funds market and support the achievement of long-term investment returns that are critical to LPs and their beneficiaries.

Please feel free to contact Chris Hayes, Senior Policy Counsel at chayes@ilpa.org with any questions on this letter.

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[18] *GP-led Secondary Fund Restructurings, Considerations for Limited and General Partners*, Institutional Limited Partners Association (April 2019), *available at:* https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-Restructurings-Apr-2019-FINAL.pdf

Sincerely,

Steve Nelson
Chief Executive Officer
Institutional Limited Partners Association (ILPA)