MEMORANDUM

TO: File No. S7-03-22

FROM: Jill S. Henderson, Senior Counsel to the Director and Chief Economist
Division of Economic and Risk Analysis

RE: Meeting with Institutional Limited Partners Association (ILPA)

DATE: April 19, 2023

On April 17, 2023, staff from the Division of Economic and Risk Analysis, the Division of Investment Management, and the Chair's Office met with representatives from the Institutional Limited Partners Association (ILPA). The general topics discussed included the Commission's proposal on *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews.*

Attendees from the SEC included Ross Askanazi, Jill Henderson, Lauren Moore, Alex Schiller, and Charles Woodworth (Division of Economic and Risk Analysis); Shane Cox, Robert Holowka, Neema Nassiri, and Thomas Strumpf (Division of Investment Management); and Jay Krawitz (Chair's Office).

Attendees from ILPA were Neal Prunier, Brian Hoehn, Amar Dzaferovic, Jody Shaw (Allstate), and Heather Traeger (Teacher Retirement System of Texas).

Attachment:

- ILPA Discussion on Recommendations for Private Fund Adviser Rules

ILPA Discussion on Recommendations For Private Fund Adviser Rules

Participants

ILPA Members
Heather Traeger – General Counsel & CCO – Teacher Retirement System of Texas (Texas TRS) – Member of ILPA Legal Advisory Council (LAC)
Adrian Ohmer – Investment Director – The Kresge Foundation – Member if ILPA Board of Directors
Jody Shaw – Counsel – Allstate Investments – Member of ILPA Legal Advisory Council (LAC)

ILPA
Jen Choi – CEO
Neal Prunier – Senior Director, Industry Affairs
Amar Dzaferovic – Director, Legal and Regulatory Affairs
Brian Hoehn – Senior Associate

Focus For Meeting

Review ILPA's recommended changes to the Private Fund Advisers Rules in key areas:

- Deeper Dive into Bargaining/Negotiations
- Fiduciary Duties – View on "Negligence" vs. "Gross Negligence"
- "Best-in-Class" MFN Process – Comparison to Initial Rulemaking Language
- Fee/Expense Reporting + Allocation of Costs to the Partnership
- Prohibitions – Review of Prohibitions with Lens Towards Side Letters

Helpful Materials

Written Analysis (WA) – https://ilpa.org/wp-content/uploads/2023/03/ILPA-SEC-Private-Fund-Advisers-Analysis.pdf

Data Packet (DP) – https://ilpa.org/wp-content/uploads/2023/03/ILPA-Private-Fund-Advisers-Data-Packet-March-2023-Final.pdf

ILPA Original Comment Letter (April 25, 2022) - https://ilpa.org/wp-content/uploads/2022/04/ILPA-Final-Comment-Letter.pdf

Negotiation/Bargaining	
Description of Issues	- GPs argue that since LPs are sophisticated investors, they can negotiate for the contractual terms they need/want to invest in PE. Therefore, GPs argue the rules are unnecessary. - However, market forces have, over the past decade, eroded elements of the partnership between LPs and advisers. This has coincided with the emergence of certain practices that must be addressed for the industry to thrive and continue to deliver superior investment results. - The structural features of the negotiating process and the lack of aligned incentives do not encourage efficiency or better negotiated outcomes. - As such, ILPA believes that thoughtful, deliberate and principles-based implementation of the proposals within the SEC rule would benefit all industry stakeholders.

ILPA Views	- Expertise, sophistication, and commitment size does not necessarily translate into bargaining power for LPs.
	- The first draft of the LPA is written by the GP and the GP's counsel. LPs nearly unanimously report that the starting point of LPA terms has shifted in favor of the GP in recent years.
	- Consolidation in the pool of GPs' external counsel serving the industry has exacerbated these effects, which means that switching to a different GP will likely not yield differences in the LPA negotiation process as experienced by LPs.
	- Extreme reluctance by GPs' external counsel to put negotiated terms in the LPA.
	- Misalignment in incentives to negotiate efficiently between LPs and GP external counsel.
	- Information asymmetry on multiple-levels:
	    - GP and its counsel have complete information on all issues being raised by all potential LPs (including the issues, beyond those ultimately agreed to in side letters and disclosed during the MFN process)
	    - GP external counsel using LP negotiations across different funds and GPs again them precedentially in negotiations
	- Several factors inhibit LPs' ability to switch GPs if they are dissatisfied with terms:
	    - One is the structural nature of the approval and investment process for LPs
	    - Another is the "fear of losing allocation" to the highest performing GPs, a meaningful consideration given the performance dispersion between top- and median-performing GPs
	    - Additionally, the requirement for larger LPs to allocate a minimum amount of capital per fund (i.e., "check sizes") dictates the minimum size of the fund in which they can invest
	    - For most, minimum institutional quality requirements also present a gating criterion that limit the pool of potential funds in which an LP can invest
	- The proposed rule would directly benefit the industry by improving key terms, thus taking them off the negotiating table and allowing LPs to focus on negotiations in other important areas. This would reduce the pressure LPs face as part of the "prisoner's dilemma" that negatively impacts the bargaining equation.
	- If LPs had the negotiation power and leverage to the extent outlined in industry groups' responses, LPs would have more success in negotiating their "must-haves." LPs are not able to address sub-optimal terms of their "must-haves" at the rate one would expect were there to be a level playing field in negotiations. Especially considering any success is typically achieved through side letters rather than the LPA itself, this also represents significant **market inefficiencies as all LPs are spending time and energy negotiating for minimum standards for cost disclosures and fiduciary duties**. This is at the heart of why ILPA supports reforms in this space.

Meaningful Data to Support Recommendations	- The **majority of LPs (65%)** indicated they are not able to exploit expertise or negotiating leverage to achieve favorable changes in common contractual terms – with **only 8% of LPs** reporting they can achieve favorable changes due to negotiating leverage. (WA – pg.4 / DP pg. 8) - LPs **nearly unanimously report that the starting point of LPA terms has shifted in favor of the GP** (observed by **97% of LPs**) in recent years, with another **87% of LPs** reporting that **final LPA terms have tilted to the GP's favor**. (WA – pg. 4 / DP pg. 9) - **71% of LPs disagree** with the notion that the PE industry is **unconcentrated** and that they **have substantial flexibility to switch GPs if they are dissatisfied with the terms being offered**. (WA – pg. 4 / DP pg. 12)

D. Prohibited Activities (i.e. Fiduciary Duties)	
4. Limiting or Eliminating Liability for Adviser Misconduct	
Rule Text	(a) An investment adviser to a private fund may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund: (5) Seek reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund
ILPA Recommendations	- SEC should change standard from "negligence" to "gross negligence" – provided the balance of the proposal remains intact across prohibitions on carving out breach of fiduciary duty, willful misfeasance, bad faith or recklessness - SEC should ensure ordinary negligence standard should still apply to material breach of LPA and side letters - SEC should prohibit contractual provisions that expressly limit or purport to waive fiduciary duties where such a limit or waiver would result in a contractual standard of care that is inconsistent with an adviser's' duty under the Advisers Act."
Meaningful Data to Support Recommendations	- LPs continue to have limited success in restoring fiduciary duties during negotiations – only **34% in 2020** and **26% in 2021** – identified they were **able to restore or improve fiduciary duties in more than half of the funds they invested in over the previous 12 months**. (WA – pg. 20 / DP – pg. 38-39) - Restoring fiduciary duties is one of the most important contractual terms LPs prioritize during negotations – **with respondents ranking fiduciary duties second in "must-have" terms** in both **2020 (37%)** and **2022 (43%)**, representing a nearly **20% increase in prioritization** for LPs over the two-year period. (WA – pg. 20 / DP – pg. 19) - The impact of LPs prioritizing fiduciary duties is counteracted by the fact that fiduciary duties represents the **single greatest shift in terms that favor the GP as a starting point in LPA negotiations over the last three years**, **according to 59% of LP respondents**. (WA – pg. 20 / DP – pg. 19) - LPs have long expressed concerns over the erosion of fiduciary duties – with **63% in 2020** and **48% in 2021** identifying that fiduciary duties had been contractually modified or eliminated in **more than half of the funds they invested in over the previous 12 months**. (WA – pg. 20 / DP – pg. 42-43) - Only **19% of LPs** were successful in consistently restoring or improving fiduciary duties in the **LPA itself**, compared to **37%** that needed to resort to securing a more limited set of enhancements through their **side letter.** (WA – pg. 20 / DP – pg. 41)

A. Quarterly Statements (i.e. Fee/Expense Reporting + Allocation of Costs to the Partnership)	
4. Fee and Expense Disclosure	
Rule Text	(b) Fund table. The quarterly statement must include a table for the private fund that discloses, at a minimum, the following information, presented both before and after the application of any offsets, rebates, or waivers for the information required by paragraphs (b)(1) and (2) of this section: (1) A detailed accounting of all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the fund during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation; (2) A detailed accounting of all fees and expenses paid by the private fund during the reporting period (other than those listed in paragraph (b)(1) of this section), with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and (3) The amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser or its related persons.
ILPA Recommendations (Specific to Fee and Expense Disclosure)	- SEC should require private fund advisers to make fee and expense reporting available at the pro rata individual investor or limited partner (LP) level, upon the investor's request. - SEC should confirm that in cases where managers already provide standardized reporting such as, but not limited to, the ILPA Reporting Template they have satisfied the requirements of the rule, obviating the need to provide additional fund-level reporting and preventing against managers electing to provide fund-level reporting alone. - SEC should make allowances for timeline to provide information based on industry accepted practices - the proposed requirement for distribution of fund-level information within 45 days of quarter close is appropriate for traditional private equity managers for all but fiscal year-end reporting, whereby 90 days or more following the stated fiscal year end of the fund is the accepted market standard. More time may be required in cases where the GP is honoring commitments to provide individual LPs with specific or pro rata reporting, as agreed per fund documents, or in instances where the strategy requires additional time, such as Secondary Managers, Fund of Funds, or Fund of Fund of Funds.
ILPA Recommendations (Allocation of Costs to the Partnership)	- SEC should require a hybrid approach to determine which costs should be covered by the management fee, combining both a principles-based approach as well as express prohibitions on charging certain costs outside of the management fee. - Express prohibitions: - Overhead (office space, furniture, computers, telephones, facilities, utilities and communication) - Remediation and settlement costs stemming from examinations, investigations or enforcement actions - Principles-based approach built on idea that the management should be reasonable and be directly tied to the normal operating cost of running the fund and operating the firm – with insight provided across Reporting/Transparency, Firm/Management Company, Fund, and PortCo levels.

ILPA Recommendations (Connection to Other Rules)	*Rule*: Prohibition on Charging Certain Fees and Expenses to the Fund - SEC should confirm that costs associated with satisfying the proposed quarterly reporting requirements would not be considered a prohibited compliance cost, as LPs would benefit from this enhanced reporting and could reasonably be expected to bear a pro rata portion of such costs, particularly in cases where the reporting is provided by a third-party fund administrator and approved by LPs within the LPA as an allocable partnership expense. *Rule*: Grandfathering - With the exception of required quarterly statements and annual fund audits, the SEC should only have the rules applied to new funds formed after the implementation date, to avoid the necessity of renegotiating existing fund agreements, side letters and subscription agreements, the cost and uncertainty of which would be borne by LPs. - SEC should require compliant quarterly reporting (within the Quarterly Statement rule) within a reasonable lookback period of 2018 fund vintages and later. - SEC should provide emerging managers with an additional year for the implementation timeline for the Quarterly Statement rule with an adjusted lookback period of 2022 fund vintages and later ILPA also supports consideration of an extended implementation timeline for smaller or newer managers that require more time to modify practices to comply.
Meaningful Data to Support Recommendations	- Majority of **LPs (55%)** still indicate that they **do not believe that GP-provided reporting on fees, expenses and performance provides the needed level of transparency** – a figure more than **double the LPs that view the current reporting as sufficient (25%)**. (WA – pg.16-17 / DP – pg. 23) - Only **8% of LPs observed that GPs would commit to provide the ILPA Reporting Template in the LPA** – with **75% indicating the commitment was typically either made through the side letter or informally** and not reflected in fund documents at all. (WA – pg. 17 / DP – pg. 24) - **56% of LPs** indicate that information transparency requests granted to one investor are generally not granted to all investors. (WA – pg. 17 / DP – pg. 25) - 59% of LPs reported receiving the template more than half the time – with **a large portion (41%) receiving the template less than half of the time**. (WA – pg. 17 / DP – pg. 26) - **Fee and Expenses Disclosures** rose significantly to be the **top "must-have" term in negotiations in 2022 at 51%** - representing a **168% increase between 2020 and 2022**. (WA – pg. 15-16 / DP – pg. 19) - Additional data provided in Written Analysis/Data Packet that speaks to the shifts towards the GP favor related to fee/expenses, including in-depth analysis of Costs Excluded from the Partnership. (WA – pg. 18-20 / DP – pg. 27-36)

E. Preferential Treatment (i.e. Side Letters and "Best-in-Class" MFN Process)	
4. Other Preferential Treatment	
Rule Text	(b) An investment adviser to a private fund may not, directly or indirectly, provide any other preferential treatment to any investor in the private fund unless the adviser provides written notices as follows: (1) Advance written notice for prospective investors in a private fund. The investment adviser shall provide to each prospective investor in the private fund, prior to the investor's investment in the private fund, a written notice that provides specific information regarding any preferential treatment the adviser or its related persons provide to other investors in the same private fund. (2) Annual written notice for current investors in a private fund. The investment adviser shall distribute to current investors, on at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with this section, if any.
ILPA Recommendations	- SEC should reaffirm that side letters are essential to investors. - SEC should clarify that this rule does not prohibit investors from entering into bespoke arrangements with private fund advisers to secure essential institution-specific requirements. - SEC should remove provisions on prohibiting what may be included in a side letter, or policy limitations on the ability for specific LPs to receive different terms to other LPs, based on commitment size, timing or other metrics, in connection with their investment into a closed-end private fund, whether in the side letter or other contractual agreement - provided there is a "Best-in-Class" Most Favored Nation (MFN) process. - SEC should require a higher floor for a minimum standard procedure to achieve greater transparency through a "Best-in-Class" MFN process for closed-end funds as a means to satisfy the desired policy objectives. - The elements of the "Best-in-Class" MFN process (full description provided in WA pg. 25-26) should include: - Transparency - Digestible Presentation by Category - Comprehensive - Optimal Electability - Reasonable Timing - Principles-based view on other elements GP should strive for as part of a "Best-in-Class" MFN process - SEC should narrow the definition of "substantially similar pool of assets" to take into account only vehicles that invest *pari passu* with a private fund.
ILPA Recommendations (Connection to Other Rules)	Rule: Prohibition on Preferential Redemption Rights - SEC should remove closed-end funds from consideration for this rule. Rule: Prohibition on Preferential Disclosure of Certain Portfolio Company Information - SEC should remove closed-end funds from consideration for this rule.
Meaningful Data to Support Recommendations	- **76% of LP** respondents in both 2020 and 2022 identified their **organization would not be able to invest in private equity without side letters**. (WA – pg. 25 / DP – pg. 45) - **72% of LPs** do not view these critical governance, statutory or regulatory protections as having a negative impact on other LPs in the fund. (WA – pg. 25 / DP – pg. 46)

	- **78% of LP** respondents identified having a better picture of what is **"market"** would help in negotations with GPs. (WA – pg. 25 / DP – pg. 47) - With a similar question – **96% of LP respondents** identified having a better picture of what terms were actually "**market" would be at least "somewhat helpful,**" with **only 4% indicating it would not be helpful at all**. (DP – pg. 48) - **64% of LP** respondents agreed that a **well-run MFN process provided the necessary transparency about the terms being offered in the fund**. (WA – pg. 25 / DP – pg. 49)