

MEMORANDUM

To: File Nos. S7-07-18, S7-08-18, S7-09-18

From: Eric Diamond, Senior Advisor to Chairman Jay Clayton

Re: Standards of Conduct for Investment Professionals

Date: October 26, 2018

On October 24, 2018, Chairman Jay Clayton and Eric Diamond (Senior Advisor to Chairman Clayton) met with the following representatives of Institutional Limited Partners Association (ILPA):

- Rich Hall, Deputy Chief Investment Officer, UTIMCO
- Maureen Hazen, General Counsel, Florida State Board of Administration
- Heather Traeger, Chief Compliance Officer, Teachers Retirement System of Texas
- Dale Martin, Director of Illiquid Alternatives, Fire and Police Pension Association of Colorado (FPPACO)
- Steven Nelson, CEO, ILPA
- Jennifer Choi, Managing Director, Industry Affairs, ILPA
- Chris Hayes, Director, Industry Affairs, ILPA

The meeting participants discussed, among other things, the SEC's proposed rules and interpretation relating to standards of conduct for investment professionals. At the meeting, the ILPA representatives distributed the attached documents.



Hedge Clauses & Their Impact on the Private Equity Market

Background: In 2004, the Delaware legislature changed its laws governing limited partnerships and limited liability companies (LLCs) to explicitly permit parties to Limited Partnerships and to LLCs to reduce and even to eliminate fiduciary duties, including the duty of care and duty of loyalty. The only safeguard remaining under Delaware law in these instances is the implied covenant of good faith and fair dealing, which only “protects the spirit of what was actually bargained and negotiated for”.¹ This change has had a significant impact on the agreements that institutional investors are negotiating with private fund advisers, with state law permitting the insertion of these types of “hedge clauses” into these contracts, which dramatically limit the liability of private equity advisers for breaching their fiduciary duties to their investors.

Heitman Capital Management No-Action Letter: Prior to 2007, these changes in state law would have been inconsistent with U.S. federal securities law. However, on February 12, 2007, the Division of Investment Management staff issued a No-Action Letter² which overturned longstanding policy (67 years) at the SEC that “hedge clauses” were a *per se* violation of the Investment Advisers Act of 1940. Since 2007, along with significant changes which have limited investor bargaining power, we’ve seen an explosion of efforts to limit liability for the general partner and the investment manager in limited partnership and LLC agreements in private funds. These have been particularly pronounced in venture and energy funds. We urge the SEC to reconsider and rescind this no-action relief for the following reasons:

- 1) Market Challenges Have Resulted in Abuse of the No-Action Relief Due to Reduced Investor Bargaining Power:** Due to a record fundraising environment in the private equity asset class, and significantly diminished yields in other asset classes, fundraising is at all-time highs in the private equity asset class.³ 2017 was the highest fundraising year ever in the asset class, with \$453 billion raised. At the same time as fundraising amounts are at all-time highs, the number of funds closed (921) is the lowest since the Great Recession, indicating larger fundraises, with less investable fund options for institutional investors such as public pension funds. This drop in the number of funds raised (and options for investment), with massive capital flows into the asset class, have resulted in significantly less bargaining power in investment negotiations for institutional investors. Many institutional investors, particularly public pensions, are forced to deploy capital into this asset class to meet their required return thresholds to pay beneficiaries. Widespread use of non-disclosure agreements and lack of investor cooperation due to perceived antitrust risks has resulted in substantial information asymmetry among investors and between investors and the investment adviser. This significantly reduced investor bargaining power has resulted in increased efforts to disclaim fiduciary duties through hedge clauses in private equity LPAs. Prior to 2007, most private equity partnership agreements did not contain language modifying or waiving an investment adviser’s fiduciary duties, even though it was permitted under Delaware state law after 2004.
- 2) Disclaiming of Fiduciary Duties through “Hedge Clauses” Runs Contrary to the Intent of the Advisers Act:** The Advisers Act and subsequently case law over 67 years, provides that

¹ Winnifred A. Lewis, *Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 82 Fordham L. Rev. 1017 (2013), available at: <http://ir.lawnet.fordham.edu/flr/vol82/iss2/20>.

² SEC No-Action Letter, *Heitman Capital Management, LLC*, File No. 801-15473, February 12, 2007, available at: <https://www.sec.gov/divisions/investment/noaction/2007/heitman021207.pdf>

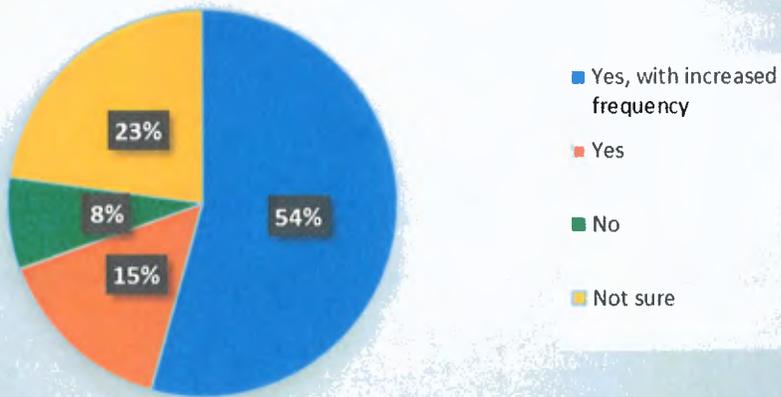
³ 2018 Preqin Global Private Equity & Venture Capital Report, p.31, available at: http://docs.preqin.com/samples/2018-Preqin-Global-Report-Sample_Pages_Combined.pdf

pursuant to the anti-fraud provisions in Section 206 of the Act, an investment adviser owes fiduciary duties to their clients, including the duties of care and loyalty. Further, under Section 215(a) of the Act, any condition, stipulation or provision binding any person to waive compliance with the Advisers Act is void. Permitting these requirements to be disclaimed by contract by an adviser under state law flies in the face of these obligations. This is even more harmful given that contractual rights are often the only way in which an investor can bring a private right of action for any damages they may have against an adviser – given that the Advisers Act is only enforceable by the SEC, and often does not recoup damages for investors.

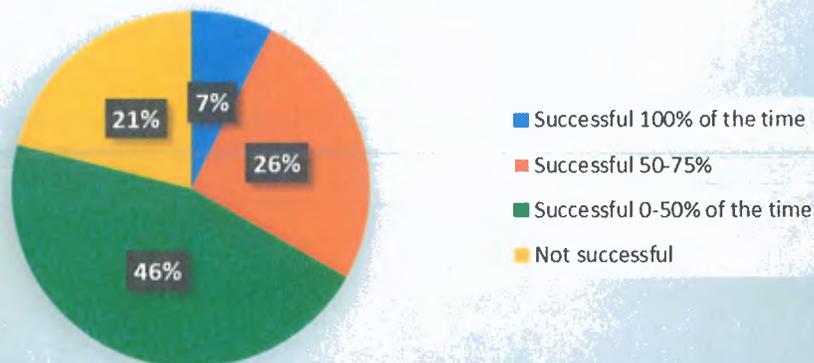
- 3) Permitting Fiduciary Duties to be Contracted Away Potentially Discourages Managers from Acting in the Best Interests of an Investment Fund:** Permitting an investment adviser to contract away its fiduciary duties changes the mindset of that adviser from acting in the best interests of the fund it is advising to merely complying with the contractual terms, including the lesser standard of care. This has potential harmful impacts in the long-term for the private equity industry, as the bulk of the money investors invest in private equity is still passively managed by registered investment advisers.
- 4) Permitting “Hedge Clauses” Promotes Significant Uncertainty in the Market and Increases Potential Unnecessary Litigation Costs:** The No-Action Relief granted by the SEC does not take a position on whether the content of specific “hedge clauses” is permissible under the Advisers Act and would “depend on all of the surrounding facts and circumstances.” As a result, what would previously be contractually clear to all parties is now subject to judicial review and analysis on the facts and circumstances would take place through litigation, which is both costly and uncertain for both investors, their beneficiaries, and investment advisers.
- 5) Private Equity’s Lack of Redemption Rights Magnifies the Loss of Fiduciary Duties:** The illiquid nature of private equity, and the long-term nature of the investment (often 12 years or more), magnifies the impact of a loss of fiduciary duties in the LPA. A limited secondary market, which evaporates upon manager wrongdoing, can result in the inability for an investor to recoup potential losses upon a breach of fiduciary duty. This could be particularly impactful to the marketplace if a failure of a large private fund adviser were to occur.
- 6) Private Equity was not regulated by the SEC when the Letter was Issued:** The SEC registration requirement for private funds was not passed until 2010, with the passage of the Dodd-Frank Act. As a result, when this no-action relief was granted, private equity was effectively unregulated in the United States. Circumstances have changed significantly since 2010, with the SEC uncovering at least 18 violations of a private fund adviser’s fiduciary duties since examinations began in 2012. Given the direction by Congress to regulate the industry and register these advisers, the circumstances that gave rise to this no-action relief have changed significantly.

The following data is drawn from an anonymized poll of over 80 LPs on how their organizations have been impacted by diminished fiduciary duty terms in private equity limited partnership agreements (LPAs). Respondents included both US and non-US LPs and reflected a range of institution types, including public and private pensions, family offices, foundations, and insurance companies.

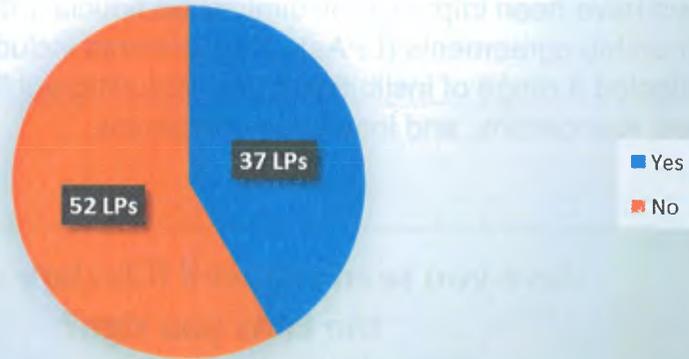
Have you seen reduced fiduciary duties in the LPAs you sign?



How successful have you been in removing diminished fiduciary protections in the LPA through your side letter agreements?



Have you ever walked away from an investment because of diminished fiduciary duties that couldn't be changed in LPA negotiations?



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State Law Developments

Squire Patton Boggs (US) LLP

—By Courtney Nowell, Matthew Cohen, and Brooke LoCoco

A Call to Duty: Waivers of Fiduciary Duty under Delaware Law

Fiduciary duty should be preserved as an essential element of a private fund manager's relationship with its investors,¹ despite the permitted waivers of fiduciary duty under Delaware law as applicable to private funds formed as limited partnerships (LPs) or limited liability companies (LLCs).² After the near collapse of the financial markets in 2009 coupled with financial scandals such as Bernie Madoff's³ Ponzi scheme, institutional investors should carefully review a fund manager's fiduciary duties and whether any waiver of such duties is incorporated into a fund's governing documents. This article provides an overview of Delaware's current approach to waivers of fiduciary duty, discusses possible implications of such waivers, and provides certain tactics when negotiating fiduciary duty in connection with a subscription to a private fund.

Delaware's Approach to Fiduciary Duty

Prior to 2004, general partners of LPs and managing members of LLCs were bound by unwavering fiduciary duties – duty of care, duty of loyalty, and duty of good faith – owed to their respective limited partners and members.⁴ In 2004, the Delaware

legislature enacted laws that shifted the focus from protecting the traditional fiduciary relationship to an emphasis on a party's right to freedom of contract. Both the Delaware Limited Liability Company Act (DLLCA) and Delaware Revised Uniform Limited Partnership Act (DRULPA) were amended to provide that fiduciary duties may be expanded, restricted or eliminated through the provisions of operating agreements and partnership agreements.⁵ As Delaware courts struggled to synthesize and, at times, disagree over enforcement of this new legislation, the Delaware legislature clarified in 2013 that in the absence of provisions to the contrary, traditional fiduciary duties still apply as a matter of default.⁶

Consistent with the underlying rationale that LPs and LLCs are creatures of contract, which should afford parties the right to negotiate the terms of their respective governing documents, Delaware courts generally uphold and enforce negotiated contract language modifying, restricting or even eliminating fiduciary duties.⁷ Similarly, Delaware courts enforce language in an agreement that specifically sets forth certain acts that will be deemed to be in satisfaction of a partner's or a member's fiduciary duties.⁸ However, despite this contractual freedom, Delaware courts require that language

intended to restrict or waive fiduciary duties be clearly provided for in the agreement, otherwise courts may still apply traditional fiduciary duties as default rules in the absence of explicit language to the contrary.⁹

In *In re Atlas Energy Resources*, the Delaware Court of Chancery expressed its concern of being “especially wary of eliminating such duties ... without sufficient evidence within the contractual language of the parties’ intent to do so.”¹⁰ In particular, the Delaware Chancery Court has wrestled with finding an explicit waiver of fiduciary duty within contractual language intended to delineate the rights of a general partner or managing member to act in its “sole discretion.” In *Paige Capital Management, LLC v. Lerner Master Fund, LLC*,¹¹ a hedge fund investor challenged a general partner’s utilization of the fund’s gate provision to limit redemptions. The gate provision provided that the general partner could invoke the gate in its “sole discretion.”¹² Despite the partnership agreement’s contractual language permitting the general partner to act in its sole discretion, the court stressed that such a clause was insufficient to constitute an explicit waiver of the general partner’s fiduciary duties.¹³ The court explained that to effectively waive fiduciary duties, the partnership agreement should clearly and unambiguously define sole discretion in a manner that is not only inconsistent with, but also precludes the application of fiduciary duties.¹⁴ Without such an explicit waiver, the court held that the general partner is still bound to act in the good faith belief that it is advancing the best interests of the fund and its partners.¹⁵ The court held that the general partner breached its fiduciary duties as it had imposed the gate provision for only self-interested reasons and not in consideration of the fund’s or the investors’ interests.¹⁶ Thus, at a minimum, Delaware courts require language in a limited partnership or limited liability company agreement to clearly set forth the fiduciary duties owed to partners or members or they will apply traditional fiduciary duties in the absence of language to the contrary.¹⁷

Implications of Waiving Fiduciary Duty

By contractually waiving fiduciary duty obligations, a fund manager “has almost no extracontractual constraints on it.”¹⁸ If all fiduciary duties are eliminated, then the limited partners are left to rely upon the “the implied covenant of good faith and fair dealing,”¹⁹ which is explicitly protected within the Delaware statutes,²⁰ but seldom found by the Delaware courts as a source of protection.²¹ Distinct from fiduciary duties, the implied covenant of good faith and fair dealing is a uniform, objective standard that applies to all contracts and intended to supply implied terms as gap fillers to any express provisions of a contract. However, as the Delaware Chancery court specifically expressed how “[p]laintiffs cannot reintroduce fiduciary review through the backdoor of the implied covenant,”²² a waiver of fiduciary duty eliminates any bargained for “code of conduct” being imposed on the fund manager.²³ This leaves an institutional investor with a thin veneer of protection at the Delaware state law level against acts by a manager or general partner it deems not acting in the best interests of the investors.

Within the context of regulated investment advisors, there is also a fundamental conflict between a waiver of fiduciary duty under Delaware law and the fiduciary duty “imposed on an [investment] adviser by operation of [securities] law because of the nature of the relationship” between an investment adviser and the fund it advises as its client.²⁴ Specifically, the Investment Advisers Act of 1940, as amended (the Act), does not set forth an obligation of fiduciary duty, but rather provides a broad framework of fiduciary duty that is inherent in court rulings and enforcement actions by the US Securities and Exchange Commission (SEC).²⁵ Fiduciary duty is also “enforceable [under] section 206 of the Act, which contains the Act’s anti-fraud provisions, and incorporated indirectly into the Act in various provisions and disclosure requirements.”²⁶ Fiduciary duty under the Act also might not be able to be “negotiated away.”²⁷

With legislation permitting contractual waivers of fiduciary duties at the Delaware state law level, government agencies such as the SEC, have expressed heightened concerns regarding the need for investment managers to be subject to a statutorily imposed fiduciary duty. SEC Chairperson Mary Jo White recently called on the SEC Staff to develop rulemaking recommendations on a uniform fiduciary standard for investment advisors and opined that the Commission should “proceed with rulemaking.”²⁸ The focus on this issue by federal regulatory agencies may result in the imposition at a federal level of fiduciary duties that could conflict with the ability to waive these duties by contract at a state level. This could also subject registered investment advisors to a different standard of care than their counterparts who are not registered, leaving institutional investors with additional due diligence tasks when evaluating potential private fund investments.

A waiver of fiduciary duty under Delaware law also raises additional concerns within the context of pension plans. Pension plans typically are managed by a manager or trustee, which owes fiduciary duties to the pension plan and its investors.²⁹ However, issues arise when such pension plan managers or trustees invest in private funds requiring them to delegate investment decisions to general partners or managing members, who may not be bound by similar fiduciary duties.³⁰ As Jeffrey Horvitz explains:

If the fiduciary institutional investor delegates, but then waives, fiduciary duty for the general partner or investment manager and/or provides substantial other exculpation and indemnification protection as to create a *de facto* elimination of fiduciary duty, there is no one left with any fiduciary duty at all. This waiver could be seen by a court as a backdoor method for eliminating the entire fiduciary duty of the plan sponsor or trustees, which might be in violation of state or federal law and public policy.³¹

The Employee Retirement Income Security Act of 1974, as amended from time to time (ERISA), imposes strict requirements on pension plan managers and trustees that delegate investment discretion to fund managers in an attempt to avoid imputation of such fund manager’s errors or wrongful acts.³² Particularly, ERISA requires pension plan managers or trustees managing “plan assets” to accept and represent to the pension plan that it is a fiduciary to such plan. Thus, a waiver of fiduciary duty might violate ERISA and create unintentional liabilities for pension plan managers or trustees.³³ Institutional investors subject to ERISA should keep this in mind when making their investment decisions regarding investment funds organized under Delaware law.

Negotiating Fiduciary Duty

As federal regulatory agencies begin to address the issue of fiduciary duties of private fund managers and general partners, institutional investors should carefully review and negotiate fiduciary duty obligations under a fund’s partnership or operating agreement. The Delaware Chancery Court has stressed that a waiver of fiduciary duty must be explicit.³⁴ Thus, negotiations of Delaware partnership and operating agreements should focus on any language ambiguities and obtaining clarifications of such terms through an amendment to the governing documents of the fund, a side letter agreement or even an email confirmation from the fund manager. In particular, institutional investors should carefully review contract language permitting a fund manager to act in its “sole discretion.” Although the Delaware Chancery Court held that simply stating that a fund manager may act in its “sole discretion” is insufficient to eliminate fiduciary duties, institutional investors should insist on written confirmation that the term “sole discretion” is interpreted to impose an obligation on the fund manager to consider and take into account the fund and its investors when exercising such “sole discretion.” The intent of such confirmation is to make it clear that the investor does not

permit the fund manager or general partner to waive its fiduciary duty under Delaware law, and could be important in maintaining an institutional investor's legal remedies under Delaware law if the manager or general partner no longer acts in the best interests of the fund or its investors.

NOTES

- ¹ Heather Traeger, Kris Easter, and Matthew Cohen, "Compliance Issues for Establishing New Client Relationships: Part 2 of 2," *The Investment Lawyer*, Vol. 20, No. 5 (May 2013); *see also* SEC Staff, *Study on Investment Advisers and Broker-Dealers: As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011), available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.
- ² *See generally* *In re Atlas Energy Res., LLC*, 2010 Del. Ch. LEXIS 216, 2010 WL 4273122 (De. Ch. Oct 28, 2010).
- ³ Stephanie Yang, "5 Years Ago Bernie Madoff was Sentenced to 150 Years in Prison – Here's How His Scheme Worked," *Bus. Insider* (Jul. 1, 2014, 6:54 PM), available at <http://www.businessinsider.com/how-bernie-madoffs-ponzi-scheme-worked-2014-7>.
- ⁴ Winnifred A. Lewis, "Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies," 82 *Fordham L. Rev.* 1017 (2013), available at <http://ir.lawnet.fordham.edu/flr/vol82/liss2/20>.
- ⁵ DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c).
- ⁶ DEL. CODE ANN. tit. 6, §18-1104.
- ⁷ *See generally* Jay W. Eisenhofer and Caitlin M. Moyna, "What Is the State of Delaware Law as It Relates to the Scope of Fiduciary Duties Owed to Investors in So-Called Alternative Entities? (Part II)," *Corporate Law & Accountability Report* (Jan. 2, 2015), available at <http://www.bna.com/state-delaware-law-n17179921814/>.
- ⁸ *See generally* Eisenhofer and Moyna, *supra* n.7.
- ⁹ *See* *Auriga Capital Corp. v. Gatz Prop., LLC*, 40 A.3d 839 (Del. Ch. 2012).
- ¹⁰ *See In re Atlas*, 2010 Del. Ch. LEXIS 216, at *23-24.
- ¹¹ *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, 2011 Del. Ch. LEXIS 116, 2011 WL 3505355 (Del. Ch. Aug. 8, 2011).
- ¹² *Id.* at *102.
- ¹³ *Id.* at *114-117.
- ¹⁴ *Id.* at *110-111.
- ¹⁵ *Id.* at *109-110.
- ¹⁶ *Id.* at *125-127.
- ¹⁷ *Id.*
- ¹⁸ Lewis, *supra* n.4, at 1036.
- ¹⁹ *Id.* at 1030.
- ²⁰ *Id.*; *see also* DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c).
- ²¹ Eisenhofer and Moyna, *supra* n.7.
- ²² *In re Encore Energy Partners LP Unitholder Litig.*, 2012 Del. Ch. LEXIS 214, 2012 WL 3792997 at *54 (Del. Ch. Aug. 31, 2012).
- ²³ Lewis, *supra* n.4, at 1037. We note that the Delaware Supreme Court recently overturned the Delaware Chancery Court's dismissal of a claim for breach of the implied covenant of good faith and fair dealing; however, this issue is beyond the scope of this article. *See* *Gerber v. Enterprise Products Holdings, LLC*, 67 A.3d 400 (Del. 2013).
- ²⁴ Staff of the Investment Adviser Regulation Office, Division of Investment Management, US Securities and Exchange Commission, "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission www.SEC.Gov," 23 (March, 2013), available at http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.
- ²⁵ *Id.*
- ²⁶ *Id.*
- ²⁷ *Id.*
- ²⁸ "Chair White Asks SEC Staff to Ready Recommendations on Uniform Fiduciary Standard," *IA Watch* (March 26, 2015), available at <http://www.iawatch.com/Content/Print/269117>.
- ²⁹ The Department of Labor recently proposed rules to redefine the scope of fiduciary duties. *See* Evan Weinberger, "Labor Dept. Seeks to Expand Fiduciary Duties," *Law360* (April 14, 2015, 3:09pm), available at <http://www.law360.com/articles/642937/labor-dept-seeks-to-expand-fiduciary-duties>. A discussion on the proposed rules is not the intent of this column, which focuses solely on current law.

³⁰ Jeffrey E. Horvitz, “Fiduciary Duty Waivers of LPs May Expose Sponsors,” *Pensions & Investments* (Oct. 14, 2013), available at <http://www.pionline.com/article/20131014/PRINT/310149994/fiduciary-duty-waivers-of-lps-may-expose-sponsors>.

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ See *In re Atlas Energy Res., LLC*, 2010 Del. Ch. LEXIS 216, 2010 WL 4273122, at *19 (De. Ch. Oct 28, 2010).

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