November 21, 2018

Brent Fields
Secretary
U.S. Securities & Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: ILPA Follow Up 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

Dear Mr. Fields:

We are writing to follow up on our letter of August 6, 2018[1], subsequent letters by ILPA members[2] in support of that letter, and the various meetings ILPA and our institutional investor members have held on this issue with the Chairman, Commissioners and staff of the Securities & Exchange Commission ("SEC" or "Commission"). These letters and meetings have centered on the challenge to fiduciary protections investors are currently facing in the private equity ("PE") market and the actions the Commission can take in terms of adjustments to staff guidance, market signals, and their recent rulemaking proposals[3] to ensure investor confidence in the marketplace.

ILPA is the voice of institutional investors in the PE asset class, known as Limited Partners ("Institutional Investors" or "LPs"). Our 470+ 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

[1] 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",* August 6, 2018.
[2] *See* Letter from Gary Bruebaker, Chief Investment Officer, Washington State Investment Board to the Securities & Exchange Commission titled *"Support for the Institutional Limited Partners Association (ILPA) position regarding Standard of Conduct or Investment Advisors, Investment Advisor Reg. File No. S7-09-18*", August 6, 2018; Letter from Jack Ehnes, Chief Executive Officer, CalSTRS to the Securities & Exchange Commission titled: *"Re: Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18*", October 11, 2018.
[3] 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")

foundations, family offices, and sovereign wealth funds, all of which invest in the U.S. PE market.[4]

Strong fiduciary duties are the foundation of the vibrant private markets in the United States. 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, increasing the risk of a negative impact on their beneficiaries. These headwinds can be greatly alleviated if the Commission acts on certain items, well within its authority, to signal to the market that it is important for investment advisers to act in the best interests of their investors. Addressing this issue 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]

To be more specific, we again urge the SEC to consider rescinding the Heitman Capital Management no-action letter[6] as part of its current review of staff guidance, as it erodes the effectiveness of the fiduciary duty standard in the Investment Advisers Act of 1940 ("Advisers Act"). We also suggest several other actions and clarifications that the Commission can take as part of the Proposed Interpretation to reestablish the effectiveness of fiduciary duties in the Advisers Act.

I. The Division of Investment Management Should Consider Withdrawing the 2007 Heitman No-Action Letter as Part of its Review of Staff Guidance

On September 13, 2018, Chairman Jay Clayton stated that "staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties." He also instructed the Division of Investment Management to "review whether prior staff statements and staff documents should be *modified, rescinded or supplemented in light of market or other developments*."[7] On the same date, the Division of Investment Management staff withdrew two no-action letters issued to proxy advisory

[4]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/

[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.

[6] Heitman Capital Management, LLC, SEC Staff No-Action Letter (February 12, 2007).

[7] *Statement Regarding SEC Staff Views,* Chairman Jay Clayton, September 13, 2018.

firms in 2004, as a reflection of the new policy.[8] We contend that the *Heitman Capital Management* letter should be similarly considered for withdrawal, given the market developments that have taken place since it was issued in 2007, most notably the significant imbalance in bargaining power between investors and private equity advisers on which it was premised.

Increasingly, LPs are faced with terms in limited partnership agreements ("LPAs") governed under Delaware law that seek to disclaim or reduce the fiduciary duties owed to them by PE Advisers. In an October 2018 poll of over 80 LP organizations conducted by ILPA, 69% of LP organizations 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. Some of the largest ILPA members 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 private equity advisers with their capital. As the poll evidences, the ability of LPs to retain basic protections has been substantially undermined since the *Heitman* letter was released in 2007. This challenge is magnified for U.S. public pensions. 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.

The *Heitman Capital Management* letter magnifies the issues of fewer or a complete loss of contractual fiduciary protections under Delaware law by permitting the inclusion of hedge clauses into LPAs. These are indemnification provisions which primarily require LPs to indemnify the private fund adviser to a higher "gross negligence" standard. The Advisers Act standard is a lower simple "negligence" standard.[9] Permitting these hedge clauses may effectively raise the Advisers Act fiduciary standard to "gross negligence" because if the SEC brings an enforcement action and settles with a PE adviser, LPs may be required to indemnify the manager for any fine the manager receives. The PE adviser effectively bears no risk by operating "negligently" under the Advisers Act

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[8] *Statement Regarding Staff Proxy Advisory Letters,* Investment Management, September 13, 2018.

[9] "Claims arising under Section 206(2) are not scienter-based and can be adequately pled with only a showing of negligence." *SEC v. Gruss,* 859 F. Supp. 2d 653, 669 (S.D.N.Y. 2012); *see also SEC v. Steadman,* 967 F.2d 636 f.n. 5 (D.C. Cir. 1992) *citing SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 195, 11 L.Ed. 2d 237, 84 S.Ct. 275 (1963), "[A] violation of § 206(2) of the Investment Advisers Act may rest on a finding of simple negligence."

because its LPs would pick up the tab. Moreover, the *Heitman Capital Management* letter sends a signal to the market that the Commission is comfortable with permitting diminished fiduciary duties in the LPA, because these indemnification clauses are often the only location in the LPA where the standard of care owed by the PE adviser to the LPs is indicated.

Rescinding this letter as part of the SEC's ongoing review of staff guidance will send a strong signal to the market that fiduciary duties matter and that investors should not be required to indemnify PE advisers for breaches of fiduciary duty under the Advisers Act.

II. The SEC Should Include the Following Clarifications in the Proposed Interpretation to Ensure There is Truly "Informed Consent" from the Client.

We encourage the staff to add several clarifications to the Proposed Interpretation that would help guide private fund advisers regarding the duty of loyalty they owe to their clients. These clarifications would not broaden any fiduciary duties under the Advisers Act, but would promote more certainty, efficiency, and understanding of the rights and obligations of both private fund advisers and the investors in their funds. The clarifications seek to ensure that disclosure is sufficient to achieve true "informed consent" from sophisticated investors. These clarifications are set forth below:

- *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.*

To promote informed consent among investors to private fund advisers, the Proposed Interpretation should require that these advisers clearly and prominently disclose the standard of care they owe to the private fund as a whole and the individual LPs within that fund. This should include the standard of care under the Advisers Act and any conflicting standard owed under the laws of where the fund is domiciled. The LPA and the private placement memorandum ("PPM") should both state this in a clear and prominent fashion. This will ensure that the investors in that fund are fully aware of the fiduciary obligations the private fund adviser is applying in their decision-making on behalf of the fund and its investors. Currently, the standard of care is not generally explicitly stated in fund documents, including the LPA. Confusing terminology and definitional terms are used to indicate what duties are owed, including the use of language permitting the adviser to act in their "sole discretion." This information is also not often prominently indicated and is buried in the legal documentation in the various documents LPs sign to invest in the fund.

- *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.*

The primary means for LPs to identify the standard of care applied by the private fund adviser to them is through the indemnification provisions of the LPA. Industry practice often limits these to a "gross negligence" standard. The SEC should make clear in the Proposed Interpretation that the standard of care that private fund advisers owe to the private fund under the Advisers Act is a simple "negligence" standard, regardless of what the fund documents may indicate. The Advisers Act fiduciary duties arise out of the antifraud provisions in section 206(1) and 206(2) of the Act.[10] The D.C. Circuit and the Southern District of New York have both indicated that section 206(2) claims can be adequately pled with only a showing of simple negligence.[11] An affirmative statement of the standard of care will add additional clarity for investors and private fund advisers.

- *"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".*

As a result of SEC examinations and enforcement actions, disclosures have proliferated on behalf of private fund advisers to their clients. While this is a positive change, many of these disclosures lack important context that prevent investors from giving true "informed consent." Many private fund advisers merely include a lengthy list of ex ante disclosures in regard to potential conflicts of interest in the fund documents prior to when an investment is made, to "pre-clear" conflicts that may arise during the life of a private fund. Many of these disclosures are vague and all-encompassing, and do not provide adequate disclosure to investors to meet the requirements of the Advisers Act.

The SEC should make it clear in the Proposed Interpretation that these disclosures must be meaningful and specific enough for investors to give "informed consent." If there is insufficient information at the beginning of the fund for these disclosures to be made, the disclosures should only be presented to the investors when and if that information can be detailed to the investors to then attain their informed consent.

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[10] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 191-192 (1963).

[11] "Claims arising under Section 206(2) are not scienter-based and can be adequately pled with only a showing of negligence." *SEC v. Gruss,* 859 F. Supp. 2d 653, 669 (S.D.N.Y. 2012); *see also SEC v. Steadman,* 967 F.2d 636 f.n. 5 (D.C. Cir. 1992) *citing SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 195, 11 L.Ed. 2d 237, 84 S.Ct. 275 (1963), "[A] violation of § 206(2) of the Investment Advisers Act may rest on a finding of simple negligence."

- *The SEC Should Indicate that for Private Fund Advisers, having a Limited Partner Advisory Committee is Best Practice, and All Perceived Conflicts Should be Presented to the Committee for Resolution.*

While not required for a private 3(c)(1) or 3(c)(7) fund, a limited partner advisory committee ("LPAC") is commonly established to provide input on conflicts of interest and other issues that impact the fiduciary duties of the private fund adviser. The LPAC often consists of the largest capital contributors to the fund, who have broader information access than the rest of the investors. Given the lack of independent boards in the private fund arena, the LPAC often serves a similar function (while not owing fiduciary duties to the fund). The Commission should indicate in the Proposed Interpretation that having an LPAC is best practice for private fund advisers and that the private fund adviser should present all perceived conflicts to the LPAC for resolution, rather than leaving that discretion to the private fund adviser. This guidance should indicate that an LPAC may be a solution to establish "informed consent" for the purposes of fiduciary duties.

- *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.*

If the Commission is unwilling to rescind the Heitman no-action letter, it should clarify the no-action letter in the Proposed Interpretation to make clear under which facts and circumstances these clauses are permissibly used and how they should be constructed. This will promote more clarity for private fund advisers and investors about the rights and obligations of the parties to the investment.

III. The SEC Should Issue Clear Guidance that Investors will not Indemnify Private Fund Advisers for SEC Enforcement Settlements

In addition to the suggested improvements to the Proposed Interpretation, the Commission should act on two other issues. First, the Enforcement Division should issue a clear statement that any settlements of an enforcement action with a private fund adviser will be conditioned upon that adviser assuming those costs, without seeking indemnification from their investors. This will help address the issue in which SEC enforcements penalize not the fund advisers, but rather the investors of a fund, and ultimately their beneficiaries, due to the indemnification clauses in the LPA. Second, the Commission should conduct an examination sweep of hedge clauses to ensure they are being appropriately and legally applied under the terms of the Heitman letter.

We look forward to continuing our dialogue with the Commission to ensure that investors and private fund advisers are aware of their rights and fiduciary obligations under the Advisers Act.

Sincerely,

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

cc. The Honorable Jay Clayton
The Honorable Kara M. Stein
The Honorable Robert J. Jackson, Jr.
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman

Dalia Blass, Director, Division of Investment Management
Paul Cellupica, Chief Counsel, Division of Investment Management