SUBMITTED ELECTRONICALLY

February 25, 2019

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-4889, File No. S7-09-18 (April 18, 2018) (the "Proposed Interpretation")

Dear Mr. Fields:

The American Investment Council (the "AIC") is submitting this letter to supplement our letter of August 7, 2018 regarding the Proposed Interpretation (the "August 7 Letter") and to respond to the February 12, 2019 letter to the Securities and Exchange Commission (the "SEC") from the Institutional Limited Partners Association ("ILPA") regarding the Proposed Interpretation (the "ILPA Letter").

The AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes, and distributes information about the private equity and growth capital industry and its contributions to the U.S. and global economy. Established in 2007, and formerly known as the Private Equity Growth Capital Council, the AIC is based in Washington, D.C. The AIC's members are the world's leading private equity and growth capital firms, united by their commitment to growing and strengthening the businesses in which they invest. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

As we stated in our August 7 Letter, the AIC's members have a longstanding and deep understanding of the fiduciary duties, including the duties of loyalty and care, imposed by the Investment Advisers Act of 1940, as amended (the "Advisers Act"). While we request that the SEC modify certain aspects of the Proposed Interpretation, we understand the SEC's desire to clarify the fiduciary duties that investment advisers owe to clients, particularly in the context of a

broader initiative to clarify and, in the case of broker-dealers, supplement the duties owed to retail clients.[1]

The ILPA Letter reflects an effort by well-resourced and highly sophisticated, large institutional investors to impose, through regulation, commercial terms that have for decades been the subject of active negotiations and which they have not always been able to achieve through negotiation. We believe that the proposals made in the ILPA Letter (i) are not necessary given (a) the robust existing regulatory framework that private equity fund sponsors are subject to under the federal securities laws and (b) the sophistication of the private equity fund investors (and their legal and other counsel); (ii) are contrary to the Congressional intent of the private fund exceptions provided in the federal securities laws; and (iii) would limit the ability of private equity fund sponsors and investors to negotiate customized provisions that reflect the particular characteristics (including the return profile) of, and the risks of investing in, a particular private equity fund.

I. The Terms of Private Equity Funds Are Extensively Negotiated by Sophisticated Investors (and Their Counsel)

Before addressing the points raised in the ILPA Letter, we believe that it would be appropriate to consider the process under which the terms of private equity funds are negotiated.

Investors in private equity funds are generally among the most sophisticated (and well resourced) investors in the world. They include government retirement plans, corporate pension plans, university endowments, charitable foundations, insurance companies and sovereign wealth funds. These investors have internal and/or outside financial advisers and lawyers who help them review and negotiate the terms of any investment in private equity funds.

Before investing, prospective private equity fund investors are provided with a fund offering circular/private placement memorandum ("PPM") and summary marketing materials, the fund partnership agreement ("LPA") and, typically, the fund manager's "brochure" (Part 2A of Form ADV, the Advisers Act registration form), as well as other legal documents and access to due diligence materials. The investors then analyze the information provided; can and do

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[1] The Proposed Guidance was issued as part of an SEC initiative that also included proposals to (i) require broker-dealers to act in the best interests of their retail customers and (2) require both broker-dealers and investment advisers to clarify for all retail investors the type of investment professionals they are and key facts about their relationship. *See* Statement by Chairman Jay Clayton on Public Engagement Regarding Standards of Conduct for Investment Professionals Rulemaking (Apr. 24, 2018). While the Proposed Guidance is not limited to duties owed by investment advisers to retail clients, we believe that the Proposed Guidance is best understood in that context.

request additional information; and meet in person, often multiple times, with the private equity fund sponsor to better understand the fund and its investment strategy and terms.

If an investor is interested in investing in the private equity fund, it will typically instruct its lawyers to review the LPA. Based on this review, the investor and its counsel will provide written or oral comments to the private equity fund sponsor and its lawyers. This negotiation process is extensive and often lasts many weeks. A single investor will often raise dozens of proposed changes – and collectively investors often make hundreds of requests for modifications of the LPA. It is common for the law firm representing a private equity fund sponsor to negotiate with a dozen or more law firms representing investors at any one time. In addition, many larger institutional investors will also insist on "side letters" addressing issues of particular concern to the investor.

Investors may and often do negotiate every aspect of a fund, including (i) the fund's term and investment period; (ii) diversification requirements; (iii) investment strategy and investment restrictions; (iv) provisions concerning key persons, general partner removal, and limitations on affiliate transactions (beyond the limits imposed by the Advisers Act); (v) the process for resolving potential conflicts of interest that might arise over the life of the fund, generally through the establishment of a limited partner advisory committee ("LPAC") or other governance provisions; (vi) fee arrangements; (vii) profit- and loss-sharing provisions; (viii) allocation of investment opportunities; (ix) responsibility for offering and fund operating expenses; (x) indemnification and the standard of care; and (xi) ongoing fund reporting obligations and investor information rights. In practice, many investors have been able to negotiate exceptions from so-called hedge clauses for certain specified matters. Investors have also negotiated for additional disclosure, process and other requirements to be followed and satisfied before a fund may provide indemnification. These developments significantly undercut the premise that regulatory intervention in the negotiation process is warranted.

Private equity investors are also provided extensive information over the life of their investment including, typically, quarterly reports and annual audited financial statements. An investor may request and receive additional information beyond the information required by the LPA and be actively engaged with the sponsor during the entire term of the fund. In addition to resolving investors' issues in order to secure their investment in the fund, the sponsor generally expects to raise capital from these investors in future funds. Thus, the sponsor is incentivized to engage constructively with the investors both in negotiating the LPA and in responding to investor questions over the life of the fund.

As described above, the terms of the LPA are determined after a robust negotiation process that results in the private equity fund sponsor and the fund's limited partners agreeing on the terms of an investment in the fund in advance of their admission to the fund. This process is consistent with Congress's understanding in enacting Section 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), the exemption from regulation under

the Investment Company Act that most private equity funds rely on. Section 3(c)(7) of the Investment Company Act was "premised on the theory that [sophisticated investors] can adequately safeguard their interests in a pooled investment vehicle without extensive federal regulation."[2] Given Congressional recognition of the sophistication of private equity fund investors, it would be inconsistent with Congress's intent to layer additional restrictions on private equity fund managers and fund investors.[3]

II. The Focus on the Heitman Letter and the Effort to Impose Additional Duties and Standards of Care on Registered Investment Advisers Beyond Those Imposed by the Advisers Act and SEC Rules Are Misplaced

The ILPA Letter requests that the SEC, among other things, rescind the Heitman Capital Management no-action letter ("Heitman").[4] This request appears to be based on the belief that the Heitman letter reduces the fiduciary standard imposed by the Advisers Act. This reflects a significant misunderstanding of the Heitman letter and the standards imposed by the Advisers Act.

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[2] SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (1992) at 110. *See also id.* at 111 – 13 (discussing the proposed section 3(c)(7) exception as well as "[a] number of exemptive or safe harbor provisions under the federal securities laws … based, in part, on the degree of sophistication of investors"). Some private equity funds rely on Section 3(c)(1) of the Investment Company Act, which is available to a fund whose securities (other than short term paper) are beneficially owned by not more than 100 persons. While the investors in these funds do not need to meet the "qualified purchaser" requirements of Section 3(c)(7), they must be sufficiently sophisticated to acquire the securities in a private placement or offering under Rule 506 of Regulation D under the Securities Act of 1933, which are generally limited to "accredited investors." The definition of "accredited investor" is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary." Regulation D Revisions; Exemption for Certain Employee Benefit Plans, SEC Release No. 33-6683 (Jan. 16, 1987). *See also* SEC Staff, Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015) at 2 – 4.

[3] We also note that private equity funds and the offerings of their securities are subject to regulation beyond the duties imposed by the Advisers Act. Private equity funds and their sponsors are subject to the anti-fraud provisions of the federal securities laws, which, among other things, prohibit misleading statements to investors and prospective investors. In addition, private fund sponsors are subject to the SEC's examination program.

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

The Heitman letter merely addressed the question of whether the inclusion of a "hedge" clause and indemnification provision in an investment management agreement was *per se* misleading under the Advisers Act. The Heitman letter confirmed that "whether an investment adviser that uses hedge clauses in investment advisory agreements that purport to limit that adviser's liability to acts of gross negligence or willful malfeasance violates sections 206(1) and 206(2) of the Advisers Act would depend on all of the surrounding facts and circumstances." The SEC staff added that in making this determination, it would consider "the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client."

Moreover, the SEC staff recognized the difficulty in addressing the use of a particular type of hedge clause.[5] Thus, the SEC staff stated that it would "not provide no-action or interpretative assurances under sections 206(1) or (2) of the Advisers Act regarding an investment adviser's use of any particular hedge clause with its clients."

We believe that ILPA's focus on the Heitman letter is linked to its desire for the SEC to impose a standard of care and other duties on private fund sponsors beyond those that are required by the Advisers Act or other laws.[6] In this respect, the ILPA Letter confuses the standard for liability under Section 206(2) of the Advisers Act in enforcement actions brought by the SEC with the general standard of care imposed on investment advisers by applicable law and applicable contractual terms.[7]

The Advisers Act (unlike the Investment Company Act, which is applicable to retail-focused mutual funds) does not contain provisions limiting the use of exculpatory provisions or hedge clauses.[8] Rather, the Advisers Act is a largely disclosure-based statute that appears to be

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[5] *See id.* ("We take no position, however, regarding whether the use of any specific hedge clause and non-waiver disclosure by a Heitman Advisor would mislead any particular Client because of the fact-intensive nature of the inquiry that would be necessary to discern the relationship and communications between a Heitman Advisor and each Client (and any Intermediary), in light of the form and content of the hedge clause, and the Client's particular circumstances.").

[6] The ILPA Letter requests that the SEC "clearly state that the standard of care owed to the clients of private fund advisers under the Advisers Act is a 'negligence' standard."

[7] In most circumstances, the clauses are merely recitations of the applicable standard of care provided under local law (*e.g.*, Delaware). We do not believe that the SEC can, or should, override state or other laws addressing the fiduciary duties of fund general partners to the extent that such laws are not inconsistent with the Advisers Act.

[8] *See, e.g.*, Section 17(i) of the Investment Company Act.

based on the premise that these contractual provisions should be negotiated between the investment adviser and its client. Notably, in its discussion of an investment adviser's duty of care in the Proposed Interpretation, the SEC does not suggest that an investment adviser is subject to a negligence standard or that contractual provisions (beyond those that purport to waive rights that are not waivable) are prohibited. Indeed, as noted in the Proposed Interpretation, an adviser's duties to its clients "follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship through contract when the client receives full and fair disclosure and provides informed consent" and that "the ability to tailor the terms means that the application of the fiduciary duty will vary with the terms of the relationship."[9] This is especially true with respect to sophisticated institutional investors.

Imposing additional restrictions on contractual provisions or heightened standards of care on private fund sponsors could have tremendous practical implications for private funds and their investors. Managing a private fund typically involves making investments that involve substantial risks as well as complex "execution" risks in acquiring such investments. Private equity fund investors knowingly accept these risks in order to seek the relatively higher returns commonly associated with private equity investing. A plain "negligence" standard could curtail appropriate risk-taking behavior in the private equity investment context and potentially impair the level of returns sophisticated investors affirmatively seek when they decide to invest in a private equity fund. It is telling that, over the decades during which the terms of thousands of private equity funds have been negotiated, this "simple negligence" standard of care is rarely requested and has not become commonplace.

Moreover, it is also not uncommon for certain institutional investors in a private equity fund to negotiate, either in the LPA or in the investor's side letter, for special rights in favor of the investor. Such rights may impose a duty on the fund's sponsor to do things (which it otherwise would not be required to do) at the request of such investor and on such an investor's behalf. For example, an investor may wish to have the right to decline to accept an otherwise permitted distribution in kind of illiquid securities and instead require the fund's general partner sell such securities on the investor's behalf and for that investor's benefit. Where an investor insists on a fund's general partner agreeing to take certain special actions on the investor's behalf, the sponsor should be permitted to negotiate the applicable standard of care to which it is

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[9] The Proposed Interpretation notes that "[a]lthough the ability to tailor the terms means that the application of the fiduciary duty will vary with the terms of the relationship, the relationship in all cases remains that of a fiduciary to a client." The Proposed Interpretation also notes that an "investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty" and that a general waiver of an investment adviser's fiduciary duty would implicate "section 215(a) of the Advisers Act, which provides that any condition, stipulation or provisions binding any person to waive compliance with any provision of this title… shall be void." Proposed Interpretation at 8 (internal quotations omitted).

willing to be subject in order to grant such additional special rights. It is entirely reasonable and appropriate that in such circumstances the fund's sponsor may require an indemnity and decline to expose itself to liability when agreeing to make such accommodations on behalf of its investors. Imposing a mandatory standard of care could result in investors being unable to obtain these additional rights.

AIC believes that, particularly in the private fund context, the scope of hedge clauses, exculpation and standard of care provisions are best left to the parties to the arrangement.[10] We do not believe it would be appropriate for the SEC to impose prescriptive requirements relating to those terms as part of an effort to address the fiduciary duties imposed by the Advisers Act, because private negotiations between two (or multiple) sophisticated parties is more likely to result in a customized agreement that reflects the intentions of all of the parties.

III. The SEC Should Not Change Disclosure Requirements Applicable to Private Fund Sponsors Through the Proposed Interpretation

The Proposed Interpretation correctly states that an investment adviser is only permitted to rely on the consent of the client where it has provided full and fair disclosure and received informed consent.[11] The ILPA Letter would change the standard to say that 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.'"

Our August 7 Letter addresses in detail our views on the aspects of the Proposed Interpretation relating to disclosures of potential conflicts of interest and informed consent. We believe that "the basis for obtaining 'informed consent' from a client is to provide the client with disclosure concerning all material facts concerning the conflict." The question of whether or not a potential conflict of interest has been sufficiently disclosed cannot be answered without taking into account the sophistication of the applicable investor. As a practical matter, this means that a private fund typically discloses the type of conflicts of interest that the fund manager may face over the life of a fund. These disclosures are typically extremely detailed in order to ensure that investors are providing informed consent.

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[10] The ILPA Letter urges the SEC to conduct an examination sweep of hedge clauses "to ensure that they are being appropriately used by private fund advisers." We have no views on this suggestion other than to suggest that it seems like a poor use of valuable SEC examination resources.

[11] Proposed Interpretation at 8.

The ILPA Letter appears to suggest that the specific details of each specific conflict must be disclosed; it is unclear whether the level of specificity requested in the ILPA Letter would go beyond disclosing the types or categories of potential conflicts that the private fund sponsor might face over the life of the fund. Such a standard would not be consistent with the law and would also be impractical. As noted in our August 7 Letter, in the context of private equity funds, we believe that the investors are sufficiently capable of evaluating whether or not the disclosures with which they are presented enable them to render informed investment decisions, including with respect to conflicts of interest.[12]

Furthermore, sophisticated investors in private equity funds can, and do, (i) require additional disclosure regarding conflicts of interest, (ii) negotiate additional governance provisions or other protections with respect to issues relating to conflicts of interest and/or (iii) choose to not make investments in private equity funds where they are not satisfied that there are sufficient protections relating to conflicts of interest.

The ILPA Letter also suggests that private equity fund sponsors 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." We do not believe any additional guidance on this type of disclosure is required. The limited partners of private funds negotiate and execute the LPA that sets forth terms such as the standard of care. We also question whether they would benefit from recitations of the requirements of state and federal law in a PPM. While these types of disclosures may be appropriate for retail investors, who may not understand applicable law, we do not believe that prospective investors in private equity funds would benefit from such disclosures as they are routinely advised by their own counsel on these matters.

IV. Additional Governance Provisions

The ILPA Letter requests the SEC to "indicate that for private fund advisers, having a [LPAC] is best practice, and all perceived conflicts should be presented to the committee for resolution."

The governance terms of a private equity fund, including whether to have an LPAC or not, and which conflicts of interest are required to be presented to the LPAC, are subject to heavy negotiation between private equity funds sponsors and their sophisticated investors. There are many circumstances where an LPAC is appropriate for a private equity fund; however, there are also many circumstances where other governance structures or arrangements would be more efficient both for the sponsor and for investors. The prevalence of LPACs reflects the fact that

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[12] Indeed, the existing law presumes that such investors are capable of these evaluations. *See supra* notes 2 – 3 and the accompanying text.

sophisticated investors are able to negotiate such protections where appropriate. We see no need for the SEC to elevate the establishment of an LPAC to a "best practice." Indeed, it would have no legal effect if the SEC were to do so.

Similarly, the types of conflicts presented to an LPAC also are customized to the particular facts and circumstances of a private fund, its sponsor, its investor base and its proposed investment activity. It is common to establish an LPAC to provide fund consent to previously undisclosed conflicts of interests, unless (i) the sponsor has received prior consent through the LPA (or other governing document) or through another mechanism (such as the consent of the limited partners or an independent third party), or (ii) the sponsor otherwise adequately mitigates or avoids the conflicts of interest in compliance with its obligations under the Advisers Act and the LPA. Given these alternatives, and the guidance provided by the SEC and its staff for dealing with conflicts of interest, we do not believe that it is necessary to require a sponsor to bring "all perceived conflicts" -- a vague and overbroad concept -- to the LPAC.

V. Enforcement Proceedings

The ILPA Letter requests the SEC "to 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, rather than seeking indemnification from investors." We believe that such a statement is unnecessary. The SEC often conditions regulatory settlements on the settling party agreeing not to seek indemnification or reimbursement for penalties. We note that private fund managers may face regulatory investigations in connection with fund investments. The extent to which fund managers are indemnified with respect to investigations arising from investments that are made by the fund (beyond limitations imposed by the settlement) should be and is the subject of negotiation between the fund manager and the limited partners. As noted above, indemnification provisions are subject to heavy negotiation between private equity fund sponsors and prospective investors. There are circumstances where the investors may agree that the investment adviser may take, and be protected for taking, certain risks, where the risks could include potential legal liability. Therefore, a blanket prohibition would upset this risk-sharing agreement. We also note that the costs of settlements of an enforcement action that solely relate to the internal affairs of the fund sponsor generally are not indemnified by the private equity fund.

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The AIC appreciates the opportunity to further comment on the Proposed Interpretation and would be pleased to answer any questions you might have regarding our comments.

Respectfully,

Jason Mulvihill
Chief Operating Officer & General Counsel
American Investment Council