MEMORANDUM

TO:	File Nos. S7-07-18, S7-08-18, S7-09-18
FROM:	Olawalé Oriola, Division of Investment Management
RE:	Meeting with Representatives of the Institutional Limited Partners Association (ILPA)
DATE:	August 30, 2018

On Thursday, August 30, 2018, representatives of the Securities and Exchange Commission ("SEC") participated in a meeting with representatives of the Institutional Limited Partners Association ("ILPA") and representatives of certain of the ILPA's members. The SEC representatives present in person were Sara Cortes, Olawalé Oriola, Benjamin Kalish, James McGinnis, and Elizabeth Miller from the Division of Investment Management; Stephen Benham from the Division of Trading and Markets. The ILPA representatives present in person were Jen Choi, Chris Hayes, and Brian Hoehn. Also present in person were Courtney Nowell (Squire Patton Boggs), Maurice Gordon (Guardian Life Insurance Co.), Deena Bothello and Lisa Pettinati (Oregon State Treasury), and Michael Feuer (District of Columbia Retirement Board).

The 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 document attached.

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 Letter[2] 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.