ilpa INSTITUTIONAL LIMITED PARTNERS ASSOCIATION

The Future of Private Equity Regulation

Insight Into the Limited Partner Experience & the SEC's Proposed Private Fund Advisers Rule

2023

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ABOUT ILPA

The Institutional Limited Partners Association (ILPA) empowers and connects limited partners to maximize their performance on an individual, institutional and collective basis.

With nearly 600 member organizations representing more than $2T USD of private equity assets under management, ILPA is the only global association dedicated exclusively to advancing the interests of LPs and their beneficiaries through best-in-class education, content, advocacy and events.

About the Analysis

Since the U.S. Securities and Exchange Commission (SEC) released the proposed Private Fund Advisers (PFA) rule in February 2022, the Institutional Limited Partners Association (ILPA) has steadily engaged with its members and other industry participants on the different aspects of the rule and the impact on Limited Partners (LPs).

This analysis provides additional commentary on the proposed rule as a supplement to ILPA's original comment letter[1] submitted to the SEC in April 2022. To view all points and recommendations for adjustments to the rule, please start with the comment letter and move onto this additional analysis.

Much like ILPA's original comment letter, this analysis is aimed at the illiquid, closed-end funds space, drawing specifically on ILPA's mandate which focuses primarily, but not exclusively, on the needs of institutional LPs invested in private equity (PE) funds.

By sharing this analysis with the industry, we seek to highlight the importance of the SEC's rulemaking efforts, provide additional LP insight and perspective on different aspects of the PE industry central to the rule and further articulate ILPA's view and the views of our members. We've also provided access to never-before, publicly released data, consisting of powerful anecdotes and survey results dating back to 2020 that reveal much about LPs' experiences as investors.

We concentrated this analysis on areas where we felt it was important to provide additional context to better understand ILPA's and our member LPs' positions on specific aspects of the SEC's proposal. We open the analysis with a focus on the central theme of the nature of the bargaining process and fund negotiation dynamics. From there, we highlight fundamental disconnects between LP and General Partner (GP) views across the landscape of the PE industry and delve into critical elements of fees and expenses and fiduciary duty. Finally, we make additional recommendations on allocation of costs to the partnership, views on a "best-in-class" Most Favored Nation (MFN) process and an approach to avoiding unintended consequences.

In writing our original comment letter, as well as this additional analysis, ILPA sought to take a balanced approach in our response to the SEC. While it's the ILPA mission to empower and connect LPs, we take great pride in our role as an industry standard-setter.

To carry out this balanced approach, we worked diligently to review all facets of the proposed rule, interacted closely with our members to deeply examine their perspectives on the interconnected challenges they face as investors in the PE industry and met with industry groups and subject matter experts to pressure test our views. In making our recommendations, we considered carefully where industry practices are today relative to where they could go as a result of the rulemaking, all with a keen eye on potential unintended consequences.

Ultimately, we strongly believe that ILPA's positions represent a moderate stance with balanced perspective, backed by data that illuminates the LP experience. Where we pushed for recommended adjustments to the proposed rule, our focus has been on creating a minimum standard that elevates the baseline for engagement between LPs and GPs to the level that ILPA and our LP members believe would move the industry forward. These are not revolutionary recommendations, but rather measured, purposeful developments that align with ILPA's longstanding commitment to improve transparency, governance and alignment of interest.

This analysis represents one piece of the story; a companion data packet is available containing additional data and perspectives we've collected from our LP members over the last several years.

[1] ILPA Private Fund Advisers Proposed Rule Comment Letter

Executive Summary – Key Findings

The lack of a level playing field in the bargaining process underpins many of ILPA's views and our overall support for the proposed PFA when implemented with our suggested amendments. Our recommendations in this analysis focus on implementing minimum standards for required cost disclosures and enhanced fiduciary duties, as well as preserving the use of side letters through requiring a "best-in-class" MFN process (aligned with existing practices in the industry today) to achieve the desired policy objectives set out by the SEC and adjustments to avoid unintended consequences.

By removing certain core items from the negotiating table, such as required cost disclosures (ranked the #1 "must-have" for LPs in negotiations in 2022) and enhanced fiduciary duties (ranked #2),[2] while also providing the desired transparency during the MFN process and protecting the use of side letters (required by 76%[3] of LPs to invest in PE), the market would operate with greater efficiency and LPs would be able to focus negotiations on other critical areas that have shifted in favor of the GP in recent years.

Expertise and sophistication notwithstanding, 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.[4]

There are many factors that contribute to the structural challenges faced by LPs, such as the nature of the negotiating process across multiple parties, incentive misalignment and collective action problems. Not to mention that LPs are paying to cover the costs of a GP's external counsel.

An additional factor is the structure of the Limited Partnership Agreement (LPA) negotiating process itself, in which the first draft of the LPA is written by the GP and the GP's external counsel. 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.[5]

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. This is illustrated by the finding that most LPs (71%)[6] 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.

The impact is then compounded by the information asymmetry that exists in negotiations, especially with GP external counsel often being found by LPs to use their negotiations with other GPs against them precedentially in negotiations. While LPs are routinely threatened with claims of collusion if they consult with other LPs negotiating with the same fund, GP external counsel use their knowledge across their full client roster against LPs and their negotiations with an entirely different GP.

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.

2 ILPA Private Fund Advisers Data Packet, *Negotiation "Must-Haves" Compared to Shifts Toward GP Favor* (from ILPA Fund Terms Survey 2020 and ILPA SEC Survey 2022)
3 ILPA Private Fund Advisers Data Packet, *Importance of Side Letters for LPs* (from ILPA LCON 2020 and ILPA LCON 2022)
4 ILPA Private Fund Advisers Data Packet, *LP Expertise and Negotiating Leverage* (from ILPA SEC Survey 2022)
5 ILPA Private Fund Advisers Data Packet, *Movement in LPA Terms Over Last Three Years* (from ILPA SEC Survey 2022)
6 ILPA Private Fund Advisers Data Packet, *Unconcentrated and Switching Power* (from ILPA SEC Survey 2022)

Private Fund Advisers Rule: An Opportunity to Address Persistent Challenges for LPs

Private equity has delivered enormous long-term financial benefits to LPs, and by extension, the millions of people and essential programs they serve.

ILPA is broadly supportive and aligned with the aims underlying the SEC's proposed PFA rule.

ILPA believes the proposed PFA rule, when implemented as suggested, offers the opportunity to address persistent challenges experienced by LPs over the last decade. With our broad support of the rule in principle, we believe several aspects will further improve transparency in private markets and foster greater efficiency in the various stages of the investment life cycle between LPs and GPs.

Private equity is critical for ILPA members – nearly 60% of LP respondents do not think their organization could meet its performance requirements without investing in PE.[7] As mentioned in our original comment letter to the SEC, ILPA is a strong believer in the positive impact of PE as "private equity has delivered enormous long-term financial benefits to LPs, and by extension, the millions of people and essential programs they serve."

Private equity has made great strides in transparency, governance and alignment of interests since ILPA's founding 20 years ago, but ILPA believes that, as an institutional asset class delivering critical returns to LP portfolios, there is still room to improve. These reforms have the potential to enhance the ability of ILPA's members, as fiduciaries, to meet their obligations to beneficiaries by strengthening the dynamics of the industry. As such, ILPA remains committed to continuing the dialogue with the SEC and industry, and to enhancing the understanding of the LP perspective.

[7] ILPA Private Fund Advisers Data Packet, *Importance of PE for ILPA Members* (from ILPA SEC Survey 2022)

Private Fund Advisers Rule: An Opportunity to Address Persistent Challenges

PROPOSAL	ILPA'S STANCE
Required Quarterly Fee & Expense Reporting GPs would provide quarterly fee and expense reporting at the fund-level to all LPs in their funds.	The SEC should require GPs to provide LP-level reporting upon request and fund-level reporting to all investors with LPs reasonably expected to bear a pro rata portion of costs for this reporting.
Addresing Fiduciary Duty GPs would be prohibited from seeking indemnification or exculpation for a breach of fiduciary duty, misfeasance, bad faith, negligence or recklessness.	ILPA supports a strong fiduciary standard and substituting "negligence" with "gross negligence" provided that ordinary negligence applies to LPA or side letter breaches.
Disclosure of Preferential Treatment GPs would be required to disclose, on a rolling basis and annually, to all current or prospective LPs any preferential treatment provided to an LP.	The SEC should reaffirm that side letters are essential to investors. ILPA's recommended "best-in-class" MFN process is designed to achieve desired policy goals without imposing additional cost or time burdens.
Reducing Clawbacks for Taxes GPs would be prohibited from reducing the clawback by taxes applicable to the advisor.	ILPA supports the intent of this proposal but believes a hypothetical but reasonable rate would prevent leakage and address unintended consequences.
Non-Pro Rata Fee and Expenses GPs would be prohibited from charging fees related to a portfolio investment on a non-pro rata basis.	ILPA supports this provision but recommends the SEC should include an exception for co-investments from the rule.
Grandfathering Open question on the status of rulemaking applying towards current funds.	Except for required quarterly statements and annual fund audits, ILPA recommends the rules should be solely applied to new funds formed after the implementation date.

Since the rule was proposed in February 2022, **ILPA has met with SEC staff on several occasions, including with Chairman Gensler, to share deeper perspective on the LP experience and answer questions about the impact of the rule on LPs**, informed by data and insights provided by ILPA members.

Working to improve the PE industry is central to ILPA's mission – and working on the areas covered under the proposed rule has been an important element of our work over the last 20 years.

From standardizing capital call and distribution notices to pushing for transparency in fee and expense reporting or laying out optimal operating principles between LPs and GPs, ILPA has long been engaged on the industry norms and practices that directly impact our members.

Many of the areas identified by the SEC over the years have been identified by ILPA and our members as issues deserving greater attention. ILPA has actively pushed for strengthened fiduciary duty and raised concerns about indemnification clauses since the release of the *ILPA Principles* in 2009; these issues have also featured in ILPA's engagement with the SEC since 2016.

Sources of Disconnect between LPs and GPs

LPs and GPs are unquestionably aligned on the importance of PE to the success of LP investment programs.

LPs and GPs are unquestionably aligned on the importance of PE to the success of LP investment programs as the asset class provides access to an increasingly robust portion of the U.S. economy[8] and has "consistently outperformed public markets over the last 20 years."[9]

However, industry responses to the proposed PFA rule have exposed a fundamental disconnect between LP and GP views when it comes to the bargaining process and the negotiating leverage that LPs can draw upon to effect specific changes in transparency, governance and alignment of interest. The fundraising environment over the last decade has been marked by a meaningful shift in terms and negotiating dynamics that favor the GP. Given the investment environment, LPs are not able to walk away as easily as is often presumed due to switching costs and vital portfolio construction considerations. These factors contribute to the headwinds that LPs encounter when pressing for critical "must-haves" such as fee and expense transparency and fiduciary duty.

This is an interconnected set of challenges for LPs that the proposed rule would begin to address. While the SEC cannot control certain behaviors highlighted below – such as the nature of LPs' engagement with GP external counsel – the SEC can (and has) targeted meaningful areas that would improve the dynamics of the PE industry, such as fee and expense disclosures and restoring fiduciary duties.

To provide additional data, ILPA carried out a survey of its members in the fall of 2022 to capture member LP perspectives. This also allowed us to compare views in key areas across surveys and polling carried out over the past several years.

Fund Negotiation Dynamics and the Bargaining Process

The challenges LPs face in the bargaining process underpin many of our views and overall support of the proposed PFA rule.

The challenges LPs face in the bargaining process underpin many of our views and overall support of the proposed PFA rule. In our original comment letter to the SEC, we wrote that "market forces have, over the past decade, eroded elements of the partnership between LPs and advisers," and that ILPA does believe that "certain practices must be addressed for the industry to thrive and continue to deliver superior investment results." Even though our LP members are sophisticated investors, limitations in LPs' ability to apply negotiating leverage has a direct impact on resulting sub-optimal outcomes.

This is a key area of disconnect between LPs and GPs. A theme embraced by several industry groups responding to the rule

8 See Appendix
9 American Investment Council (AIC) Private Fund Advisers Proposed Rule Comment Letter

LPs say that, despite their expertise and apparent negotiating leverage, they are not able to achieve favorable changes in common contractual terms.

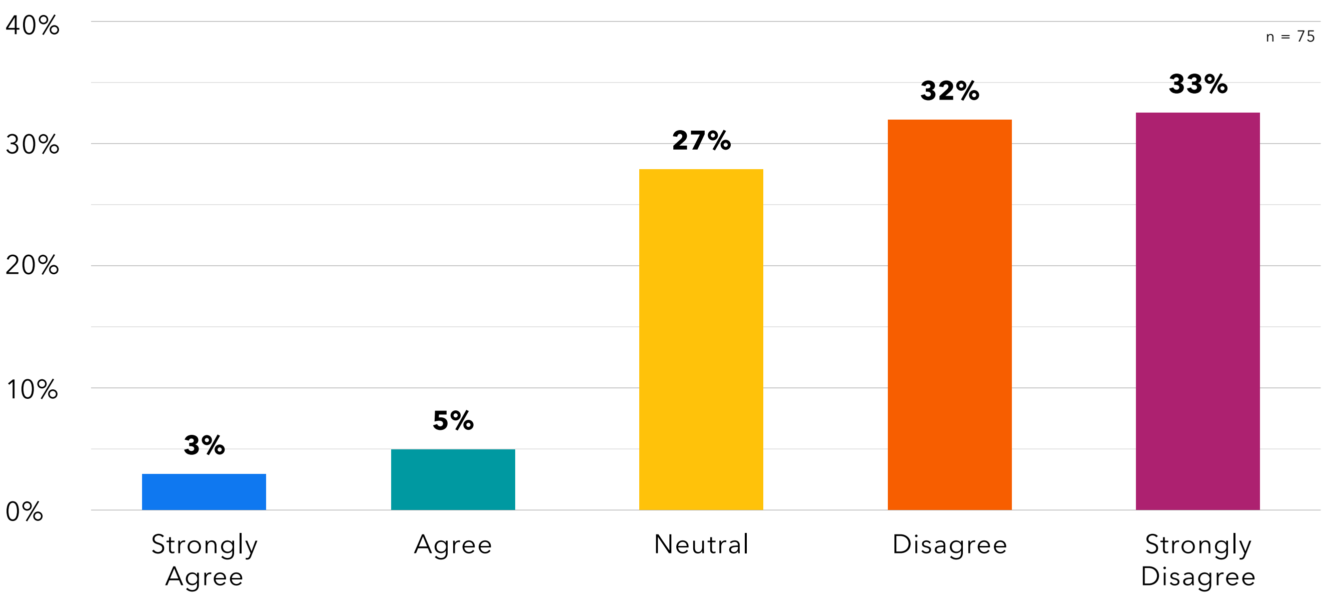
proposals posits that "there is abundant evidence" that LPs can "use their expertise and negotiating leverage (and top-notch, expert legal counsel) to achieve favorable changes in common contractual terms."[10]

To gauge our members' views, ILPA asked directly about their perspective on using their expertise and negotiating leverage (Table 1).

Table 1: Bargaining - LP Expertise and Negotiating Leverage

How much do you agree with the following statement:

The Private Equity industry has been characterized in recent years by the investors' ability to use their expertise and negotiating leverage to achieve favorable changes in common contractual terms.



Source: ILPA SEC Survey 2022

The survey results back up the sentiment long-described by LPs and highlight the disconnect with the views embraced by several industry groups. There is a strong indication (65%)[11] that LPs are not able to use their expertise and negotiating leverage to achieve favorable changes in common contractual terms, despite being sophisticated investors with access to "top-notch, expert legal counsel."[12] In this case, while LPs have expertise and sophistication and know the terms on which to push back as individual investors, they are not able to achieve the results one would expect if the playing field were level.

This dynamic is even more telling when compared to how few LPs (indicated by only 8%) are able to use negotiating leverage to achieve favorable changes.[13] The underlying reasons that certain LPs can apply leverage to revise certain terms are wide-ranging, including longstanding relationships with specific GPs, size of investment, timing of investment (i.e., seed or anchor investors), strategically

10 *Ibid.*
11 *Supra* 4.
12 *Supra* 9.
13 *Supra* 4.

important investors (i.e., co-investors) or investing in smaller GPs. However, neither expertise nor sophistication was cited as a factor for success in negotiating LP-favorable terms.

This dynamic creates structural challenges in the industry for LPs in negotiations and speaks to the industry not operating as efficiently as it could.

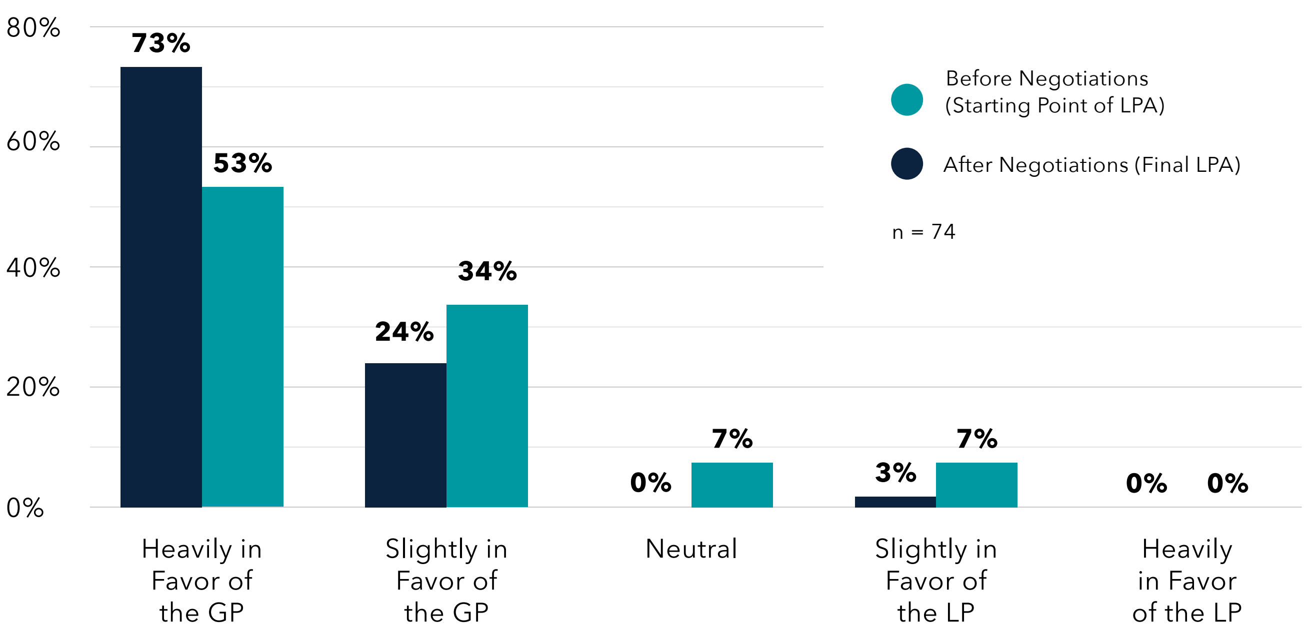
When looking at drivers behind the bargaining problem, LPs point to the complex nature of the industry and the negotiating process across multiple parties (beyond just the principal-agent equation).

The structure of the LPA negotiating process itself contributes to fund terms shifting meaningfully in favor of the GP over the last decade.[14] The first draft of the LPA is written by the GP and GP external counsel, which serves as the contractual starting point before negotiations even begin. In turn, this directly impacts where fund terms ultimately end up within the LPA. LPs then negotiate from the initial draft LPA by submitting comments and questions through their counsel to the GP's external counsel. While LPs often raise common issues in their negotiations, in an individual transaction, an LP often negotiates with a GP without an awareness of the issues being raised by other LPs in that particular transaction. By contrast, the 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). This information asymmetry contributes to the incentive and collective action problems described further below.

To gauge our members' views, ILPA asked about how terms have evolved over the last three years to favor one party over another, both at the starting point in contractual negotiations as well as the ending point (Table 2).[15] The survey results show that, over the last three years, 97% of LPs observe that the starting point of LPA terms has moved in favor of the GP, while 87% report that final LPA terms have shifted in favor of the GP.[16]

Table 2: Movement in LPA Terms Over Last Three Years

In your experience over the last three years, how would you describe the overall movement of LPA terms – in favor of GPs or LPs?



Source: ILPA SEC Survey 2022

14 Further insight is provided in the next section on the impact the structure of the LPA negotiating process and the LP investment program/process have on switching costs.
15 Each portion of the negotiation process - Before Negotiations (Starting Point of LPA) and After Negotiations (Final LPA) - was asked about in a separate question to isolate how each stage has been impacted over the last three years independent from the other stage.
16 *Supra* 5.

There are several factors driving this. According to LPs, the pool of external counsel that GPs are working with has consolidated, meaning that GPs of all sizes and strategies are working from form agreements provided by a smaller set of firms, reportedly securing business in part based on providing a starting document that is drafted in the GP's favor. Switching to a different GP will likely not yield differences in the LPA negotiation process as the shifts to the GP favor in the starting documents are common to funds being raised at that time across the industry. This is a feature, not a bug, as the creation of the starting documents with market setting terms is part of the external counsel's marketing[17] as they seek to build out their brand:

> *"Indeed, a law firm's particular form of limited partnership agreement is a type of branding: the more recognizable and sponsor-favorable the form, the more powerful the brand, and the more the firm will attract sponsor businss."*[18]

The incentives to negotiate efficiently are also not aligned. Contractually, LPs are obligated to cover organizational expenses for the fund, meaning that LPs cover the costs of the GP's external counsel creating the starting document and negotiating the fund agreement. In essence, LPs are paying to negotiate against lawyers who represent the GP — often to the tune of millions of dollars.[19] This is in addition to LPs paying their own in-house and external counsel to review the LPA and other fund documents to protect their own interests, as well as to carry out the negotiations.

Most LPs are driven by budgetary constraints to limit their own spending on negotiations, and their views on the appropriate amount to spend may be colored by the perception that negotiations often do not yield significant benefits, which in turn can create a "vicious cycle" in which LPs further reduce spending and experience less success in negotiations.

Moreover, an individual LP may be reluctant to spend limited time, resources and negotiating capital seeking preferred LPA terms that benefit all LPs collectively, rather than requirements specific to that LP's ability to invest, such as terms typically covered in side letters (as described in more detail later). Overall, greater opportunity costs and price sensitivity for LPs limit LP bargaining power, especially when considering the incentives to negotiate efficiently, with GPs and GP external counsel.[20]

Both GPs and LPs, and their respective external counsel, are generally knowledgeable about the market for PE fund terms. However, the structure of the negotiating process, exacerbated by the consolidated pool of GP external counsel, results in information asymmetry that hinders LPs' ability to fully leverage their expertise and sophistication.

Running a PE program gives many LPs the benefit of seeing a broad spectrum of fund documents and terms from multiple GPs and GP external counsel. LPs also have access to retrospective, industry data that highlights developments in terms. LPs do not, however, have insight into the terms to which a particular GP has previously agreed with other LPs in the same fund or the terms of other funds of the same GP in which that LP may not have invested previously.

In contrast, GP external counsel draws on the knowledge of all the terms offered and agreed to by the firm's full roster of GP clients. GP external counsel can access the full range of LP negotiations taking place across all funds and GPs, including the terms agreed to by dozens, or even hundreds, of LPs in a particular fund. LPs find that GP external counsel often use this information against them precedentially in negotiations. In effect, LPs are not only negotiating with the GP and GP external counsel, they are also directly negotiating against themselves and what they have agreed to in historical fund negotiations with an entirely different GP. The larger a given external counsel's roster of GP clients, the more information that can be used as leverage against LPs in negotiations.

LPs report that GP external counsel will often attempt to leverage this information asymmetry by arguing "market" terms based on the terms afforded their top-tier manager clients, but do so in negotiation with non-top-tier managers,

17 See Appendix
18 Elisabeth de Fontenay & Yaron Nili, Side Letter Governance, WASH. U. L. REV. (April 2022)
19 ILPA Private Fund Advisers Data Packet, *Lack of Cost Control on Organizational Expenses* (from ILPA Fund Terms Survey 2021 - Data Presented by Colmore)
20 Also described in more detail below are findings that the costs of negotiating side letters and the MFN process can be excluded from organizational expense caps, which further impacts the misalignment between LPs and GPs to run an efficient negotiation process.

or even emerging managers. This further compresses the range of terms being offered by a broad variety of managers, all while individual terms are shifting in favor of the GP in the starting documents drafted by GP external counsel.

Further, LPs are routinely threatened with claims of collusion if they consult with other LPs negotiating with the same fund.

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.

Concentration of PE Industry and Switching Costs

As LPs navigate the challenges with the bargaining process, they are often faced with the decision to invest with GPs despite not being fully satisfied with negotiated terms. Eighty-three percent of LPs[21] said they have proceeded with a deal despite having reservations about certain legal terms. LPs point to "fear of losing allocation"[22] with GPs if they push aggressively for certain terms; this was the most cited reason for accepting sub-optimal legal terms (59% of LPs).[23] Additionally, 84% of LPs indicated they have accepted unsatisfying terms at least "in some funds" due to fear of losing access (or receiving a smaller allocation to the fund).[24]

This fear of losing allocation speaks directly to the switching costs and vital portfolio construction considerations that make it difficult for LPs to walk away (more on this later). Given there are more LPs looking to get access to top-performing GPs and the structural investor coordination problem, LPs recognize that pushing for more LP-favorable terms might mean they lose access to the GP. [25]

Still, many industry groups point to the fully functioning state of the market by highlighting that "because the private equity industry is unconcentrated, investors have substantial flexibility to switch firms if they are dissatisfied with the terms being offered by a particular firm."[26]

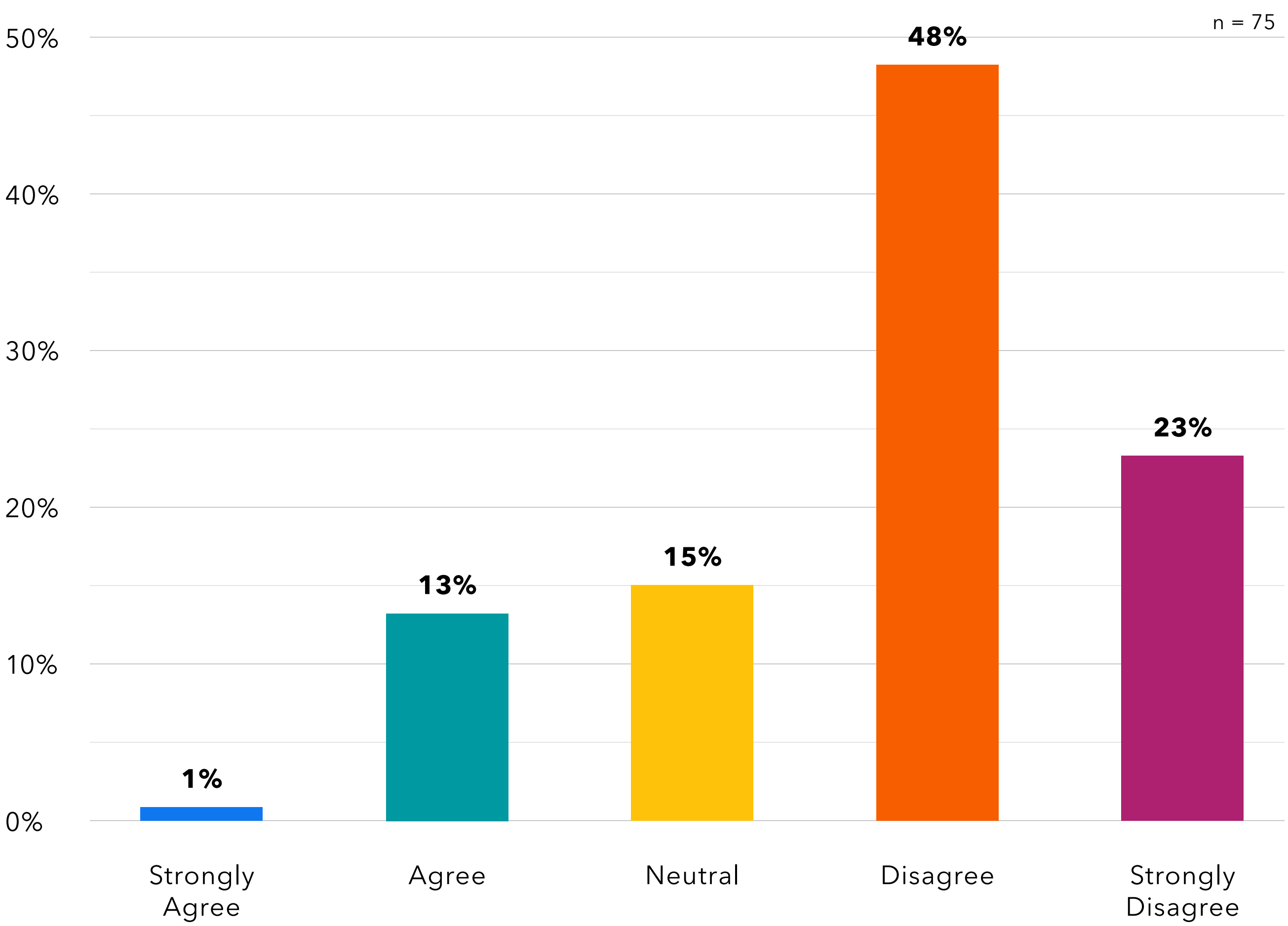
21 ILPA Private Fund Advisers Data Packet, *Proceeded With A Deal Despite Reservations About Legal Terms* (from ILPA LCON 2020)
22 Important to note that "fear of losing allocation" doesn't necessarily mean LPs fear having their entire allocation eliminated (although this can happen), but rather receiving a smaller allocation to the fund (often with GPs not providing insight into why their allocation was trimmed and presenting it as a "take it or leave it" scenario).
23 ILPA Private Fund Advisers Data Packet, *Top Explanations Why LPs Are Accepting Sub-Optimal Legal Terms in LPAs* (from ILPA LCON 2021)
24 ILPA Private Fund Advisers Data Packet, *Accepting Unsatisfying Terms* (from ILPA LCON 2021)
25 See Appendix
26 *Supra* 9.

To gauge our members' views on this point, ILPA asked about the nature of the PE industry (Table 3).

Table 3: Unconcentrated and Switching Power

How much do you agree with the following statement:

The Private Equity industry is unconcentrated and investors have substantial flexibility to switch GPs if they are dissatisfied with the terms being offered by a particular GP.



Source: ILPA SEC Survey 2022

59% of LPs said they accept sub-optimal legal terms due to "fear of losing allocation" if they push too aggressively for LP-favorable terms.

The survey results, in stark contrast with the view put forth by several other industry groups, showcases that LPs strongly disagree (71%)[27] 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. Part of this is related to the structural developments taking place in the industry as highlighted previously. More importantly, any one investment decision by LPs does not contemplate the entirety of the PE asset class, but rather a small subset of managers that align with a particular portfolio need or investment objective. For example, there may be only a dozen funds that satisfy an LP's requirements to carry out their fiduciary duties to diversify investments and meet economic objectives.

LPs have highlighted numerous factors that contribute to high switching costs in PE and why it is difficult to walk away:

Performance dispersion. The dispersion between top-performing GPs and bottom-performing GPs is significant in the PE industry,[28] meaning once LPs get access to a high-performing GP, they are less inclined to walk away for performance reasons.

Check size and institutional quality requirements. To meet their allocation targets for PE, which have been continuously rising over the last decade due to relative projected performance, LPs have increased their per fund commitments. Many institutional LPs write large, and increasingly larger, checks to keep their number of manager relationships at a manageable level or to maintain a pro-rata position in the funds from an allocation perspective as the fund size continues to grow. Not all funds can absorb large check sizes. Further, only a subset of GPs in the market have the requisite institutional track record to warrant consideration from institutional LPs as they consider their risk tolerance and their own fiduciary duties.

Structural nature of PE and LP investment programs. LPs are making commitments to funds each year, with the expectation that each fund will last 10 years, but typically longer. These investments are connected to GPs' fundraising schedules; for LPs seeking to have continued exposure to a single valued manager across multiple vintages, they need to be prepared to reinvest in the GP's next fund (or fear having their allocation trimmed or eliminated in future funds).

During different market environments, the pace of fundraising can hit a fever pitch with GPs fundraising for their next fund within 18 months of their last fund launch. For LPs investing with managers new to the portfolio where there is no pre-existing relationship, the timing of that manager's fundraise may or may not align with available space in an LP's program. Allocation (i.e., space in the fund) may also be a consideration given that managers are also taking on reinvestment from existing LPs.

Diversification is also a concern, as LPs also need to be active year-in and year-out to achieve exposure across multiple vintage years. LPs also need to achieve different levels of diversification across size, sector, strategy and geography to meet different program objectives or requirements. While the span of the PE industry is vast, the true investable universe for LPs in any given year is limited when taking all of these factors into account.[29]

Structural nature of PE and LP investment process. Identifying new GPs to invest with can take years of relationship-building from the LP investment team. In order to get comfortable with making an investment and entering into a 10-year relationship with the GP (especially considering the GP's desire for LPs to reinvest in its next fund), the LP investment team carries out deep evaluations across the operational and investment capabilities of the GP.

27 *Supra* 6.
28 23.6% dispersion between returns for median to 5th percentile manager, see Cambridge Associates, Maureen Austin & David Thurston, *Building Winning Portfolios Through Private Investment* (Aug. 2021)
29 Conversations with industry parties (including several advisers and consultants) and directly with LPs suggest that there may only be "a handful" or "a dozen" eligible funds for a given investment when considering the factors that can exist in the initial requirements (i.e., check size, institutional track record, timing, pace of fundraising, space, and diversification across vintage years, size, sector, strategy, and geography). And this is all before getting to the LPA negotiation stage of the investment process.

Reinvestments in existing GPs also require months of diligence for LPs. While there will be a review of “red flag” terms (e.g., deal breaker, walk away terms) by the LP legal team during early stages of diligence, once the LP investment team approves of an investment, the initial draft LPA (which has shifted to the GP’s favor) might only be finalized three to four weeks before the closing. This is a reduction in time from years past. This means the LP legal team, often with the assistance of LP external counsel, is under a time crunch to review the LPA and carry out negotiations, which places the LP legal team in a position to focus more squarely on the "must-have" terms.

Even though LPs would prefer to have terms in the LPA, there is typically an easier path forward in getting them agreed to in side letters, as there is strong resistance to putting terms in the LPA by the GP external counsel. LP legal teams also observe that GP external counsel will often assign only junior associates to review LP comments on the initial draft, who generally have little to no ability or authority to accept any changes. It will often take multiple rounds of negotiations before more senior staff at GP external counsel get involved, which makes the act of negotiating a costly endeavor as LPs are paying for both sides of the negotiations.

If the LP legal team insists on walking away from investments over certain terms, the LP investment team will need to find another fund in order meet allocation targets and the needed diversification. However, due to the consolidation in the market with GP external counsel, there is a strong likelihood the LP will encounter the same external GP counsel, with the same terms and the same condensed timeline to negotiate the LPA if they do walk away. This dynamic makes it less likely that an LP will walk away outside of “red flag” or so-called “deal killer” terms.

30 ‘With “competition” here referring to the view that “Investors say that they shy away from demanding high-quality terms primarily because they are afraid that if they do so, their investment allocations will be given to more accommodating investors that are not raising such concerns.” See *Supra* 25.
31 & 32 *Ibid.*
33 ILPA Private Fund Advisers Data Packet, *Walk Away Due to Fiduciary Duties vs. Distribution Waterfall* (from ILPA LCON 2020)

As noted by Professor Will Clayton in his comment letter, “[the SEC claims in the PFA proposal] that investors lack bargaining power and that investor competition[30] for investment opportunities makes it harder for investors to bargain for effective outcomes.”[31] 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.[32]

Nuances in the Negotiation Process

While the majority of LPs have at some point accepted unsatisfactory terms, the reasons why LPs proceed with a deal despite reservations about legal terms are nuanced:

Legal terms that LPs accept, but with reservations, are not “red flags” that would cause them to walk away. For example, only 35% of LPs report having walked away from a potential investment due to diminished fiduciary duties, however this is more than double the proportion of LPs who have walked away from a potential investment due to the terms of the distribution waterfall.[33] If an LP is involved in a fiduciarily sound review process, it is inevitable they will identify unsatisfying terms in a fund when looking at terms individually.

When LPs make concessions in important areas, such as “for cause” provisions that give rise to claims against a GP or trigger a GP’s removal, LPs are assessing the very low likelihood of a cause event as an acceptable risk to take in order to access a top-performing manager.

All of this further highlights the importance of taking certain "must-have" terms off the negotiating table, such as fee and expense disclosures and fiduciary duties (more on this in the next section). Doing so would reduce LPs’ fear of losing allocation over pushing for minimum standards, allowing LPs to spend more time focusing on other important terms during negotiations.

“…There is a large market, but LPs have responsibilities [for] what they can invest in. LPs are generally making large investments which typically narrows which funds they can invest in. LPs also need to diversify across sectors and strategies, not working off the full menu of funds that are available. And available options are made significantly smaller to individual LPs based on investor policy statements and their own fiduciary duty.” - ILPA Member

Importance of Required Cost Disclosures and Enhanced Fiduciary Duties

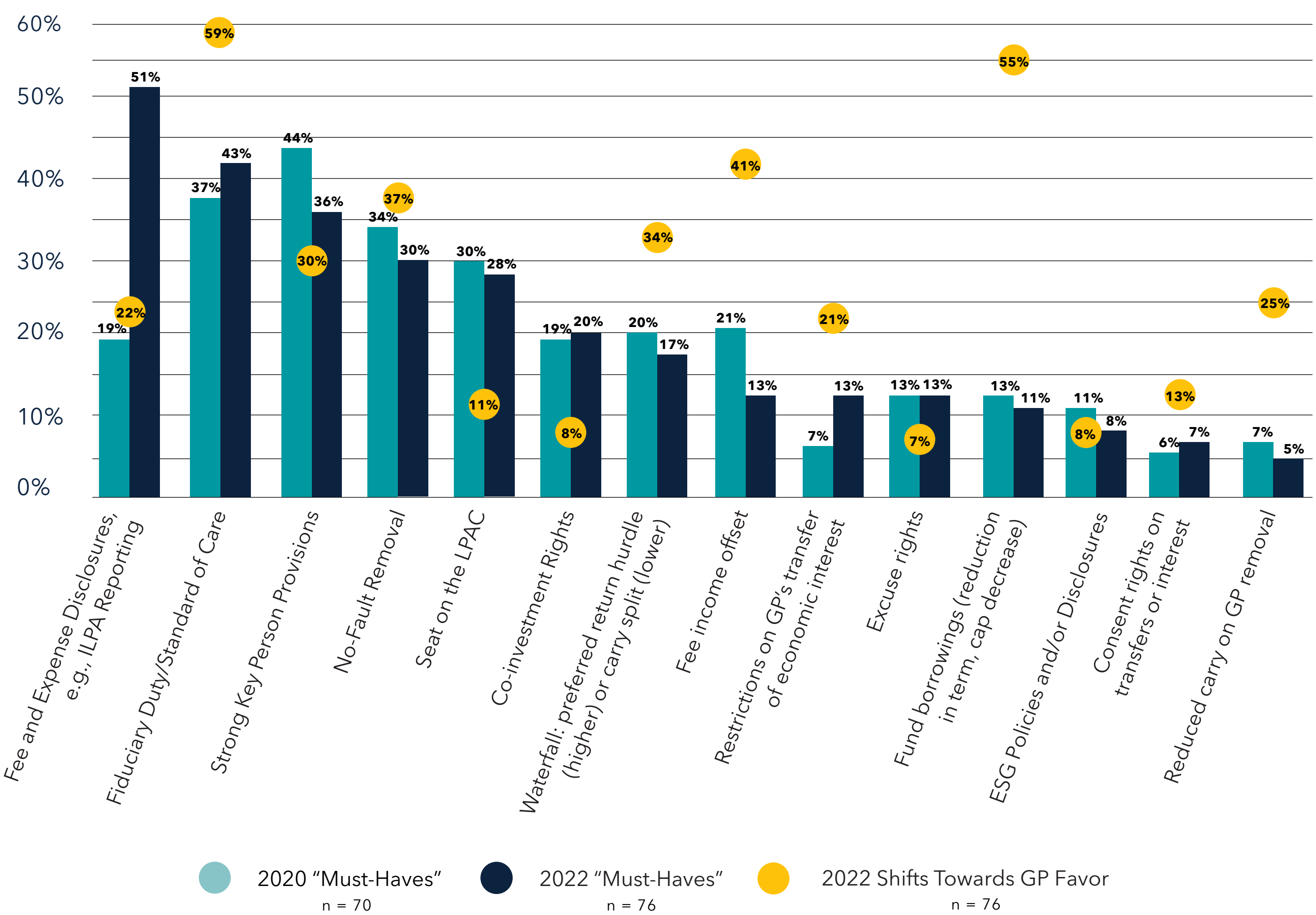
LPs are using their limited negotiating capital to address concerns and shortcomings in fee and expense transparency and erosion in fiduciary duty, both areas that the SEC seeks to address in meaningful ways through the proposed PFA rule.

Erecting a minimum standard in both areas, as the SEC has proposed to do, would allow LPs to focus negotiations on other critical governance terms such as strong key person provisions, no-fault removal and diligence letters.

To provide a more granular view on how negotiations have shifted in favor of the GP, ILPA examined LPs' views on "must-have" provisions during fund negotiations in both 2020 and 2022, and then mapped this data against where our LP members indicated they have seen the greatest shift on terms over the last three years (Table 4).[34]

The survey results identified that LPs are prioritizing and using limited negotiating capital on fee and expense transparency and restoring fiduciary duties, both areas that the SEC seeks to address in meaningful ways through the proposed PFA rule. The limited bargaining power of LPs is evident when comparing these "must-haves" for LPs in negotiations to the specific terms LPs view as shifting in favor of the GP.

Table 4: Negotiation "Must-Haves" Compared to Shifts Toward GP Favor



Source: ILPA Fund Terms Survey 2020 and ILPA SEC Survey 2022

34 The 2022 data points (*Negotiation "Must-Haves" and Shifts toward GP Favor)* were asked about in a separate question to isolate how each development has played out independent from the other. In 2020, only the Negotiation "Must-Haves" data points were asked about. Also worth noting that LPs were only able to each select "up to three" "must-haves" – this means a 51% figure (for example) indicates that 51% of LPs selected this option as one of their top three options. This forced selection was designed to mimic the actual negotiation process where LP's must prioritize certain terms over others.

While the "must-haves" for LPs have remained largely consistent, the clear exception is a more recent surge in emphasis on fee and expense disclosures, representing a 168% increase between 2020 and 2022.[35]

There is also a strong connection between what LPs view as "must-haves" in negotiations and where LPs perceive recent shifts in the starting point of LPA negotiations that favor the GP. Fiduciary duty, a consistently top-ranked LP "must-have," is also the area where the greatest number of LPs (59%) have noticed a shift in favor of the GP when it comes to the starting point for negotiations.[36]

Additionally, if LPs had the negotiation power and leverage to the extent outlined in industry groups' responses, LPs would have more success in negotiating for these "must-haves." As outlined below, 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.

Fees and Expenses

Enhanced, standardized reporting on fees and expenses has long been a cornerstone issue for ILPA, central to transparency, governance and alignment of interest between LPs and GPs.

This longstanding support is at the foundation of ILPA's agreement with Chair Gensler's assessment that the proposal would "increase transparency and would provide comparability to fund investors."[37]

As such, ILPA and our LP members strongly believe that eliminating the need to negotiate for universal, consistent reporting would have a positive impact on the PE industry. Doing so would provide LPs with more information needed to monitor the costs that they increasingly bear as fund economics have evolved in favor of the GP, and ultimately, to make more informed decisions over time regarding the gross-to-net spread for any manager in their portfolio as they contemplate future investments with their existing managers.

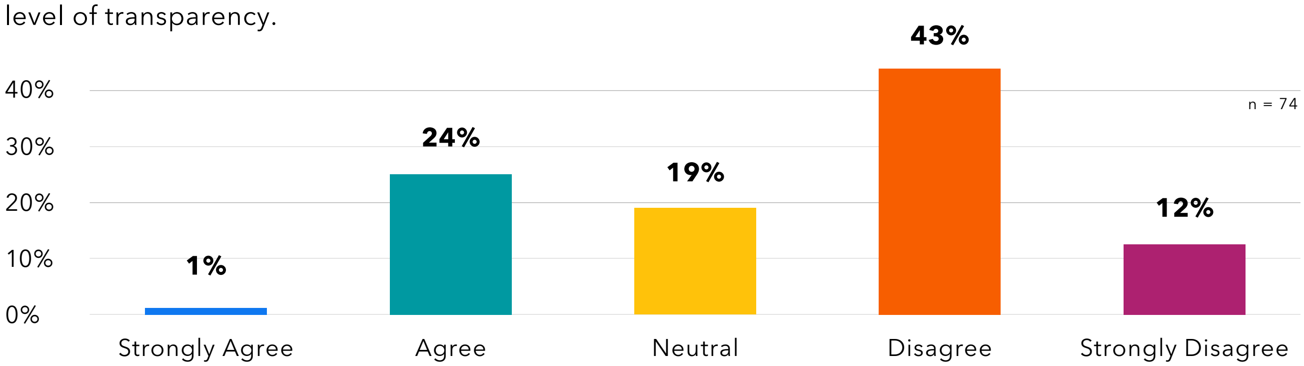
Industry responses to the proposed PFA rule illuminated a disconnect between the experience of LPs and GPs relating to the current state of transparency surrounding fees and expenses. Many groups, pointing to the industry operating efficiently, highlighted that the SEC's "proposal is unnecessary and would fail to provide increased transparency, given that most advisory firms already provide various forms of quarterly and other periodic reporting and investors are generally able to negotiate for and receive the disclosure appropriate for their particular needs."[38]

To gauge our members' views, ILPA asked whether current reporting on fees, expenses and performance is satisfactory (Table 5).

Table 5: Transparency - Reporting Provided by GPs

How much do you agree with the following statement:

Overall, the reporting provided by GPs across fees, expenses and performance provides the needed level of transparency.



Source: ILPA SEC Survey 2022

35 *Supra* 2.
36 *Ibid.*
37 Chair Gensler, *Prepared Remarks Before the Small Business Capital Formation Advisory Committee* (Feb. 2022)
38 Alternative Investment Management Association Limited (AIMA), Private Fund Advisers Proposed Rule Comment Letter

Despite industry progress, **most LPs (55%) do not believe** that reporting provided by GPs across fees, expenses and performance provides the needed level of transparency.

The *ILPA Reporting Template* was first released in 2016, and since then, we've seen real progress when it comes to its adoption. In 2021, **59% of LPs reported receiving the template more than half the time.** With a large portion (41%)[42] receiving the reporting template less than half of the time, LPs must continue to use their negotiating resources to receive the template.[43]

The survey highlights that while the industry has made progress with transparency, most LPs (55%) still indicate that they do not believe that GP-provided reporting on fees, expenses and performance provides the needed level of transparency – with only 25% of LPs viewing the current reporting as sufficient.[39] LPs also need to prioritize fee and expense disclosures as a negotiation "must-have" in part because requests for greater transparency in these areas are seldom granted within the LPA. LPs must instead negotiate for needed reporting through side letters, granting enhanced transparency only to the requesting LP.

LPs attribute that increased fee and expense disclosures stems from:

- A significant increase in treatment of fees and expenses in waterfall calculations that favors GPs
- Increased demand from stakeholders for greater vigilance on fees and expenses
- SEC Risk Reports that mention misallocation of fees and expenses
- Increased use of outsourcing by GPs (i.e. fund administrators) making automated reporting easier to deliver
- Ongoing experience of GPs not providing the same transparency rights to all investors
    - Only 8% of LPs observed that GPs would commit to provide the *ILPA Reporting Template* in the LPA
    - 75% percent indicated the commitment was typically either made through the side letter or informally and not reflected in fund documents at all[40]
    - 56% percent of LPs indicate that information transparency requests granted to one investor are generally not granted to all investors[41]

The proposed minimum standard would create significant market efficiency as the current practice is rather time consuming and costly since each LP needs to individually negotiate for reporting given GP external counsel's strong resistance to putting these terms in the LPA. This is despite the fact that there are no meaningful additional costs to providing each additional LP with reporting once reporting systems are in place.

Erecting a minimum standard for universal, consistent reporting would improve transparency for all LPs by providing greater access to information used in decision making. While LPs have needed to focus their limited negotiation leverage in order to receive sufficient transparency, there has been a shift in favor of the GPs with fees and expenses and inputs into the waterfall/carried interest calculations. Taking transparency off the negotiation table would free up LP negotiating capacity to focus on these developments to a greater degree.

39 ILPA Private Fund Advisers Data Packet, *Transparency – Reporting Provided By GPs* (from ILPA SEC Survey 2022)
40 ILPA Private Fund Advisers Data Packet, *ILPA Reporting Template – Addressed Within Fund Documents* (from ILPA Fund Terms Survey 2020)
41 ILPA Private Fund Advisers Data Packet, *Transparency Rights Not Provided to All Investors* (from ILPA LCON 2020)
42 ILPA Private Fund Advisers Data Packet, *Progress Through Using Negotiation Resources* (from ILPA Fund Terms Survey 2021)
43 See Appendix

Example:

- A $5B USD fund charges a 1.5% management fee, which equates to $75M USD annually
- A $500M USD fund charges a 2% management fee, which equates to $10M USD annually
- The annual management fee paid to the $5B USD fund is 650% more than that of the $500M USD fund
- Given the intended purpose of the management fee – to keep the lights on - does it cost 650% more to "keep the lights on" at a $5B USD fund compared to a $500M USD fund?

"In the past, the average fund would be exited before the next fund is raised. Now, because of the pace of fundraising, managers are charging fees on multiple funds. Two percent on $500M feels reasonable, but funds over $5 billion shouldn't need more than one percent."

- ILPA Member

The following highlight a sampling of the developments in this space that have shifted to GP favor:[44]

Management Fee. While fees may have fallen below 2% (funds over $1B USD), headline management fee rates have largely held steady even as fund sizes have grown dramatically, outstripping the decrease in management fee rates as the absolute dollar amounts continue to grow meaningfully.[45]

Costs charged to the partnership. Eighty-two percent of LP respondents identified that the increase in costs charged to the partnership outside of the management fee have grown at a greater rate than the decrease in costs associated with the reduced management fee.[46] Read more about this development on page 19.

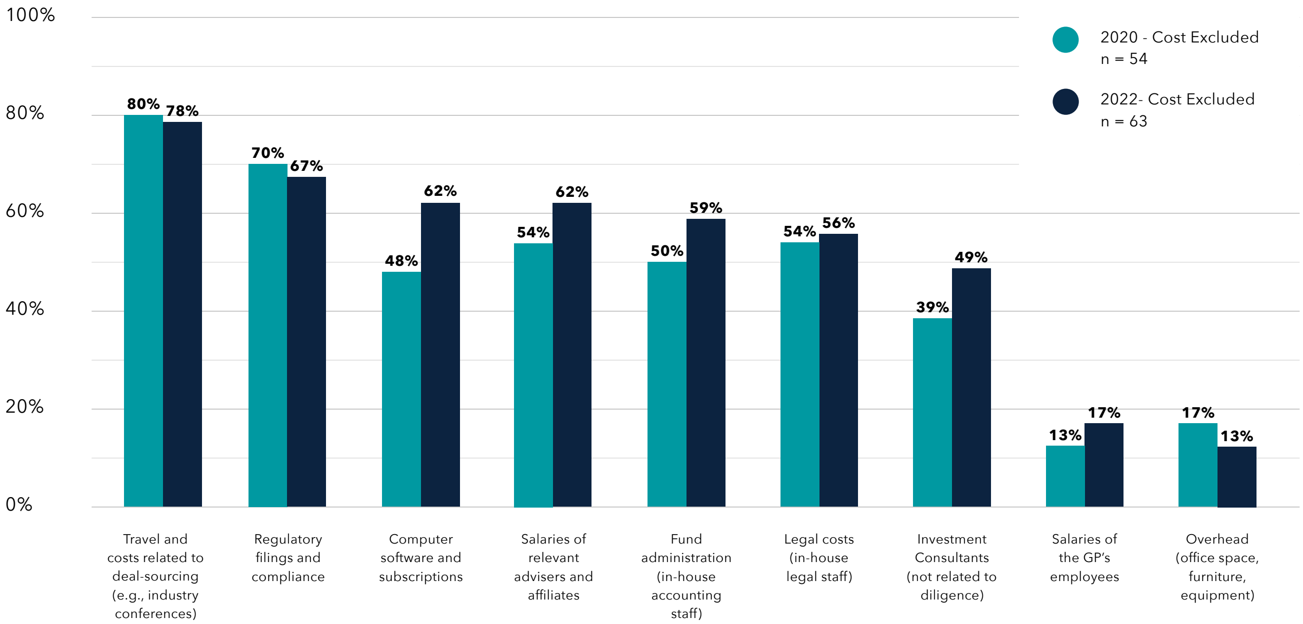
Organizational Expenses. These expenses increased 123% between 2011 and 2020, with additional increases taking place in 2021,[47] especially among funds greater than $3.5B USD.[48] Per K&L Gates, "the dollar limits on organizational expenses to be borne by the fund have increased so much that in many cases they are meaningless, and, in any event, they do not appear to constrain sponsors in their negotiations with investors."[49]

- Additionally, according to Colmore's analysis, in some cases, "organizational expenses exclude the costs of side letter negotiations and the MFN election process, which effectively shifts such expenses from organizational expenses to operating expenses, which are typically not subject to dollar limits."[50]
- And while offsets are typically set for 100% of transaction fees, monitoring fees, directors' fees and other "similar" fees paid by the fund or portfolio companies to GP affiliates, this offset concept has been "eroded by exclusions for fees paid to so-called 'operating partners' and other GP-related parties for certain services."[51]

Waterfall/Carried Interest Calculations. One-third of LPs (34% of respondents) ranked waterfall calculations as the term that has most shifted in favor of the GP over the last three years.[52] Funds with a hurdle rate below 8% have increased over time, as have funds with no hurdle rate. And, in instances where the hurdle rate has risen over 8%, LPs observe that such a change typically occurs alongside carried interest charged on gains gross of expenses, which helps greatly offset risk to the GP with a higher hurdle.[53] LPs are also observing increased prevalence of funds with so-called premium carry, i.e., above 20%.[54]

44 See Appendix
45 ILPA Private Fund Advisers Data Packet, *Overall Costs for LPs* (from ILPA LCON 2022)
46 *Ibid.*
47 *Supra* 19.
48 ILPA Private Fund Advisers Data Packet, *Organizational Expense Cap Increase* (from ILPA LCON 2022 – Data Presented by Colmore)
49 ILPA Private Fund Advisers Data Packet, *Quotes from ILPA Fund Terms Survey 2021* (from ILPA Fund Terms Survey 2021)
50 *Ibid.*
51 *Ibid.*
52 *Supra* 2.
53 ILPA Private Fund Advisers Data Packet, *Changes in Hurdle Rates* (from ILPA LCON 2022 – Data Presented by Colmore)
54 ILPA Private Fund Advisers Data Packet, *Changes in Incentive Allocation* (from ILPA LCON 2022 – Data Presented by Colmore)

Table 6: Cost Excluded From Management Fee Over the Last 12 Months



Source: ILPA Fund Terms Survey 2020 and ILPA SEC Survey 2022

To further evaluate the increased costs LPs experience, ILPA asked members about specific costs excluded from management fee in both 2020 and 2022 (Table 6). The survey results demonstrate the frustrating trend that LPs have long described of costs routinely being charged to the partnership for activities that squarely fall under the category of benefiting the firm broadly and not solely or primarily the fund.

This development erodes any potentially beneficial impacts of a reduced management fee rate, given that travel for deal sourcing, computer software and subscriptions and in-house personnel are increasingly being charged to the partnership.[55] As ILPA wrote in 2021, "The traditional purpose of the management fee—keeping the lights on—increasingly seems like a relic of the bygone era."[56]

Even more unfathomable is the notion that, in 2022, 13% of LPs observed that overhead, e.g., office space, furniture, equipment, is being charged to the partnership.[57]

Costs that squarely fall under the category of benefiting a GP broadly, and not solely or primarily the fund, are being routinely charged to the partnership.

This cost shifting to the partnership underscores the importance of elevated transparency for LPs related to fees and expenses, and the benefits to LPs of the SEC rule proposals that would grant LPs a minimum level of transparency that could obviate the need to advocate for basic cost transparency in fund negotiations.

55 *Supra* 45.
56 *Supra* 49.
57 ILPA Private Fund Advisers Data Packet, *Costs Excluded From Management Fee Over the Last 12 Months* (from ILPA Fund Terms Survey 2020 and ILPA SEC Survey 2022)

Fiduciary Duties

Dating back to the release of the first *ILPA Principles* in 2009, ILPA has highlighted the need to prevent the erosion of fiduciary duties as a core element of the alignment of interest foundational to the LP-GP relationship.

Despite this, LPs continue to have limited success in restoring fiduciary duties during negotiations - only 34% in 2020[58] and 26% in 2021[59] - identified that they were able to restore or improve fiduciary duties in more than half of the funds they invested in over the previous 12 months.

This is particularly concerning when factoring in that LPs spend considerable resources negotiating for fiduciary duties and consider it to be one of the most important contractual terms to prioritize during negotiations – 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. 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.[60]

LPs have long expressed concerns over the erosion of fiduciary duties – with 63% in 2020[61] and 48% in 2021[62] 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. While there was a decrease between 2020 and 2021, even 48% is a significant number of LPs that experienced a reduction (or complete elimination) of protections against conflicts of interest. This points to why ILPA has been vocal about the widespread use of sole discretion language and expansive indemnification and exculpation provisions.[63]

When LPs are successful in restoring or improving fiduciary duties, only 19% were able to consistently secure the enhancements in the LPA itself compared to 37% that needed to resort to securing a more limited set of enhancements through their side letter.[64] This notion combined with the opposing pull between LPs (ranking restoring fiduciary duty as #2 must-have)[65] and GPs (with fiduciary duty representing the top ranked shift in terms that favor the GP)[66] means the negotiation process for fiduciary duties is time consuming and costly for LPs. Since LPs only rarely achieve restoring fiduciary duty in the LPA (where it would apply to all LPs), each LP needs to individually negotiate against the diminished fiduciary duties. Once again, the proposed minimum standard would create significant market efficiency compared to the structure that exists today.

Despite ILPA's longstanding push to improve fiduciary duties, the environment has become ever more challenging and inefficient for LPs as they try to navigate a series of hedge clauses and qualifications in LPAs and subscription documents, as well as pre-clearing consents to conflicts in interests, sole discretion language, expansive indemnification and disclaimers that attempt to lessen the standard of care during negotiations.

Thus, ILPA has advocated for a minimum articulated standard of care, i.e., gross negligence,[67] while at the same time supporting the SEC's proposed rule for an ordinary negligence standard applied to material breaches of the LPA and side letters. ILPA believes that an umbrella application of the ordinary negligence standard would have the unintended consequence of impacting a GP's risk tolerance and potentially damaging returns produced in private funds. ILPA believes, however, that stipulating an ordinary negligence standard as applied to breach of contract would assure meaningful progress towards the SEC's stated goal of restoring fiduciary duties in private funds while avoiding any unintended consequences as with the proposals as originally drafted. This would represent a substantial step forward in the alignment of interest between LPs and GPs.

The disconnects between LP and GP sentiment regarding the need for reforms are intended to illustrate why ILPA considers selective SEC intervention to be beneficial for LPs. While progress has been made, SEC engagement in this space will help raise the bar for all LPs and address persistent challenges that LPs face in negotiating for stronger transparency, governance and alignment of interest.

58 ILPA Private Fund Advisers Data Packet, *Ability to Restore of Improve Fiduciary Duties – 2020* (from ILPA Fund Terms Survey 2020)
59 ILPA Private Fund Advisers Data Packet, *Ability to Restore of Improve Fiduciary Duties – 2021* (from ILPA Fund Terms Survey 2021)
60 *Supra* 2.
61 ILPA Private Fund Advisers Data Packet, *Fiduciary Duties Contractually Modified or Eliminated - 2020* (from ILPA Fund Terms Survey 2020)
62 ILPA Private Fund Advisers Data Packet, *Fiduciary Duties Contractually Modified or Eliminated - 2021* (from ILPA Fund Terms Survey 2021)
Note: Additional Citations on Following Page.

Recommendations on Allocation of Costs to the Partnership

As identified in our comment letter to the SEC, ILPA supports the movement toward standardizing reporting on fees and expenses. And as identified previously, LPs have pushed for further transparency into fees and expenses given increases in the total fees they are paying, with a major pain point being the increase in charges that fall outside of the management fee.

To help address the issues related to treatment of fees and expenses, ILPA encourages a hybrid approach to determining 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. ILPA believes that, in nearly all instances, the following costs are not appropriate to allocate as a partnership expense:

- Overhead (office space, furniture, computers, telephones, facilities, utilities and communications)
- Remediation and settlement costs stemming from examinations, investigations or enforcement actions[68]

While individual LPs may deem other costs to be inappropriate to allocate to the fund as a partnership expense, strict prohibitions are problematic. We hesitate to press for expansive and prescriptive strict prohibitions given the risk of unintended consequences, such as an increase in management fee rates charged to LPs, without the benefit of itemized disclosures of expenses.

Instead, ILPA has historically taken a largely principles-based approach as it comes to fees and expenses rather than an item-by-item framework for outlining costs that should be covered by the management fee and those that should be allocated to the partnership.

Most egregious is the practice of swelling fee income to the point that it becomes a profit center for the GP, representing returns leakage to the detriment of the LP and their ultimate beneficiaries. These instances create a financial conflict of interest between LPs and GPs. Examples of this behavior include:

- Management fees that are artificially high relative to the costs of running the fund, particularly in the case of a successor fund that benefits from existing infrastructure
- The practice of "double-dipping," i.e., charging a management fee that covers GP salaries while also allocating salaries for specific roles (such as legal or compliance staff) to the partnership as a discrete expense without offsetting against the management fee
- Charging fees to the portfolio company, e.g., Operating Partners, Directors' Fees, without offsetting where appropriate against the management fee, which creates an additional revenue stream for the GP and negatively impacts the return profile for the portfolio company at exit

63 ILPA Follow-up Letter to Chair Gensler on Priorities for Investor Protection Reforms in the Private Funds Marketplace (Sept. 2021)
64 ILPA Private Fund Advisers Data Packet, *Means For Restoring or Improving Fiduciary Duties* (from ILPA Fund Terms Survey 2020)
65 *Supra* 2.
66 *Ibid.*
67 *Supra* 1.
68 *Ibid.*

However, it is a challenge to develop a comprehensive, prescriptive list of all fees and expenses that should be prohibited from being allocated to the partnership as there are many variables at play that need to be considered. For example, the calculus between large, established GPs and emerging managers is drastically different — LPs would be more comfortable with in-house administration costs allocated to the partnership for an emerging manager than for a well-established GP that has a comprehensive back-office operation utilized across the entire firm. LP views on the practice are highly subjective, with more latitude afforded a single-product GP where it is difficult to split costs between the firm and fund.

While these variables impact the principles-based view as well, the key tenets of ILPA's previously stated principles-based views (found in *Principles 3.0*) are as follows:

Overall

- The management fee should be reasonable and be directly tied to the normal operating cost of running the fund and operating the firm
- Management fees should consider the lower levels of expenses incidental to the formation of a follow-on fund, at the end of the investment period or if a fund's term is extended, with corresponding step downs for each situation
- Consideration should be applied to the appropriate blended percentage of fees based on the amount of capital committed and invested; this is especially true when structuring the initial management fees for any follow-on fund
- Any fees generated by an affiliate of the GP, such as an advisory firm or in-house consultancy, whether charged to the fund or an underlying portfolio company, should be reviewed and approved by a majority of the LPAC and offset against the management fee
- Any third-party expenses incurred in the provision of services that typically would be provided by the GP to similar funds, such as accounting services, should be reviewed by the LPAC and offset against the management fee
- If in-house resources are to be used, the GP should provide the rationale for utilizing internal resources and the market basis applied in calculating any such charges and offset against the management fee:
    - For example, in-house GP counsel costs charged to the partnership at the same rates as external counsel will include additional costs such as insurance premiums and overhead, meaning that the GP is in effect double charging for these items

Reporting/Transparency

- Fees and expenses allocable to the fund should be clearly disclosed prior to the initiation of the fund and at regular intervals to all LPs, i.e., clarified in capital call notices
- LPs should at minimum be notified of any fee or expense assessed, either to the partnership or to any portfolio companies, as specified in the *ILPA Reporting Template*
- Listing all fees that could be charged in a multi-page section of the LPA, rather than fees that are likely to be charged, is not constructive

Firm/Management Company

- Expenses that benefit the firm broadly, and not solely or primarily the fund, should be borne by the firm and excluded from partnership expenses
- For multiple-product firms, fees generated by a GP of a fund should be directed predominantly to the professional staff and expenses related to the success of that fund
- Examples of expenses that should be covered by the management fee:
    - Overhead costs (office space, furniture, computers, telephones, facilities, utilities and communications)
    - Salaries of the GP's employees, including:
        - In-house fund administration
        - In-house legal counsel
        - Accounting, reporting, IR functions
        - Compliance, risk staff
    - Salaries of any relevant advisers or affiliates
    - Travel and other costs related to the investment activities of the manager on behalf of the partnership (sourcing deals, networking and preliminary due diligence)
    - Industry conferences
    - Cost of research and information services, including subscriptions
    - Investment consultants
    - Costs and expenses associated with maintenance of required books and records
    - Expenses incurred in fulfilling regulatory compliance requirements, e.g., registration, maintenance of registration
    - Technology, cybersecurity and software implementation or upgrades to the GP's existing system solely or chiefly benefiting the GP
    - Costs of entertainment, including speaker fees at LPAC meetings/annual investor meetings

Fund

- The fund should not incur the costs of services that can rationally be expected to be covered by the management fee as a cost of operating the fund
- Examples of expenses that can be allocated to the partnership:
    - Broken deal expenses
    - LPAC meetings/annual investor meetings, excluding the costs of speakers or entertainment
    - Third party administration
    - Specialized consulting services
    - Travel – when potential investment advances past the initial term sheet
        - Travel policy should also be provided to LPs, which should include parameters addressing use of non-commercial travel, e.g., private planes, entertainment
    - Interest expenses and fees related to credit facilities
    - Audits – annual fund audits and audits related to the partnership or GP conducted by regulatory bodies to the specific fund
    - Legal expenses – third-party legal expenses incurred specifically in connection with fund matters

- Indemnification, insurance, and litigation expenses – with ensuring proper standard of care limitation and that obligations only extend to fund matters
- Regulatory expenses tied to specific costs of transactions by the fund, i.e., not tied to the costs of registration or maintenance of the firm's registration with the regulator
- Complying with required quarterly statement reporting as outlined in PFA proposal

Portfolio Company

- No fees should be charged to portfolio companies – any portfolio company fees that are charged should be 100% offset against the management fee and subject to standard disclosure (any exceptions to this should be rare and clearly defined in the LPA)
- If these expenses are not paid by portfolio companies or fully offset – should be paid directly by the GP and covered under the management fee
- Examples of expenses charged to the portfolio company that should be fully offset against the management fee:
    - Operating partners/consultants
    - Relevant advisors or affiliates

The shifting treatment of fees and expenses is why consistent, mandatory minimum transparency is so critical to allow LPs to have targeted dialogue with GPs on identified instances that are not in accordance with the principles-based approach. One benefit of the SEC proposed rule for LPs is the ability to shift focus away from negotiating for minimum transparency into fees and expenses to negotiating for the treatment of fees and expenses to help rationalize the costs of investing in PE.

Recommendations for Requiring a "Best-in-Class" Most Favored Nation (MFN) Process (Preferential Treatment Disclosures)

Side letters are critical for investors and the private equity industry. Many institutional investors are required to receive governance, statutory or regulatory protections that are specific to their institution to invest in an asset class as sophisticated as private equity. LPs rely on side letters to secure these provisions. In fact, 76% of LP respondents in both 2020 and 2022 identified their organization would not be able to invest in private equity without side letters.[69] Additionally, 72% of LPs do not view these critical governance, statutory or regulatory protections as having a negative impact on other LPs in the fund.[70]

Given the importance of side letters, we wanted to provide an alternative to the requirements outlined in the proposed PFA rule to satisfy the desired policy objectives in the context of closed-end funds.

ILPA's members believe that greater transparency in the industry can only be beneficial – 78% of LP respondents identified having a better picture of what is "market" would help in negotiations with GPs[71] – and as mentioned previously, the multiple types of information asymmetry that exist between LPs and GPs and GP external counsel is a pain point in the negotiation process.

While supportive of greater transparency in spirit, the proposed rule governing the disclosure of preferential treatment may cause unintended consequences. Determining what constitutes "preferential treatment" on a facts and circumstances basis could cause confusion within the industry and make it more challenging for LPs to negotiate for important legal protections. Additionally, the proposed timelines for the disclosures (annually and to prospective investors) would be overly burdensome, costly and provide little utility for LPs to negotiate for better terms.

A best-in-class MFN process would satisfy the spirit of this provision: greater transparency. Sixty-four percent of LP respondents agreed that a well-run MFN process provides the necessary transparency about the terms being offered in the fund.[72]

It is important to highlight that the "best-in-class" MFN recommended on the following page is directly aligned with practices today among many established GPs and supported by LPs as providing satisfactory transparency. These recommendations do not represent a major shift in market practice, but rather set a higher floor for minimum standard procedure for a greater number of GPs. A well-run MFN process allows LPs to understand what terms other LPs in the fund have agreed to and how those terms will impact their investment and the governance of the fund.

69 ILPA Private Fund Advisers Data Packet, *Importance of Side Letters for LPs* (from ILPA LCON 2020 and ILPA LCON 2022)
70 ILPA Private Fund Advisers Data Packet, *Side Letter Terms Do Not Have a Material Negative Impact on Other LPs* (from ILPA SEC Survey 2022)
71 ILPA Private Fund Advisers Data Packet, *Better Picture of What is "Market"* (from ILPA LCON 2022)
72 ILPA Private Fund Advisers Data Packet, *MFN Process – Provides Necessary Transparency* (from ILPA SEC Survey 2022)

As an alternative to the requirements outlined in the SEC's PFA proposal, elements of a "best-in-class" MFN process would include:

1. Transparency

GPs should compile an MFN compendium that covers all relevant terms agreed to between LPs and the GP that are not in the LPA. All LPs in the fund should receive the compendium and gain insight to terms agreed upon, regardless of commitment size or ability to elect specific terms. GPs should strive to avoid using redactions wherever possible, except in scenarios where personal/private information is disclosed.

2. Digestible Presentation by Category

The compendium should group provisions addressing the same topic together in an effort to make the compendium readable and transparent, i.e., all statutory provisions that apply to individual LPs only.

3. Comprehensive

All relevant terms agreed to by the GP and LPs that may impact the fund should be disclosed in the MFN process. This should include any terms agreed to in representation letters, due diligence letters or any other separate agreement.

4. Optimal Electability

Individual LPs should not be allowed to 'opt out' of the MFN process and exclude their terms from the compendium.

64% of LP respondents agreed that a well-run MFN process provides the necessary transparency about the terms being offered in the fund.

5. Reasonable Timing

GPs should distribute the MFN compendium to all LPs within [60] calendar days of the final closing of the fund. LPs should have minimum [30] calendar days to review the MFN compendium and make any elections.

From a principles-based view on a "best-in-class" MFN process, GPs should also strive for:

- Treatment of costs associated with the MFN process as an organizational expense (as opposed to a fund or partnership expense)
  and subject to any caps or other restrictions as governed by the LPA
- Maximum readability, usability and transparency through use of term summaries, breaking out electable and unelectable terms, etc.
- When a majority of LPs are eligible to elect a particular term – or in instances where there are terms common across the majority of a fund's side letters – the GPs should include these terms in the LPA
- When the GP clarifies the intent of an LPA term, or makes an allowance of an LPA term, GPs should strongly consider adding the clarification or allowance into the LPA

Recommendations for Avoiding Unintended Consequences

In carrying out the work that went into our original comment letter and this additional analysis, ILPA spent considerable time evaluating potential unintended consequences of the PFA as initially written. ILPA commends the SEC's openness and responsiveness to feedback during the comment period and in the time since to help address concerns with potential unintended consequences in order to have the final rule yield the greatest positive impact on the PE industry.

In our original comment letter, ILPA provided recommended adjustments to rules and thoughts on open questions across a variety of topics, including (but not limited to) grandfathering, implementation timelines, clawbacks, quarterly statements and core areas (covered in even greater detail in this analysis) related to treatment of fees and expenses and fiduciary duty.

Given the nature of comment letters submitted to the SEC by other industry groups, we are providing further clarity related to co-investments and emerging managers to help further reduce the likelihood of any unintended consequences.

Co-Investments

When providing thoughts on the Prohibition on Certain Non-Pro Rata Fee and Expense Allocation rule in our original comment letter, ILPA encouraged the SEC to "ensure that the final rule does not impede the commercial speed with which advisers and LPs must act in co-investment situations and does not suppress the availability of co-investment opportunities" and requested the SEC provide clarity on the impact of the provision on co-investors – with a distinction between co-investors participating as co-underwriters and those participating on a syndicated basis.

Given co-investments play an important role in the PE industry with numerous benefits for both LPs and GPs – with widely accepted market practices that are fully built into the rationale for LPs operating as co-investors – ILPA recommends the SEC include an exception in the final rule for co-investments to maintain current efficient market practices.

While it is important to make the distinction between syndicated co-investors and co-underwriters, as there are different treatments of fees and expenses given a differentiated presumption of risk, role in process (i.e., timing, level of involvement) and governance rights, we ultimately believe that both types of co-investments should receive an exception from the rule. With the different areas where fee and expenses are impacted (such as management vs. carry vs. broken deal), the best way to avoid unintended consequences is an exception.

At a high level, co-underwriters are typically involved in the early stages of the deal and play a much more active role in completing due diligence, valuations, negotiations and monitoring alongside the GP, with more advanced governance rights (i.e., board seat(s), or veto/consent rights) commensurate with their ownership stake.

On the other hand, syndicated co-investors are typically brought into the process at a later stage in the deal and participate in a more passive manner, with smaller ownership stakes and limited to no governance and information rights.

As such, the current market practice is for co-underwriters to typically bear pro-rata transaction costs and any broken deal fees with no management fees/carry. For syndicated co-investors, the current market practice is to typically bear pro-rata transaction costs but no broken deal fee and generally no management fees/carry.

Additionally, as mentioned in our initial comment letter, the co-investment vehicle is often formed at the time of the consummation of the deal and is not in a position to absorb a pro rata share of broken deal fees should the deal fall through before the vehicle has been formed. Such vehicles may also involve third-party co-investors that are not participating in the commingled fund, making a pure pro rata allocation of expenses problematic.

In considering unintended consequences, ILPA believes the rules as currently written would have a negative impact on LPs' ability to operate as co-investors and would reduce the benefits recognized by the industry. And as referenced below, this could also have an outsized impact on emerging managers.

Emerging Managers

One of the most consistent areas of industry pushback to the PFA was the outsized impact the rules would have on emerging managers. Given ILPA has been a longtime supporter of emerging managers – with a portion of our website dedicated to an Emerging Manager Toolkit and a historical showcase of Emerging Managers[73] at our annual ILPA Summit – we do want to be particularly mindful of any unintended consequences the rules may have for this subset of GPs.

While we do not fully agree with the industry responses related to the impact the PFA would have on emerging managers, in order to reduce any unintended consequences, we've outlined recommendations below, in line with our initial comment letter and reflecting additional insight:

Intersection of the Quarterly Statement Rule and Prohibition on Charging Certain Fees and Expenses to the Fund

- *Recommendation:* SEC should not prohibit GPs from charging the costs of complying with the Quarterly Statement rule to their LPs when using a third-party administrator.

- *Insight:* LPs could reasonably be expected to bear a pro rata portion of costs associated with complying with the Quarterly Statement Rule, particularly in cases where the reporting is provided by a third-party fund administrator[74] and approved by LPs within the LPA as an allocable partnership expense.

- *Recommendation:* 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 (with all other GPs operating under the initial implementation timeline and recommended lookback period of 2018 fund vintages and later).

Initial Registration and Filing Costs Covered in the Prohibition on Charging Certain Fees and Expenses to the Fund

- *Recommendation:* SEC should allow for an emerging manager exception to the blanket prohibition on charging the partnership the cost of covering the initial registration with the Commission and filing costs (such as Form PF and ADV).

- *Insight:* LPs would be more willing to pay for these costs for emerging managers through either a higher management fee or through allocation as a partnership expense. In instances where the costs would be covered by a higher management fee, ILPA outlines in *Principles 3.0* that "the GP should provide a budget that lays out the rationale for the management fee proposed."

73 See Appendix
74 See Appendix

Co-Investment Fees and Expenses Covered in the Prohibition on Certain Non-Pro Rata Fee and Expense Allocations to the Fund

- *Recommendation:* In following with the recommendation outlined above, the SEC should include an exception for co-investments from the rule.

- *Insight:* There is additional importance for emerging managers as LPs' co-investors can make up an outsized percentage of total fund assets relative to established managers. For example, it would not be uncommon to see a fund with a total of $400M USD in assets have $200M USD coming from a single LP co-investor. As co-investors have a vested interest in the success of the emerging manager, there are instances where co-investors will adjust their typical expectations for reduced management fee and carry given they can make up (using the example above) 50% of the total assets in the fund – and having this pool of money with a 0% management fee would have an outsized impact on emerging managers.

Use of Side Letters Relating to Prohibition on Preferential Redemption Rights & Holdings Transparency[75] and Disclosures of Preferential Treatment

- *Recommendation:* SEC should apply the "best-in-class" MFN process recommended above to emerging managers as it would create a minimum standard to follow that provides LPs with the necessary transparency into side letters, while still allowing for seed/anchor investors to negotiate for different terms that are accepted market practice in emerging managers.

- *Insight:* ILPA's support for the critical importance of side letters has an extra layer of importance for emerging managers. Emerging managers rely more heavily on seed/anchor investors to build out their program. These investors typically receive economic incentives that align to either the size of their investment or timing of their entrance into the fund. These are widely accepted market practices and not deemed to have a material, negative impact on other LPs in the fund. While seed/anchor investors in emerging managers may negotiate different terms, they do not want to negotiate for terms that may adversely impact other LPs in the fund since seed/anchor LPs have a vested interest in the emerging manager's ability to attract other LPs into the fund.

[75] See Appendix

Appendix

Additional Citations

[8] To fully access the U.S. economy, investors increasingly need to invest in PE. The number of private companies grew by "52 percent from 2012 to 2017, compared with 8 percent growth in the number of public companies over the same period." See Institutional Investor, Hamilton Lane Flashes Warning on Buyout Funds. Additionally, in the decade ending in 2020, the "number of U.S. sponsor-backed companies has increased by 60 percent," while "the number of U.S. publicly traded companies has stayed roughly flat (but is down nearly 40 percent since 2000)." See McKinsey, McKinsey's Private Markets Annual Review.

[17] "Serving more than 500 private equity clients around the globe, our practice generates the largest deal flow of any law firm. Kirkland consistently ranks at the top among legal advisers to private equity buyouts in the U.S., Europe and Asia. Our substantial end-to-end involvement provides a unique view into every facet of the PE landscape. Using market-moving technologies derived from our vast experience, we drive terms and set the market for the benefit of our clients." See Kirkland & Ellis, Services - Private Equity (Feb. 2023).

[25] As Professor Will Clayton explains in his comment letter, "Investors say that they shy away from demanding high-quality terms primarily because they are afraid that if they do so, their investment allocations will be given to more accommodating investors that are not raising such concerns… [In private funds], the coordination problem being alleged by investors seems to be that managers under-disclose information (and impose other problematic terms on investors) primarily because investors have a rational reason to be afraid of demanding strong terms." See Prof. William Clayton Brigham Young University Private Fund Advisers Proposed Rule Comment Letter.

[29] Conversations with industry parties (including several advisers and consultants) and directly with LPs suggest that there may only be "a handful" or "a dozen" eligible funds for a given investment when considering the factors that can exist in the initial requirements (e.g., check size, institutional track record, timing, pace of fundraising, space and diversification across vintage years, size, sector, strategy, and geography). And this is all before getting to the LPA negotiation stage of the investment process.

[43] Worth noting, one area that industry groups identified as showcasing that LPs can "switch firms if they are dissatisfied with the terms being offered by a particular firm" was given the "real progress" with the "clear and consistent reporting of fees and expenses." However, highlighting this is misleading as the ILPA statement quoted refers to the progress that the industry has showcased going from 0% adoption of the ILPA template in 2016 (pre-launch) to the current adoption levels today. That is real progress for sure – but also a clear indication that more is needed to get transparency to the level it should be to meet LP expectations (as further seen by the only 25% of LPs who view the current reporting as sufficient). See *Supra* 9.

[44] Also worth noting, one area that industry groups identified as showcasing that LPs can "achieve favorable changes in common contractual terms" was the reduction in management fee. Even though there has been a reduction of the once "standard" 2% management fee (especially in funds over $1B USD), the dramatic increases in fund sizes and costs charged to the partnership create an environment where LPs are actually experiencing an increase in absolute dollar of fees. See *Ibid*.

[73] Important to note that there is not an industry-wide accepted definition of "emerging manager." Many LPs have their own definition and classification for what qualifies as an emerging manager in Private Equity, as well as in other asset classes (such as Equity, Fixed Income, Private Credit, Real Estate, Real Assets). As such, ILPA is not seeking to create a new industry definition for what constitutes an emerging manager in Private Equity, let alone in other asset classes. A general guideline based on an examination of different LP emerging manager programs points towards common attributes such as fund size ($1B USD or less), track record (first, second or third institutional fund), and firm assets ($1B USD – $2B USD or less).

[74] To put the headline costs on using a third-party fund administrator into perspective, conversations with industry parties (including several administrators used by emerging and well-established managers alike) suggest that the costs of the full suite of reporting to LPs (including capital calls and distributions, fee and expense reporting, and performance reporting) costs between $40,000 – $90,000 USD per year for each fund for all LPs. While there would be additional setup costs internally to migrate to a third-party fund administrator, this price point does not appear to significantly shift the break even point for an Emerging Manager to operate (especially with the notion that LPs would cover their pro rata portion of the costs). Even before the PFA, LPs were increasingly of the view that that failure to use a third-party fund administrator was inconsistent with operating at an institutional level (with the exception being large, mega funds that have the resources to carry out fund administration work internally).

[75] ILPA also believes the concerns outlined with both elements of this prohibition (redemption rights and holdings transparency) are more consistent with open-ended funds and should not apply to closed-end funds. If the preferential redemption rights are going to apply to closed-end funds, ILPA recommends that in-kind distributions are not defined as preferential liquidity.

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