Private Equity Regulatory Update

July 28, 2017

Industry Update

Rules and Regulations

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ILPA Issues Guidance on Use of Subscription Credit Lines

On June 27, 2017, the Institutional Limited Partners Association ("**ILPA**") issued guidance (the "**Guidance**") for limited partners and general partners regarding the use of subscription line credit facilities. **As we reported in April**, subscription line financing has been the subject of increasing attention, particularly in connection with disclosures relating to IRR calculations. In the Guidance, ILPA recommends that limited partners request (1) greater disclosures from fund managers regarding the use of subscription lines and (2) greater clarity in the partnership agreement regarding the parameters for the use of subscription lines. For example, the Guidance makes the following recommendations that, in ILPA's view, would leverage the cash flow benefits of lines of credit while also providing LPs with a greater degree of transparency and disclosure:

- LPs should require their managers to disclose quarterly information on the size of the lines, number of days outstanding, specific uses of the capital and impact of credit line facilities on reported IRRs. During due diligence, LPs should request that prospective managers provide the impact of subscription facilities on past reported performance.
- Within partnership agreements, waterfall provisions should specify that the date used to calculate the GP's preferred return hurdle is the date when the credit facility is drawn, rather than the date capital is ultimately called from the GPs.
- Partnership agreement provisions addressing the use of subscription facilities should establish reasonable thresholds for their use, such as a maximum percentage of all uncalled capital (*e.g.*, 15-25%) and maximum number of days outstanding (*e.g.*, 180 days).

While many of the suggestions have been and continue to be considered and addressed by experienced investors and managers, the Guidance will likely spur more focused discussion. Sponsors should consider reviewing such disclosures and practices with fund counsel. The Guidance, together with any subsequent revisions, will be incorporated into the revised ILPA Principles that are scheduled to be published in early 2018.

- ► **See a copy of the Guidance**

Rules and Regulations

Interacting with Retirement Investors under the DOL Fiduciary Rule

The new Department of Labor ("**DOL**") fiduciary rule took effect on June 9, 2017. For now the DOL and Internal Revenue Service have announced that they will not take enforcement action against impacted parties in reasonable compliance. The fate of the rule over the longer term remains uncertain as the rule is under review by the new leadership of the DOL and bills have been introduced in the House and Senate to override the rule. Nevertheless, the basic thrust of the rule has taken effect.

Under the rule, a party will be deemed to have provided advice and become a fiduciary to an employee benefit plan or individual retirement account ("**IRA**") if the party directs a communication toward a specific audience that includes a plan or IRA and, based on its content, context and presentation, the communication would reasonably be viewed as a recommendation that the receiving party engage in or refrain from taking a particular course of action with respect to an investment. If a fund manager were deemed to have provided fiduciary advice to a plan or IRA with respect to a plan's or IRA's investment in the manager's funds, this would not only attract fiduciary responsibility for that advice but would arguably cause any fees or allocations received by the manager or its affiliates to be viewed as a prohibited transactions under the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**") and the Internal Revenue Code of 1986, as amended (the "**Code**"). Under ERISA and the Code, fiduciaries are prohibited from providing advice where they have a potential conflict of interest and the resulting excise taxes and other penalties could be draconian.

One important exception under the rule that has received some attention in the private funds community is the so-called "sophisticated investor" exception. Under this exception, communications with a plan or IRA will not create an advisory relationship if they are made to a sophisticated independent fiduciary of a plan or IRA. Before relying on this exception for communications to a plan or IRA, a fund manager must know or reasonably believe that:

- the communications are being received on behalf of the plan or IRA by an independent fiduciary who is responsible for exercising its judgment in evaluating the communications and related transactions;
- the independent fiduciary is a bank, insurance carrier, registered investment adviser, registered broker-dealer or independent fiduciary with at least $50 million in assets under management; and
- the independent fiduciary is capable of evaluating the relevant investment risks independently.

In addition, the fund manager must not receive any fee specifically for the information or advice provided in its communications and must inform the independent fiduciary that the manager is not providing impartial investment advice and that the manager receives fees and other benefits from managing the funds.

Given the condition that fund managers must know or reasonably believe that their communications are being received by an independent fiduciary meeting the criteria above, fund managers might consider requiring any pension plan investor to confirm that it is represented by a qualified independent fiduciary in connection with its investment in the manager's funds. This can be accomplished by including appropriate representations and acknowledgements in the funds' subscription documents.

While pension plan investors are usually represented by qualified independent fiduciaries in connection with their investment in private funds, IRA investors are usually not and therefore fund managers likely would not be able to rely on the sophisticated investor exception in their communications with IRA investors. The DOL has indicated that IRA owners cannot qualify as sophisticated independent fiduciaries of their own IRAs, regardless of their wealth.

Because the sophisticated investor exception is likely unavailable with respect to IRA investors, fund managers will need to be cautious in their communications with current and potential IRA investors to avoid having these communications rise to the level of investment advice under the new rule. In general, fund managers and their employees should not recommend, suggest or advise any given course of action or inaction to IRA investors and should limit their communications with IRA investors to providing information and answering general questions. The more individually tailored a communication is, the more likely that it would be viewed as advice. As a further safeguard, all communications with IRA investors should include a disclaimer that the communication does not constitute advice and the investor should consult its own adviser regarding its investment decision. This disclaimer is often included in investor reports and similar distributions, but managers should consider making it a staple of all substantive communications and presentations.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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