November 18, 2019

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| The Honorable Maxine Waters<br>Chairwoman<br>Committee on Financial Services<br>U.S. House of Representatives<br>Washington, D.C. 20515 | The Honorable Patrick McHenry<br>Ranking Member<br>Committee on Financial Services<br>U.S. House of Representatives<br>Washington, D.C. 20515 |

Dear Chairwoman Waters and Ranking Member McHenry:

The Institutional Limited Partners Association ("ILPA") appreciates the opportunity to submit comments in conjunction with the November 19, 2019 hearing, **"America for Sale, An Examination of the Practices of Private Funds**."

ILPA serves the shared interests of more than 530 institutional investors that direct capital to private funds globally, otherwise known as Limited Partners ("LPs"[1]). These members include public and private pension funds, university endowments, insurance companies, charitable foundations, sovereign and treasury funds, Taft-Hartley plans and family offices, among others. One-third of our membership represents American public pension funds, which rely on the returns and diversification generated by private equity to deliver a secure retirement to hundreds of thousands of teachers, policemen, firemen and other public workers across the United States.

As such, ILPA supports the Committee's desire to evaluate legislative changes that ensure the health of the private equity industry for the long-term. The industry's scale and range of investment activities requires a meaningful discussion of reforms that level the playing field for LPs, while also safeguarding the fair treatment of workers at underlying portfolio companies and engaging productively with a wide range of stakeholders.

**We are strongly in favour of targeted reforms for private equity aimed at enhancing governance, alignment of interests and transparency, and believe such change can be achieved through the adoption of provisions outlined in the *Investment Adviser Alignment Act.***

With that said, while ILPA believes targeted reforms are necessary, we have significant concerns about any changes that would hobble the industry and prevent LPs from earning the returns necessary to support their beneficiaries. The goal of policymakers and regulators should be to achieve better balance without fundamentally disrupting an investment model that has, in aggregate, served our pensions, endowments, foundations and other long-term pools of productive capital so well.

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[1] For a partial list of ILPA's member institutions that have agreed to be publicly disclosed, please visit: https://ilpa.org/member-list/.

Additional commentary on topics covered in the November 19 hearing is below:

## I. ILPA Strongly Supports the Investment Adviser Alignment Act

Over the past year, ILPA has engaged with policymakers in Congress regarding the challenges LPs face in the private equity market, and we have encouraged specific reforms that are focused on transparency between private equity fund managers ("GPs") and LPs. We believe the *Investment Adviser Alignment Act*, a targeted, bipartisan reform package that establishes minimum standards in law and protect millions of beneficiaries who rely on the LPs' ability to negotiate and invest knowledgeably on their behalf, represents a compelling solution.

Over the past decade, it has become increasingly difficult for LPs to negotiate reasonable terms with private equity funds and accurately monitor fund performance. There is immense competition to access top-performing funds that provide the returns they require, resulting in LPs often being unable to measurably improve the skewed investment terms for fear of having their investment allocations reduced or excluded. Once invested in a fund, information flows regarding fees and expenses, as well as other pertinent information, are not always provided in a consistent fashion or otherwise, resulting in an information asymmetry that negatively impacts decision making.

ILPA believes Congress should take action on three fronts. First, Congress should eliminate the loophole in the Investment Advisers Act of 1940 ("Advisers Act") that permits GPs to reduce or eliminate their fiduciary duties of care and loyalty in their investment contracts. Second, Congress should require GPs to disclose to their investors how much they are charging them, on a quarterly basis, in fees and expenses. Third, Congress should require GPs to share pertinent information that is not always being disclosed today with their investors, including the organizational identity of fellow investors (for communication purposes), as well as any compliance issues the Securities & Exchange Commission ("SEC") has uncovered. Each of these provisions are components of the *Investment Adviser Alignment Act and detailed as follows:*

### A. Fiduciary Duties Are the Foundation of Trust in Private Equity

Strong fiduciary duties—of care, loyalty, and good faith—are the foundation of the trust between LPs and GPs, and give investors' confidence to invest in the illiquid private markets, which by their very nature are less transparent. As the Chief Justice of the Delaware Supreme Court, Leo Strine, recently noted: "*[a]mong the hallmarks of [contractual agreements in private equity] are broad waivers of all fiduciary duties, including the duty of loyalty. Traditionally, the duty of loyalty provided the most meaningful protection to passive investors in corporations and partnerships.*"[2] This dynamic results in a difficult choice, according to the Chief Justice, "*the practical alternatives for a skeptical*

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[2] Leo Strine & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom,* Harvard Law School John M. Olin Center Discussion Paper No. 789, (August 1, 2014) p. 3, *available at:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2481039.

*investor are often stark: invest without adequate protection against self-dealing or avoid the asset class altogether.*"[3]

The primary sources of fiduciary obligations owed by GPs to LPs are found in two places: the Advisers Act and those included in the investment contract between the LP and the GP, generally governed under the laws of the state of Delaware. The fiduciary duties under the Advisers Act are only enforceable by the SEC, and only apply to the fund as a whole, not to the individual LPs within it, and therefore are less helpful to LPs. Contractual obligations around duty of loyalty are understandably critical to LPs, given their passive role as investors in these funds and the possibility of conflicts of interest.

Eighteen of the SEC enforcement actions against private fund advisers since 2014 included breaches of fiduciary duties, such as the failure to disclose either real or potential conflicts of interest or inappropriately charged fees and expenses. While these enforcement actions may have deterred similar behaviors, they have spawned a "mountain" of disclosures in the investment contracts known as limited partnership agreements ("LPAs") that LPs sign with GPs. Even a sophisticated LP may find it difficult to truly give informed consent when confronted with written terms and disclosures that are broad, opaque, voluminous, and sometimes contradicted by the oral statements of the GP.

Contracts negotiated by GPs increasingly feature diminished fiduciary obligations to LPs, allowable under Delaware and Cayman law, where most of these funds are domiciled. Some of the largest U.S. institutions have been forced to walk away from investment opportunities due to unsatisfactory duty of care or loyalty, e.g., language that permits the GP to act in its "sole discretion", putting its own interests ahead of those of the LPs in the fund. This is a particularly acute problem for some U.S. public plans, who to some extent are statutorily proscribed from reducing their own fiduciary obligations through contract.

These practices are harmful for investors who must accept reductions in fundamental protections in order to invest and are not in the best long-term interest of the industry. Congress must take action to ensure that GPs subject to the fiduciary requirements of the Advisers Act are not reducing or eliminating those same duties for their investors in the investment contracts.

### B. LPs Should Be Sufficiently Informed About the Fees & Expenses being Charged

ILPA has sought greater fee and expense transparency in the private equity industry for several years. The lack of fee and expense transparency in the marketplace as an issue became apparent soon after the SEC began examining GPs. In 2014, the SEC indicated after their initial round of 150 examinations that *"[w]hen we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we*

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[3] *Id* at 4.

*believe are violations of law or material weaknesses in controls over 50% of the time."*[4] A 2016 speech by then-SEC Division of Enforcement Director, Andrew Ceresney further highlighted the transparency challenges around costs facing LPs: *"[I]nvestors in certain circumstances do not have sufficient transparency into how fees and expenses are charged to portfolio companies or the funds. Sometimes fees are not properly disclosed, conflicts are not aired, expenses are misallocated, and investors are defrauded… even experienced [and sophisticated] investors can be defrauded if they lack transparency into the various fees, expenses and practices."* As LPs became more aware of these issues in the industry, they needed a solution to ensure they could verify the fees and expenses they were being charged.

In 2016, ILPA released its Reporting Template[5] as an industry standard format for reporting fees and expenses to investors to satisfy this need. Many GPs and LPs have adopted the template as the solution for providing LPs with a consistent view into fund charges. As of April 2019, 26 GPs have endorsed the template[6], committing to provide the template data to any LP requesting it. A number of states, including California and Texas, have also imposed requirements to require fee reporting to be received by their public pensions, creating a bifurcation between various LPs in the marketplace.[7] Moreover, the Financial Conduct Authority, the United Kingdom's securities regulator, has also recognized the opacity in this market and taken action to encourage enhanced fee and expense reporting in the UK, including the ILPA template as an option.[8] Given the complexity of the fees and expenses charged to the fund and to portfolio companies, quarterly fee and expense reporting is critical to investors and must be included in any reform seeking transparency in private equity.

### C. <u>Free Flow of Information Is Critical for Fund Governance</u>

Often, private equity LPAs include provisions limiting the ability of LPs to communicate with one another about the fund, even within that same partnership. In addition, GPs do not routinely provide a complete list of all LPs in the fund. Investors are therefore impeded from exercising their contractual rights with respect to fund governance where matters require investor consent or a vote within the partnership.

Additionally, since SEC registration of private equity managers was enacted in 2010, the SEC has examined a significant portion of the industry. While the default expectation is

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[4] Andrew Bowden, *Spreading Sunshine in Private Equity,* PEI Private Equity Compliance Forum 2014, New York, May 6 ,2014, *available at:* https://www.sec.gov/news/speech/2014--spch05062014ab.html

[5] https://ilpa.org/reporting-template/

[6] Template endorses include significant GPs like Apollo, Blackstone, Carlyle and KKR, among others. https://ilpa.org/reporting-template/template-endorsers/

[7] *See AB 2833 New California Law Opens Lid on Private Fund Fees,* REED SMITH CLIENT ALERT, October 4, 2016, *available at:* https://www.reedsmith.com/en/perspectives/2016/10/ab2833-new-california-law-opens-lid-on-private-fun

; Christine Williamson, *Texas to Peek Over Shoulders of Public Funds,* PENSIONS & INVESTMENTS*,* (June 24, 2019), *available at:* https://www.pionline.com/print/texas-peek-over-shoulders-public-funds

[8] Alex Lynn, *Fee Reporting Template Becomes a Focus for UK Regulator,* PRIVATE FUNDS CFO, November 8, 2010, *available at:* https://www.privatefundscfo.com/uk-regulator-taps-uss-exec-catalyse-fee-template-adoption/

that GPs will follow the terms of the contract, there have been material exceptions. When a GP has been examined, LPs should be privy to compliance or other shortcomings identified by the SEC—today, this information is protected, and most GPs refuse to share it with existing and prospective LPs. LPs must be informed if the SEC uncovers compliance issues, including non-compliance with the terms of their LPAs.

## II. ILPA's Views on the Stop Wall Street Looting Act (H.R. 3848/S.2155)

This summer, Senator Elizabeth Warren and Representative Mark Pocan introduced the *Stop Wall Street Looting Act* (S. 2155 and H.R. 3848) (the "Pocan Bill"). **The Pocan Bill represents a far-reaching overhaul of the private equity industry, which poses substantial risks to LPs being able to rely on much needed investment returns and portfolio diversification from private equity. While there is overlap between certain provisions in the Pocan Bill and the Investment Adviser Alignment Act, we view portions of the Bill as harmful to the industry, our LP members and their beneficiaries.** We strongly urge the Committee to instead consider a targeted and constructive set of reforms, again, with the *Investment Adviser Alignment Act* serving as a roadmap for a healthier industry. Specifically, we view the following provisions in the Pocan Bill as being generally aligned with the *Investment Adviser Alignment Act*:

**Fiduciary Duty (Section 502):** ILPA is supportive of provisions in the Pocan Bill that prevent the waiver of fiduciary duties under the Investment Advisers Act. This issue concerns many LPs and is a core reform sought by ILPA. ILPA believes that the provisions which amend ERISA fiduciary protections, while well meaning, should be removed, as these would only apply to ERISA-governed plans, predominantly Taft-Hartley (union) plans and corporate pensions. These provisions would not elevate the standard of care required for public pension investors and may result in ERISA plans not having access to the returns and diversification provided in the private equity market.

**Fee & Expense Reporting (Section 501)**: ILPA is supportive of provisions that require GPs to report their fees and expenses to investors. While the Pocan Bill requires these to be reported annually, we believe they should be reported quarterly to be relevant to investors. Additionally, we believe this provision should be drafted to ensure all current and future conceived direct and indirect fees are covered.

**Disclosure of other LPs in the Partnership (Section 501)**: ILPA supports provisions which permit LPs to know who their fellow LPs are in private equity funds. These provisions help LPs exercise governance rights in the LPA, which often require active coordination among LPs in the fund. LP names must already be disclosed in the UK public register and many public pensions report this information. While we support sharing LP names amongst other investors in the fund, we do not necessarily support sharing these names publicly.



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## III. Conclusion

On behalf of its members and their beneficiaries, ILPA appreciates the opportunity to engage on this important topic and encourages the Committee to move forward with sensible reforms, like those in the *Investment Adviser Alignment Act*, to ensure the long-term health of the private equity industry.

Respectfully Submitted,

Steve Nelson
Chief Executive Officer
Institutional Limited Partners Association