Testimony to the Pension Review Commission by Jennifer Choi, Managing Director, Institutional Limited Partners Association (ILPA)

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Introduction / Background on ILPA

The Institutional Limited Partners Association ("ILPA"), appreciates the opportunity to share our perspective with the Commission on the evolution of transparency in the private equity industry.

The focus of my comments today will be to provide some history around ILPA's efforts to advance more fulsome and uniform reporting by fund managers to investors, perspectives on the adoption of reporting standards across the industry, as well as some observations on efforts to legislatively mandate reporting standards for private equity.

First, a few words about ILPA. ILPA is the voice of institutional investors in the private equity asset class, known as Limited Partners, or LPs. Our more than 480 member institutions represent over $2 trillion in private equity assets under management, or nearly half of global institutional capital invested into private equity funds. ILPA is unique as the first, and still only, organization exclusively designed to address the needs of limited partners, who constitute our entire membership.

Collectively, our membership comprises more than 4,500 individual practitioners across 50 countries, spanning not only the investment office but also professionals in legal and compliance, accounting and back office—ILPA supports the entire institutional infrastructure that touches private equity.

ILPA's members include U.S. and global public and private pension funds, insurance companies, university endowments, charitable foundations, family offices and sovereign wealth funds, all of which invest on behalf of beneficiaries—teachers, first responders, retirees, charitable institutions, policyholders—that depend heavily on the investment returns produced by private equity funds.

ILPA's mission is to engage, empower and connect limited partners to maximize their performance on an individual, institutional and collective basis. We achieve this by delivering education, fostering professional connections and developing best practices that empower our members to make effective and informed investment decisions and to advance the quality of transparency and alignment of interests across the industry.

ILPA's hallmark achievements in this regard are the ILPA Private Equity Principles, which lay out preferred fund terms as well as governance and disclosure best practices for fund managers and their investors, and our reporting standards, including the template for fees, expenses and carried interest that we will discuss today.

<u>History of the ILPA Reporting Template for Fees, Expenses and Carried Interest ("ILPA Reporting Template"</u>

ILPA's members have long called for greater transparency and standardization in the industry. In 2012, ILPA issued guidance on quarterly reporting to LPs, prescribing what managers should disclose to investors about the underlying companies in the fund's portfolio, as well as the information to be included in capital calls and distributions.

In the years that followed, as the private equity industry adjusted to being regulated for the first time, investor demands for transparency escalated, for several reasons: SEC revelations of deficiencies in GP disclosures and reporting hygiene; political pressure in the US and elsewhere to rationalize the higher costs and perceived opacity of private equity; and select cases, including SEC enforcement actions, that underscored the need for assurances that fees charged conform with the partnership agreement, the contract defining how costs and profits will be split between the GP and the LPs in the fund.

Moreover, ILPA's members articulated that the lack of consistency in GP reporting significantly hampered their ability to answer legitimate, but often complex, questions about the true and full costs involved in managing a sophisticated private equity program, i.e., what does it really cost to do PE well. Beyond the essential task affirming that all fees charged were compliant with the contract, LPs found it difficult to make comparisons between GPs about cost structures relative to performance, or to inform their institution's determinations on the optimal balance between internal and external management of a private markets portfolio.

In 2015, in response to rising calls for greater transparency in fee disclosures from our members, ILPA convened a working group to identify the means for resolving the gap between the information needs of LPs and the inconsistencies in GP reporting.

This effort, dubbed the ILPA Transparency Initiative, drew on extensive consultations within the LP community and with the GP community and technical experts to develop the ILPA Reporting Template for fees, expenses, and carried interest. {It's worth recognizing the contributions to that work from my fellow panelists; both Lorelei and Renee lent considerable input to the project on behalf of the South Caroline Retirement System Investment Commission and the State of Rhode Island, respectively}.

The Template, released January 29, 2016, provides LPs with an improved baseline of information that permits more streamlined analysis and informed internal decision making. Benefits and innovations afforded by the Template include:

- A reduced compliance burden for general partners, who must provide reporting that satisfies a range of non-uniform reporting formats provided by their LPs. *One very large GP summarized their motivation to embrace the ILPA Reporting Template as follows: "we are being inundated with large and small data requests from large and small investors alike – often because they don't want to receive the information in the way that another LP has requested it. We have tremendous institutional interest in standardization and hope that this process will advance that and reduce the number of individual report formats that we have to produce."*

- The recommended quarterly cadence enables LPs with non-December fiscal year ends to aggregate information in a way that aligns with their own institutional reporting cycles.
- For the first time, standardized disclosures related to fees collected by the GP but not offset against management fees, as well as reporting of fees collected via related parties, allowing LPs to more closely monitor potential conflicts of interest impacting on the fund's economics.
- The Template provided definitional clarity and itemized detail for offsets against management fees, and common organizational expenses. ILPA learned through the Transparency Initiative that the practices of GP back offices can be highly individualized, with a tremendous amount of variability in the finance and operation function, outside of FASB/GAAP.
- Presentation of this information in a single format (rather than across multiple reports such as end of year financials, capital calls and footnotes to financial statements) eases identification of outliers warranting follow-up, or incomplete data.

But responsibility for reporting standardization does not lie solely with the GP. There is tremendous benefit to conformity within the LP community – a single, coherent "ask" of the GPs carries greater weight, accelerates implementation, provides incentives via efficiencies and economies of scale in technology support, process and staffing requirements.

Industry Adoption and Response

At the outset of the Template's release, many GPs were conceptually supportive of standardization but wary of the compliance challenges presented by the level of detail in the Template, particularly those with more limited infrastructure or complex fee models.

GPs also expressed skepticism about the "shelf life" of the standard and its "one size fits all" application, and raised concerns about subsequent revisions to the standard that would force them out of compliance or make their internal process mapping and infrastructure obsolete.

Many questioned whether LPs could usefully absorb such granular information considering the lack of robust internal LP systems for capturing and analyzing such data, and what questions LPs sought to answer with the data being provided.

Some LPs, for their part, expressed hesitation in insisting on the Reporting Template, worrying that they would be alone in their demands for adherence to the standard or outmaneuvered by managers in a capital rich fundraising environment, where managers can pick and choose which LPs they wish to allow into their funds.

To address these concerns and frequently asked questions about implementation, ILPA released clarifying guidance and expanded definitions in October 2016, 10 months after the Template's initial release but without making any substantive revisions to the Template itself. ILPA continues to emphasize the careful consideration that would be given to any future revisions to the template and anticipates any such iterations to be minimal, made with ample notification to users. As early adopters have been able to demonstrate the feasibility and usefulness of the Template, the concerns noted above have eased.

ILPA monitors both endorsement and adoption of the Template. Endorsement is intended as a public signal of a manager's intention to provide the standardized data for any investor that requests it, on a prospective basis for current funds and funds going forward.

Additionally, endorsement represents the commitment to integrate the reporting standard into processes and infrastructure so that over time a manager can provide the template data to all LPs as part of their regular reporting package.

Since the template's release in January 2016, endorsement has grown from 29 organizations initially to **166** today. By some estimates, adoption, i.e., utilization of the template by managers, has grown nearly 70%.

- As of this month, **166** organizations have endorsed the Reporting Template–including **30** GPs and funds of funds, **107** LPs and **29** service providers and other industry groups.

- Endorsing GPs account for **26%** of private equity capital under management today.

- Public plans that have endorsed the template represent **US$230 Billion** of PE AUM.

- ILPA estimates that **over 300 managers** today provide the template to those LPs requesting it.

- A survey of GPs by a fund administrator indicated that **22%** of GPs currently use the ILPA template for one or more of their LPs.

- A poll of ILPA members conducted in July 2018 indicated that **90%** were receiving the template from **one** or more of their GPs, and 26% are receiving the ILPA template for at least half of their newer vintage funds.

Where are We in the Adoption Cycle?

Adoption of the reporting standard is an inherently LP-driven phenomenon. It is essential that LPs continue to telegraph their interest in standardized reporting, while at the same time limiting bespoke additions or enhancements to the standard, i.e., "Template-plus" formats. For many LPs, the most successful means for securing GP commitments to provide the Template is as part of the negotiation process at the start of a fund, often as request in the side letter that accompanies the partnership agreement.

As we move from adoption to implementation of the Template, both LPs and GPs are seeking ways to manage the data flowing between them. Several software providers and fund administrators are working to meet those needs, with increasing focus on automation. For their part, LPs are seeking to both verify the information received and to draw insights from the data; benchmarking remains the goal for LPs but is still some ways off.

Public Reporting Standards and Legislative Efforts

This brings us to a discussion about standardization in public disclosures. As evidenced in a study published by the Pew trust in 2016 and confirmed via additional ILPA analysis of CAFRs released in 2016 and 2017, there continues to be great variability in the level of detail provided in public disclosures of private equity costs. Public plans in most states report performance on a net of fee basis, but the level of disclosure on the fees and expenses charged to the plan vary. Some plans report down to fund-level costs, others indicate only those fees and expenses directly charged but exclude costs netted out of distributions. Reporting of carried interest varies as well, with a minority of states including this level of detail in their reporting. This variance is attributable to several factors, such as the individual institution's ability to acquire the data from their managers, methodological differences to CAFR reporting between plans and differing philosophies about what should be considered a cost, versus profit sharing.

State-Level Legislation (US)

There have been several attempts to legislate greater transparency in private equity cost disclosures in the United States, focused primarily on the information being provided by the LPs (and by extension, compelling LPs to acquire this information from their managers).

The most notable example is in California, which passed a law (AB 2833) in 2016 mandating that public plans collect and report data on fees, expenses, offsets and each institution's pro rata share of GP income not offset, including related parties (all data included in the ILPA template). Plans are required to report this data at least once annually.

The law applies to all new contracts entered into after Jan 1, 2017. The law does not expressly prescribe use of the ILPA Reporting Template, but California plans have indicated that the ILPA Template meets nearly all of the requirements in the law.

Some of the largest California plans indicate that 80% or more of their GPs are producing the template data, as the result of LP requests made to conform with the statute.

There have been reports that a handful of managers have elected not to raise capital from California plans that must comply with this law, a small minority.

This illustrates an important consideration for legislators: private market investments, even more so than other asset classes, are relationship-driven. The arrangements between LPs and managers are both voluntary and negotiated. While market cycles can influence whether the terms of such arrangements favor the GP or the LP, the managers in highest demand, regardless of market cycles, can be selective in their LP relationships.

Variance in mandated disclosure requirements state to state can therefore present challenges for investors: attractive managers can elect to raise capital for their funds in jurisdictions with less onerous requirements or risk of exposure of sensitive commercial information. Should individual states prescribe specific methodologies that are out of step with other jurisdictions or with industry, this can also add to the methodological complexity that hinders compliance and hampers benchmarking.

Federal regulation (US, UK, Australia)

This begs the question of whether federal level requirements may be a more optimal solution. Regulators have indicated that GP compliance with the ILPA Reporting Template addresses many of the present shortcomings in private equity fee disclosures, as well as the compliance and hygiene concerns flagged, for example, during the SEC's examinations of private fund advisers. In the case of the SEC, the agency's purview is on the adviser, rather than the fund or the individual GP-LP relationship; to date support has been greater for encouraging the adoption of the industry standard for fund-level reporting rather than a regulator-issued reporting standard that may be less adaptable to shifting market dynamics or realities.

In 2017, the UK's Financial Conduct Authority (FCA), the national securities regulator, convened an independent advisory body, the Institutional Disclosure Working Group, as part of broader study on asset management costs and transparency, including but not limited to private equity. The group created templates for account-level disclosures, intended to roll up an aggregate plan-level view of costs across all asset classes and externally managed accounts for use by plan trustees. The recommendations of the working group were issued in June; while templates were provided for "mainstream" asset classes, the working group offered optionality for private equity—either a slightly modified version of the ILPA standard developed by the IDWG, or the ILPA standard itself.

Australia's Securities and Investments Commission's (ASIC) Regulatory Guide 97 (RG 97) went into effect in 2017, requiring superannuation funds to disclose both direct and indirect fees and costs in their product disclosure statements (PDS) and the periodic statements they provide members. The compliance deadline was pushed forward three times to allow more time for addressing certain costs that are problematic to standardize, such as facility management costs related to real assets. The Australian authorities have acknowledged that one potential risk to mandated disclosures is excessive or even unhealthy focus on cost at the expense of all other factors—risk-adjusted return, diversification benefits and ultimately the benefit to plan members.

Embrace of uniform reporting standards such as the ILPA Template is critical to understanding costs in context—what is the benefit to the plan's bottom line? What is the performance of private equity investment relative to other parts of the portfolio, and are such comparisons being made on a fully costed basis? ILPA believes that a more uniform baseline for comparative analysis of net returns –and how managers achieve that performance—remains the goal.