Testimony of
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Subcommittee on Economic Policy

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Good afternoon Chair Warren, Ranking Member Kennedy, and other distinguished members of this subcommittee and guests. My name is Michael Frerichs. I am the Illinois State Treasurer, and it is an honor to be invited to speak to you today to share my experience managing investments on behalf of the people of Illinois.

The Illinois State Treasurer is a constitutionally established, elected office in our state that performs a variety of roles. I am the state's Chief Investment and Banking Officer. In that role, my office manages approximately $50 billion, including $25 billion in state funds, $16 billion in retirement and college savings plans, and $9 billion on behalf of state and local government entities.[1] I also serve as a trustee on the Illinois State Board of Investment ("ISBI"),[2] which manages approximately $31 billion in assets on behalf of over 226,000 beneficiaries of a number of state retirement plans.[3]

As an elected steward of public funds, I have a responsibility to make prudent investment decisions, and I also have a responsibility to the long-term fiscal health of our state, which relies on a vibrant and sustainable economy. Furthermore, I have a responsibility to the communities that I represent to tend to their well-being and to be mindful of how the decisions that our office makes might impact the livelihoods of workers and their families.

As an active investor in the space, I view private equity as an essential part of our capitalist system. The idea of the industry is simple and reasonable: sometimes a company has room to grow and become more productive, but its current ownership is not in a position to capitalize on that opportunity. In this situation, it makes sense for an investment vehicle run by experts to pool

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[1] Illinois State Treasurer, *Investments*, available at https://illinoistreasurer.gov/Office_of_the_Treasurer/Investments.
[2] I am testifying today in my capacity as the Illinois State Treasurer and as an individual trustee of ISBI. These views are my own and are not intended to represent the views of ISBI.
[3] Illinois State Board of Investments, *About Us*, available at https://www.isbinvestment.com/.

private capital, buy the firm, take it to the next level, and then sell it. This generates a profit for private equity firms and their investors, it helps the company grow, and it creates more economic opportunity for society at large.

For investors like the Illinois Treasury and other institutional investors, private equity investments provide an opportunity to further diversify our portfolios, help drive economic development in Illinois and beyond, support small businesses, invest in qualified minority- and women-owned investment firms, and provide a competitive return that complements our investments in other asset classes such as public equities and fixed income.

The problem is that as private equity has continued to evolve as an asset class, becoming a larger and larger portion of our economy, it has remained dangerously under-regulated. That means that predatory and destructive activities like pillaging assets, opaque fees, and strategically using bankruptcy without regard for the well-being of workers remain perfectly legal. As private equity continues to evolve, there is a need for sensible reforms that will enhance long-term outcomes for investors, including public pensions, and continue to focus private equity on what it does best, helping companies to grow and expanding economic opportunity for our communities.

As Treasurer, my office directly invests in private equity funds, and we intend to continue to do so in the future. Through the Illinois Growth and Innovation Fund ("ILGIF"), my office makes targeted investments with venture capital, growth equity, and private venture debt funds that invest in technology-enabled businesses that are either based in Illinois or possess a significant workforce in Illinois with the goal to attract, assist, and retain these quality technology-enabled businesses in Illinois.[4] As of March 31, 2021, we have $430 million invested in private equity and venture capital through this program. To date, these investments have been our highest performing

[4] *See* Illinois Growth and Innovation Fund, *Mission*, available at http://www.ilgif.com.

asset class with a net internal rate of return of 21.3% since the inception of the program in 2016.[5] After evaluating this program, I saw great potential in these investments for Illinois, both in terms of the return on investment and the ability to stimulate growth in our economy, and that led me to advocate for a change in the state law to allow my office to increase the percentage of funds invested in ILGIF from 2% of the state investment portfolio to 5%.[6]

A core investment objective for ILGIF in addition to driving performance and economic development, is fostering a more diverse and inclusive manager and private equity ecosystem across Illinois. It is my core belief that a more inclusive private equity ecosystem means more opportunities for diverse founders which in the long term, has the opportunity to build generational wealth and advance equity, diversity, and inclusion in our communities. We know the importance of providing individuals with traditional and non-traditional backgrounds necessary opportunities to grow within the private equity space and the benefits a greater level of diversity adds to the ecosystem overall.

As of March 31, 2021, of the $430 million committed to Illinois venture capital firms under ILGIF, $183 million has been committed to minority-, women-, veteran-, and disabled-operated (MWVD) venture capital firms. That represents over 42% of committed capital to date. Investments from ILGIF fund managers have supported more than 110 diverse-owned portfolio companies to receive funding. Through ILGIF, the Illinois Treasurer actively seeds and anchors new MWVD-operated venture capital and private equity funds furthering the investment objective to foster a more diverse and inclusive manager pool and entrepreneurial community across Illinois.

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[5] *See* Illinois Growth and Innovation Fund, *Impact*, available at https://www.ilgif.com.
[6] *See* the Technology Development Act, 30 ILCS 265, available at https://ilga.gov/legislation/ilcs/ilcs3.asp?ActID=502&ChapterID=7; *see also* "Treasurer Frerichs Announces Increase in Venture Funding to Help Grow Technology Businesses in Illinois," Illinois Venture Capital Association, Aug. 29, 2020, available at https://ivca.memberclicks.net/treasurer-frerichs-announces-increase-in-venture-funding-to-help-grow-technology-businesses-in-illinois.

For example, our office continues to push toward increasing economic equity to broad swaths of Chicago, in which there has been decades of disinvestment and undercapitalization that has left entire communities vulnerable and marginalized. Entrepreneurship is a potent tool in closing long-standing wealth gaps. That is why in partnership with minority-owned and operated venture capital firm Cleveland Avenue, ILGIF anchored and helped launch the Cleveland Avenue State Treasurer's Urban Success Fund, a $70 million fund dedicated to investing in underrepresented founders within underserved communities on Chicago's South and West sides.

Likewise, as a trustee of ISBI, which maintains approximately 7% of its total portfolio in private equity investments, I have also given considerable thought to the role that these investments play in support of the long-term growth of our state pensions.

I have seen first-hand the benefits of private equity investment for our state, but also the ways in which the current lack of regulation allows for abuses that harm institutional investors, workers, and businesses. Specifically, I want to underscore the need for greater transparency to allow institutional investors, including ILGIF and our state pension programs, to fairly evaluate the prospective costs and benefits associated with a particular private equity investment, as well as the need for reforms targeting bad actors in this industry that allow workers and their families to become collateral damages when an investment goes awry. I see these reforms as a way to enhance this industry by aligning the goals of private equity firms, institutional investors, and the people and communities that work every day to make their businesses a success.

Lack of Transparency

Regulators have recognized that the lack of transparency in this industry often operates to the detriment of institutional investors. Since 2014, the SEC has brought to light many cases where fees and expenses were improperly charged or insufficiently disclosed to investors in private funds.[7] In June 2020, the Office of Compliance Inspections and Examinations ("OCIE") at the U.S. Securities and Exchange Commission ("SEC") released a risk alert identifying numerous issues with allocation and disclosure of fees and expenses by private fund advisors that had arisen in recent compliance examinations.[8] OCIE noted that many of the deficiencies discussed in the Risk Alert may have caused investors in private funds "to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest concerning the private fund advisor and the fund."[9] Earlier this year, in testimony before the full Senate Banking Committee, SEC Chairman Gary Gensler stated that "[u]ltimately, every pension fund investing in these private funds would benefit if there were greater transparency and competition in this space."[10]

In my own experience, the lack of transparency surrounding private equity investments, specifically related to fee arrangements and the calculation of the internal rate of return creates significant challenges for institutional investors like my office and our state retirement plans.

The fees and costs associated with a particular investment can significantly affect the long-term return on these investments. The fees charged by private equity managers are among the highest in the investment industry, thus, any lack of transparency represents a meaningful risk. Private equity firms use different terms, different methodologies around calculating asset values,

[7] See Andrew J. Bowden, Director of OCIE, "Spreading Sunshine in Private Equity," May 4, 2014, available at https://www.sec.gov/news/speech/2014--spch05062014ab.html; *see also* Marc Wyatt, Acting Director of OCIE, "Private Equity: A Look Back and a Glimpse Ahead," May 13, 2015, available at https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.
[8] *See* U.S Securities and Exchange Commission, Office of Compliance Inspections and Examinations, Risk Alert, dated June 23, 2020, available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.
[9] *See* OCIE Risk Alert*, supra*.
[10] Testimony of Gary Gensler before the United States Senate Committee on Banking, Housing, and Urban Affairs, September 14, 2021, available at https://www.banking.senate.gov/imo/media/doc/Gensler%20Testimony%209-14-21.pdf.

and different metrics to report on their performance, with some breaking out fees and expenses to investors while others make fee and expense information much harder to identify. This makes evaluation cumbersome and makes direct comparisons between funds nearly impossible. Additionally, private equity firms are increasingly using bridge loans, known as subscription lines, to pay for assets, manage capital calls, and boost returns, adding more debt to already leveraged transactions without always accounting for their true impact on returns. In order to assess the value of these investments, institutional investors have to hire specialists who are expensive and drive up costs, or risk paying more for an investment than we should.

Clear and standardized fee and expense disclosures, similar to the template established by the Institutional Limited Partners Association, would allow institutional investors to streamline their analysis and will drive better decision making. These basic reforms would also reduce the compliance burden and cost, not only on Limited Partners, such as the programs my office manages, but also on General Partners being asked to report against a range of varying templates from investors. Investors would also be able to accurately understand and account for general partner fees, fee offsets, and fund expenses in order to verify what they are being charged against what was agreed upon in investment contracts.

While some might argue that access to more granular reporting can be achieved through negotiations between more sophisticated Limited Partners like large institutional investors and the private equity firms, this approach has yet to result in a change in market practice. As a larger institutional investor, my office attempts to negotiate an increased level of transparency by leveraging a reporting template that is modeled off of the Institutional Limited Partners Association's reporting template to ensure private equity firms demonstrate that they are allocating costs appropriately. However, basic market transparency should be available to all investors, including smaller institutional investors such as city or county pension funds, not just those with the buying power to negotiate a more favorable release of information.

Protection for Workers and Communities

In my role as an elected officer of the state of Illinois, I take my responsibility towards the communities in my state very seriously. As an investor of public funds, I also see it as my obligation to integrate sustainability factors into our investment decisions, including minimizing risks and negative impacts to what we call our human capital – the workers who drive our economy. While I see strong value in private equity investment, there are many examples of firms that have profited off a business model that allows them to buy companies, load them up with debt, pay themselves massive and often opaque fees with that borrowed money, and then leave the company in bankruptcy. Hundreds of thousands of workers have lost their jobs in private equity owned corporate bankruptcies,[11] tearing families and neighborhoods apart. To this end, Congress should consider reforms that prioritize worker pay in the bankruptcy process, create incentives for job retention so that workers can benefit from a company's second chance, and incentivize value-generating management and investment over asset-stripping.

Conclusion

Madam Chair, Ranking Member Kennedy, and other distinguished members of this subcommittee and guests, I ask for your help in strengthening private equity markets, which will help ensure the long-term success of the industry, establish market efficiencies, and lead to better outcomes for all stakeholders. I firmly believe that private equity can help unlock economic

[11] The Center for Popular Democracy, "Pirate Entity: How Wall Street Firms are Pillaging American Retail, The Center," July 23, 2019, available at https://www.populardemocracy.org/pirateequity.

opportunity in ways that grow our communities, expand the circle of possibility, and provide excellent, long-term returns for investors like the Illinois Treasury. With your support, I know that a reformed private equity market can accomplish all this, and more.