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September 13, 2010

AGENDA ITEM 3

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Regulation Relating to Disclosure of Placement Agent Fees

II. PROGRAM: Total Fund

III. RECOMMENDATION: Staff recommends that the Committee adopt staff's revisions to proposed Regulation 559 Disclosure of Placement Agent Fees, Gifts, and Campaign Contributions

IV. ANALYSIS:

On March 15, 2010, the Investment Committee ("Committee") authorized staff to proceed with formal rulemaking pursuant to the California Administrative Procedure Act to add a new section to the California Code of Regulations addressing placement agent disclosures. The proposed regulation is very similar to the Policy for Disclosure of Placement Agent Fees, Gifts and Campaign Contributions ("Policy") adopted by the Committee on May 11, 2009, and thereafter revised on November 16, 2009.

The proposed regulation was subject to a public hearing held during the Investment Committee on June 14, 2010. Based on comments received prior to June 14, 2010, staff did not propose any changes to the proposed regulation considered by the Investment Committee. CalPERS, however, received several comment letters that were not received in time to be fully considered by the Investment Committee. Several of the comments requested staff to delay the proposed regulation until Assembly Bill 1743 (Hernandez) was fully considered.[1] AB 1743 is a bill co-sponsored by CalPERS that would require Placement Agents to register as lobbyists. This bill impacts some of the statutory definitions that the

[1] See the June 14, 2010 comment letter submitted by the Securities Industry and Financial Markets Association ("SIFMA") and the June 14, 2010, comment letter submitted by the law firm Skadden, Arps, Slate, Meagher & Flom LLP ("Skadden Arps"). (See Attachment 3)

proposed regulation addresses and received significant public input. Based on the status of AB 1743, staff delayed moving forward with the proposed regulation while AB 1743 continued to be refined. To date, AB 1743 has been amended three times since June 14, 2010, and was most recently amended on August 17, 2010.

The bulk of amendments to the proposed regulation are being made to align it with the statutory definitions in the most recent version of AB 1743. While the legislative process is always uncertain, CalPERS, other sponsors of AB 1743, Assembly Member Hernandez, and the numerous other co-authors are hopeful that the bill will have been adopted by the Legislature by the date of the September Investment Committee meeting .

The Notice of Modification, amended proposed regulation, and the forms incorporated by reference are attached as Attachment 1. The June 14, 2010, agenda item and attachments are attached as Attachment 2. The comment letters not addressed by the June 14, 2010, agenda item are included in Attachment 3. The most recent version of AB 1743 is attached as Attachment 4. Staff made the suggested changes to the proposed regulation and provided the public with the required 15 day notice pursuant to the Administrative Procedures Act.

AB 1743 Conforming Changes

The majority of changes made to both AB 1743 and the proposed regulation are technical in nature. These changes were driven by an analysis of AB 1743 done by Mr. Keith Bishop, former Commissioner of the Department of Corporations. Mr. Bishop's letter to Assembly Member Ed Hernandez dated May 20, 2010, is attached as Attachment 5.

In summary, Mr. Bishop commented that AB 1743 did not do a good job using established securities law terminology to describe and differentiate between (a) external managers who provide investment management services pursuant to contract and (b) those external managers that manage a legal entity like a limited partnership or limited liability company that offers securities to investors, e.g., CalPERS hedge fund and private equity managers. The proposed changes are a result of collaboration between the CalPERS Legal Office, including outside counsel, and Mr. Bishop. The clearest example of the type of changes made in response to Mr. Bishop's analysis is illustrated by the amended definition of "external manager." External manager is proposed to be amended as follows:

> External Manager means (i) a Person ~~an asset management firm~~ that is seeking to be, or ~~has been~~is, retained by CalPERS or by a CalPERS Vehicle to manage a portfolio of ~~assets (including~~ securities~~)~~ or other assets for ~~a fee~~compensation or (ii) a Person that is engaged, or proposes to be engaged, in the business of investing, reinvesting,

> owning, holding or trading securities or other assets and that offers or sells, or has offered or sold, its securities to CalPERS or a CalPERS Vehicle. The External Manager usually has full discretion to manage CalPERS assets, consistent with investment management guidelines provided by CalPERS and fiduciary responsibility. A CalPERS Vehicle Manager is an External Manager.

Other changes to the proposed regulation made in response to Mr. Bishop's May 20, 2010 letter include the addition of the definition of "Person," amendments to the definitions of "CalPERS Vehicle," "Placement Agent," subsection (d)(6), and other minor style and technical changes.

Responses to Written Comments

As noted above, CalPERS received several comment letters that were not fully considered by the Investment Committee on June 14, 2010. The comment letters are summarized below along with CalPERS response.

SIFMA Comment Letter

SIFMA supports enhanced disclosure of placement agent fees and relationships, but asked for clarification on three issues. First, SIFMA seeks confirmation that only placement agent agreements that could result in compensation to a Placement Agent based on a CalPERS investment be disclosed. Staff agrees and minor clarifying changes were made to the proposed regulation and forms.

Second, SIFMA requests that CalPERS not require copies of written placement agent agreements or that the written agreement be redacted to exclude "proprietary and confidential information and/or trade secrets." Staff disagrees and believes that full disclosure of placement agent compensation is crucial to the effectiveness of the regulation. To do so, staff believes that a review of the entire written agreement is necessary in order to fully understand the compensation paid to a Placement Agent.

Finally, SIFMA suggested waiting to finalize the proposed regulation until AB 1743 was further along in order to resolve conflicts between the proposed regulation and the proposed statutes. As discussed above, staff generally agrees with that recommendation.

Skadden Arps Comment Letter

Skadden Arps requested delaying the proposed regulation to assure consistency with AB 1743. Staff generally agrees and notes that the definitions of Placement Agent in the proposed regulation and AB 1743 are essentially the same. Staff does note, however, that AB 1743 does exempt one group of potential Placement Agents from the definition of lobbyist while still requiring disclosure of

any agreements relating to that group. Specifically, individuals that meet the criteria below are exempt from the definition of lobbyists, but still subject to disclosure.

> An employee, officer, or director of an external manager, of an affiliate of an external manager, is not a placement agent if all of the following apply:
>
> (1) The external manager is registered as an investment adviser or a broker-dealer with the Securities and Exchange Commission or, if exempt from or not subject to registration with the Securities and Exchange Commission, any appropriate state securities regulator.
>
> (2) The external manager has been selected through a competitive bidding process subject to subdivision (a) of Section 22364 of the Education Code or subdivision (a) of Section 20153 of this code, as applicable, and is providing services pursuant to a contract executed as a result of that competitive bidding process.
>
> (3) The external manager has agreed to a fiduciary standard of care, as defined by the standards of conduct applicable to the retirement board of a public pension or retirement system and set forth in Section 17 of Article XVI of the California Constitution, when managing a portfolio of assets of a state public retirement system in California.

This exception was the result of a comment letter on AB 1743 by the Investment Advisers Association ("IAA") and a series of communications between the IAA, staff, and the co-sponsors of AB 1743. The IAA letter is attached as Attachment 6.

National Venture Capital Association ("NVCA") Comment Letter

NVCA believes the placement agent definition will capture internal employees who have limited and intermittent roles in fundraising processes, such as a venture capital firm's chief financial officer ("CFO"). While NVCA accepts the definition of Placement Agent as contained in the CalPERS Placement Agent Policy, it is concerned that the proposed regulation's exception for investment professionals who spend one-third of their time, during a calendar year managing assets for CalPERS "introduces unnecessary ambiguity and appears to broaden the statutory definition of a 'placement agent.'" Staff disagrees and instead believes that the typical CFO does not meet the definition of Placement Agent since he or she is not "hired, engage, retained by, or serving for the benefit of or on behalf of an external manager….in connection with the offer or sale of the securities, assets or services of an external manager to CalPERS or a CalPERS Vehicle." CalPERS has had numerous discussions with NVCA on this point and

has provided assurance that the addition of the exception for certain investment professionals was not intended to broaden the scope of who is Placement Agent in the first instance.

CalPERS received similar form letters from individual venture capital firms, including Forward Ventures, Enterprise Partners Venture Capital, and Mission Ventures, building on the NVCA's concerns.

Keith Bishop's Comment Letter

In addition to Mr. Bishop's comment letter regarding AB 1743, Mr. Bishop submitted a letter containing two sets of comments addressing the proposed regulation. One set of comments concerned the adequacy of the regulatory notice and the other set concerned the text of the proposed regulation. Staff discussed many of Mr. Bishop's notice issues with the Office of Administrative Law and responds to Mr. Bishop's comments below. While many of Mr. Bishop's comments regarding regulatory notice might have some merit, staff nevertheless believes the notice was adequate.

Notice Related Comment #1: The Notice of Proposed Regulatory Action does not cite the proper authority and does not include all required references.

Staff agrees with Mr. Bishop's comments and amended the authority and reference sections of the proposed regulation.

Notice Related Comment #2: The Notice of Proposed Regulatory Action wrongly states that the proposed rule will not impact costs for any state agency.

Staff agrees with Mr. Bishop's comments that the proposed regulation will have some absorbable costs for CalPERS.

Notice Related Comment #3: The Notice of Proposed Regulatory Action wrongly states that CalPERS is not aware of the cost impacts on representative private persons or business.

Staff agrees with Mr. Bishop's comments and provided the public with a copy of Form 399 which sets forth an estimate of the costs on representative private persons or businesses.

Notice Related Comment #4: CalPERS has not provided evidence that it has complied with Government Code section 11346.4.

CalPERS believes it has substantially complied with Government Code section 11346.4 and therefore made no additional revisions based on this comment.

Notice Related Comment #5: The Notice of Proposed Regulatory Action fails to provide a citation to the comparable federal regulation and a brief description of the differences.

CalPERS made no additional revisions based on this comment. The proposed regulation is required by AB 1584 which requires disclosure of placement agent agreements with sufficient detail prior to the time any investment decisions are made by CalPERS. Rule 206(4)-3 of the Investment Advisers Act of 1940 does not require such disclosure.

Notice Related Comment #6: The Notice of Proposed Regulatory Action incorrectly states that the CalPERS Board of Administration proposes to amend regulations.

Staff agrees with Mr. Bishop's comments.

Text Related Comment #1: The proposed rule text does not include the required statement of authority and reference.

Staff added additional statutory references as suggested by Mr. Bishop.

Text Related Comment #2: The proposed definition of "Consultant" violates the clarity standard for regulations.

Staff disagrees but made some minor changes to the definition of "Consultant" in response to Mr. Bishop's comments.

Text Related Comment #3: The proposed definition of "Placement Agent" violates the clarity standard for regulations.

Staff has kept the term "consultant" in the definition of "Placement Agent" but changed it to lower case in an attempt to signal the reader that the defined term is not to be utilized in that section.

Text Related Comment #4: The proposed requirement that disclosures be made by "any employee actively providing placement agent services" violates the clarity standard.

Staff disagrees. The proposed regulation specifies that: "When an entity is retained as a Placement Agent, any officer, director, or employee actively providing placement agent services with regard to CalPERS or receiving more than 15% of the placement agent fees shall provide information required by this subsection."

Text Related Comment #5: The requirement that information must be updated within 14 calendar days of the date when the External Manager should have known of the change in the information violates the clarity standard.

Staff disagrees but believes that adding a "reasonable" qualifier as suggested by Mr. Bishop is a good idea and has changed the proposed regulation accordingly.

Text Related Comment #6: The proposed rule incorrectly assumes that Placement Agents must be registered with the Securities and Exchange Commission, the Financial Industry Regulatory Authority, or the Commodity Future Trading Commission.

CalPERS is aware that not all Placement Agents are required to register with the above entities. Nonetheless, the proposed regulation requires registration for the reasons set forth in the Initial Statement of Reasons: "Being subject to the Securities and Exchange Commission (SEC) or another regulatory agency provides some protection that a Placement Agent is subject to certain ethical obligations, levels of oversight, and enforcement. Because CalPERS invests globally and in a broad variety of assets, CalPERS allowed for registration with the SEC, the Commodity Futures Trading Commission and similar non-U.S. regulatory authorities."

Text Related Comment #7: CalPERS does not have the authority to impose the remedies specified in the proposed rule.

CalPERS disagrees. CalPERS has broad rulemaking authority pursuant to Government Code sections 20120 and 20121.

Text Related Comment #8: The disclosure forms proposed by CalPERS must be adopted as regulations in accordance with the rulemaking provisions of the California Administrative Procedure Act.

Staff has incorporated the forms by reference into the latest revisions to the proposed regulations.

Text Related Comment #9: The proposed rule is not consistent with the California Public Records Act and the California Information Practices Act.

Staff disagrees. CalPERS will comply with the California Information Practices Act and the Public Records Act when implementing the proposed regulation.

Staff Initiated Amendments – "Management Fee Offsets"

The last sentence of (d)(5) has been deleted such that CalPERS in the future will not permit external managers to call capital from CalPERS to pay Placement Agents even where there is a corresponding offset, i.e., a corresponding

deduction to CalPERS management fees. Staff believes that allowing general partners to pay placement agent fees out of CalPERS capital endorses the continued use of Placement Agents and leads to a perception that CalPERS is paying the placement agent fees. Moreover, these provisions potentially allow a general partner to "borrow" against future management fees to pay placement agent fees.

Timeline

If the Committee accepts staff's revisions to the proposed regulation, the rulemaking file will be forwarded to OAL for review and approval. Once OAL has approved the proposed regulation, it will be forwarded to the Secretary of State for filing and publication in the California Code of Regulations. The proposed regulation will become effective 30 days after filing with the Secretary of State.

The Committee may alternatively make changes to the proposed regulation in response to public comments or for any other reason. Depending on the materiality of the changes, additional notice periods may be necessary before final adoption can occur.

Below is an updated regulatory timeline for final adoption.

March 15, 2010		Agenda item to the Investment Committee
March 23, 2010		CalPERS submits regulation package to OAL
April 2, 2010		OAL publishes notice of regulatory change in the California Regulatory Notice Registry
April 30, 2010		CalPERS files Notice of Rescheduled Public Hearing, Extension of Public Comment Period and Revision of Initial Statement of Reasons
April 30, 2010 – June 14, 2010		Rescheduled 45 Day comment period on the proposed regulation
June 14, 2010		Public hearing and agenda item requesting the Committee to adopt the regulation.
August 12, 2010 – August 26, 2010		Revised Notice of Modification of Text of Proposed Regulations comment period
September 13, 2010		Investment Committee consideration of the Proposed Regulation revisions
September 30, 2010		If no changes, submit final package to OAL.
November 16, 2010		Deadline for OAL approval or denial of regulation (OAL gets 30 days from submission)
December 16, 2010		If approved, OAL files regulation with Secretary of State
January 16, 2011		Regulations effective.

The timeline may be delayed if changes are made by the Investment Committee at the September 13, 2010 meeting. Additional notice periods or public hearings may be required depending on the materiality of the changes made. In addition, OAL review may cause delays in the rulemaking process.

V. STRATEGIC PLAN:

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

The results of this item will provide CalPERS with enhanced efficiencies and ability to manage the overall portfolio. The new policy will provide a foundation for compliance, accountability, and transparency.

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