May 16, 2016

Item Name: Assembly Bill 2833 (Cooley) Public Retirement Alternative Investments Disclosure

As Amended April 12, 2016

Sponsors: State Treasurer John Chiang and the American Federation of State County and Municipal Employees (AFSCME), Local 2399

Program: Total Fund

Item Type: Action

Recommendation

Adopt a **Support If Amended** position on Assembly Bill (AB) 2833 to only apply to new private equity investments, define the term “related parties”, separate reporting on fees and expenses from reporting on carried interest, and allow the reported data to be calculated by the public retirement system.

Executive Summary

AB 2833 requires public retirement systems to require each alternative investment vehicle in which it invests to make specified disclosures regarding fees and expenses, and to disclose that information at least once annually at a meeting open to the public.

The California Public Employees’ Retirement System (CalPERS) Legislative and Policy Engagement Guidelines suggest a support position on proposals that promote transparency and accountability for the System or entities that conduct business with the System, provided these proposals do not jeopardize the System’s ability to conduct business or infringe on the CalPERS Board of Administration’s (Board) fiduciary authority.

The transparency improvements contained in AB 2833 are generally consistent with CalPERS ongoing efforts to promote transparency and accountability for the System and its business partners, as well as specific efforts by the Board to strengthen risk management, transparency, and governance in the Private Equity Program and bring uniform reporting to the private equity industry. However, as currently written the bill has significant negative impacts on CalPERS. To address these impacts, staff recommends amendments that would eliminate negative impacts and align the proposed legislation with CalPERS current reporting standards.

Strategic Plan
This item supports CalPERS 2012-17 Strategic Plan Goal B to cultivate a high-performing, risk-intelligent, and innovative organization.

Investment Beliefs
This agenda item implicates several CalPERS Investment Beliefs, including:

- Investment Belief 8, that costs matter and need to be effectively managed, and its associated Sub-beliefs:
    - CalPERS will balance risk, return, and cost when choosing and evaluating investment managers and investment strategies.
    - Transparency of the total costs to manage the CalPERS portfolio is required of CalPERS business partners and itself.
    - Performance fee arrangements and incentive compensation plans should align the interests of the fund, staff, and external managers.
    - CalPERS will seek to capture a larger share of economic returns by using its size to maximize its negotiating leverage. CalPERS will also seek to reduce cost, risk, and complexity related to manager selection and oversight.
    - When deciding how to implement an investment strategy, CalPERS will implement in the most cost effective manner.

Background
CalPERS Alternative Investments

CalPERS' Private Equity (PE) Program, previously known as the Alternative Investment Management (AIM) Program, specializes in private equity investments as a Limited Partner, or LP, through the use of external investment managers, known as General Partners, or GPs. The strategic objective is to maximize risk-adjusted rates of return and enhance the equity return of the total CalPERS' portfolio. The program currently invests in three ways: 1) direct and co-investments with existing CalPERS GPs; 2) fund investments; and 3) fund of funds for specific mandates only. The PE Program has a rigorous and comprehensive due diligence system in place for selecting external investment managers and evaluating private equity investment proposals, and for continuously monitoring CalPERS' private equity investments.

The California Public Records Act (CPRA) requires CalPERS, the California State Teachers' Retirement System, the University of California Retirement System, and the 1937 Act County Retirement Systems to disclose the following key characteristics of all alternative investments (defined to include private equity funds, venture funds, hedge funds and absolute return funds):

- The name, address, and vintage year of each alternative investment;
- The capital committed and contributed by the public investment fund to each alternative investment since inception;
- The capital distributions received by the public investment fund from each alternative investment;

- The capital distributions plus remaining value of assets in each alternative investment;
- The internal rate of return of each alternative investment since inception;
- The investment multiple of each alternative investment since inception;
- The management fees and costs paid by the public investment fund to each alternative investment;
- The annual cash profit received by the public investment fund from each alternative investment;
- Any record regarding alternative investments that are not specifically exempted from disclosure under the CPRA; and
- Otherwise excluded information that is already publicly released by the keeper of the information.

Analysis

Specifically, AB 2833:

- Expresses the intent of the Legislature to increase the transparency of fees paid by public pension funds to alternative investment vehicles. Because fees paid to alternative investment vehicles reduce returns, public fund trustees need to see and understand all fees they are charged.
- Declares that its provisions further the purposes of the Public Records Act, and that the information required to be disclosed is necessary to ensure public confidence in the integrity of investments made by retirement boards.
- Requires every public pension or retirement system to require that each alternative investment vehicle contract entered into, amended or extended on or after January 1, 2017, disclose at least annually on a form prescribed by the system the following:
    - Fees and expenses paid directly to the alternative investment vehicle, the fund manager, or related parties;
    - Fees and expenses not included above that are paid from the alternative investment vehicle, including carried interest, to the fund manager or related parties;
    - Fees and expenses paid by the portfolio positions held within the alternative investment vehicle to the fund manager or related parties;
    - The gross and net rate of return of each alternative investment vehicle since inception; and
    - Any additional information relating to alternative investments that the CPRA requires public pension or retirement systems to disclose.
- Requires every public pension or retirement system to disclose the information provided to the fund pursuant to the above at least once annually in a report presented at a meeting open to the public.
- Defines:
    - “alternative investment” as a private equity fund, venture fund, hedge fund or absolute return fund;
    - “alternative investment vehicle” as a limited partnership, limited liability company, or similar legal structure through which a public pension system

or retirement system or the University of California invests in an alternative investment;

- “fund manager” as the general partner, managing manager, adviser, or other person or entity with primary investment decision-making authority over an alternative investment vehicle, and related parties of the fund manager;
- “carried interest” as any share of profits from an alternative investment vehicle that is allocated a fund manager or general partner or related parties, including allocations of alternative investment vehicle profits received by a fund manager in consideration of having waived fees that it might otherwise have been entitled to receive; and
- “portfolio positions” as individual portfolio investments made by the alternative investment vehicles.

Recent CalPERS Efforts to Improve Transparency

CalPERS staff identified a need to better track and report program expenses, carried interest, and other portfolio and fund level data in its private equity investments in 2011, and the next year implemented standardized reporting forms for GPs in CalPERS private equity investments that were adapted from an International Limited Partners Association (ILPA) standardized capital call and distribution template. The purpose of the standardized form was to improve efficiency and transparency, as well as create an industry-wide best-practice for private equity investments. CalPERS began reporting “carried interest” paid to the GPs in its private equity investments in 2015, as part of its development of the Private Equity Accounting and Reporting Solution (PEARS) system, a proprietary tool that allows CalPERS to comprehensively report information from private equity investments.

In late January of this year, CalPERS endorsed the use of fee reporting templates developed by the ILPA for private equity general partners, and announced that it would request that private equity fund managers comply with the reporting practices illustrated by the templates beginning with the Q3 2015 reporting period. The templates include quarterly reporting by managers that detail at the limited partner level changes and balances for management fees and any offsets applied, partnership expenses, and carried interest. The new ILPA template will be added as a source of information for PEARS.

Recommended Changes

CalPERS strongly supports AB 2833 in principle but several amendments are necessary to minimize negative impact on CalPERS operations, reduce costs, and allow for standardization in reporting among the private equity funds in which CalPERS invests. There are four key issues that need to be addressed to assure consistency between the proposed legislation and CalPERS current practices.

These issues include: 1) reporting on existing contracts; 2) need to define “related parties”; 3) need to separate reporting of fees and expenses from carried interest; and 4) allow reporting of data as calculated by CalPERS as well as reporting of information disclosed by the alternate investment vehicle.

Each of these issues is addressed in greater detail below. If the issues are not addressed, there will be a negative impact on CalPERS private equity operations as well as significant costs incurred to make needed changes to comply with the proposed legislation.

Reporting on Existing Contracts
Staff recommends that the bill only apply to new private equity contracts entered into as of January 1, 2017. As drafted, the bill’s reporting requirements will be triggered whenever a retirement system enters into, extends, renews, or amends an alternative investment vehicle contract on or after January 1, 2017. This will require CalPERS staff to secure a fund manager’s agreement to comply with this new disclosure regime before responding to any request for an amendment or consent involving an existing private equity fund.

The CalPERS Private Equity Program reviewed over 120 requested amendments and consents from fund managers during the 2015 calendar year. These amendments and consents had a range of impacts. Many of the agreements extended the term of an existing private equity fund so that more time could be allowed to let investments mature. Also, follow-on capital may be requested in an amendment to help build or stabilize a portfolio company; and investment restrictions may be waived to allow new investment opportunities.

If the bill is enacted as currently drafted, CalPERS staff will be required to obtain the general partner’s compliance with the new reporting requirements before CalPERS can vote on any amendment or consent. Many of these contractual agreements may be over ten years old and the general partner may not be willing to renegotiate the reporting requirements contained in those agreements. The general partner will need to carefully analyze the reporting requirements and be able to confirm that it can comply, and decide whether other limited partners will be given the opportunity to elect the same type of reporting the bill requires CalPERS to obtain. For these reasons, the general partner may be unable or unwilling to quickly commit in writing to these new obligations. In such cases, CalPERS will be unable to vote on the proposed amendment or consent.

Limited Partnership Agreements (LPAs) can also be amended without CalPERS consent by a majority or other percentage interest of the fund’s limited partners. As a result, an LPA may be amended without CalPERS consent and without the ability on CalPERS part to compel the general partner to agree to the reporting requirements of AB 2833. This places CalPERS in a position where it must refuse to vote for an amendment that it believes is in CalPERS interest because a general partner is unable or unwilling to agree to a new disclosure regime.

With the proposed “extension, renewal or amendment” triggering language, CalPERS will be required to negotiate the enhanced disclosure and may have to abstain from amendments that otherwise are in CalPERS best interest because a general partner is not willing to change its disclosure practices. This loss of participation and control could negatively impact CalPERS investment returns in material amounts, potentially tens or hundreds of millions of dollars.

Define the Term "Related Parties"
As currently drafted, AB 2833 requires retirement systems to report fees, expenses, and carried interest paid to fund managers or related parties. Not defining the term "related parties" risks that individual retirement systems will establish their own definitions, or that the general partner community will interpret the obligations of the bill differently, thus leading to a lack of standardization in reporting. In addition, leaving the term undefined in the bill is likely to cause the CalPERS private equity and legal offices to expend significant time and resources negotiating with fund managers to ensure a level of consistency amongst the many legal agreements entered into, and maintain compliance.

Staff recommends including in the bill a definition for the term "related parties" contained in the ILPA fee reporting template. This template, which has been endorsed by dozens of institutional investors and fund managers, including CalPERS, will help standardize disclosure and control costs to implement the bill's requirements.

Separate Reporting on Fees and Expenses from Reporting on Carried Interest
AB 2833 requires retirement systems to obtain from fund managers annually, information on fees, and expenses, other than those the retirement system pays directly to the fund manager, that are paid from the alternative investment vehicle, including carried interest, to the fund manager or related parties. This requirement is separate from the disclosure requirement for fees and expenses the retirement system pays directly to the fund.

Establishing a reporting category for fees and expenses paid from the investment vehicle separate from the fees and expenses paid directly by CalPERS, and then blending the reporting of carried interest with certain management fees and expenses, would be inconsistent with CalPERS reporting practices and the practices of most other institutional investors that are currently reporting this information.

CalPERS recommends the reporting of carried interest be separate from the reporting of any management fees and expenses, and recommends reporting of fees and expenses regardless of source (from a retirement system or from the alternative investment vehicle) be consolidated as a single line item. If the bill were enacted as currently drafted, CalPERS would incur significant costs to revise its fee reporting templates and database system.

Allow Reporting of Data Calculated by CalPERS
The bill requires reporting of data solely disclosed by the alternative investment vehicle and does not provide for reporting of information as calculated by CalPERS. This is of concern because the calculations provided by an investment vehicle may not be standardized and may not match the calculations CalPERS prepares independently based on its own records.

CalPERS uses a standard methodology for reporting that may be different from the methodology used when investment vehicles calculate performance. For example, CalPERS calculates and reports alternative investment vehicle information it is currently required to disclose under the CPRA, including the net internal rate of return and the investment multiple for each alternative investment vehicle since inception. CalPERS uses standardized calculation methods for calculating all performance, which may differ from the methodology used when an alternative investment vehicle calculates performance. Staff recommends amendments to allow retirement systems to disclose the required alternative investment vehicle information based on its own calculations or based on calculations provided by the alternative investment vehicle.

Budget and Fiscal Impacts

AB 2833, if amended as suggested, would not have any significant fiscal or budgetary impact on CalPERS, as it already requires newly contracted fund managers to provide such data on alternative investment fees and expenses. However, if the bill were not amended, staff anticipates the following costs:

Benefit Costs:

Requiring disclosure of specified fees and expenses for contracts extended, renewed or amended on or after January 1, 2017 will require CalPERS to negotiate the enhanced disclosure or abstain from amendments that otherwise are in CalPERS best interest because a general partner is not willing to change its disclosure practices. This loss of participation and control could negatively impact CalPERS investment returns in material amounts, potentially tens or hundreds of millions of dollars.

Administrative Costs:

Establishing a reporting category for fees and expenses paid from the investment vehicle separate from the fees and expenses paid directly by CalPERS, and then blending the reporting of carried interest with certain management fees and expenses, would be inconsistent with CalPERS reporting practices and the practices of most other institutional investors that are currently reporting this information. CalPERS would incur significant costs to revise its fee reporting templates and database system.

Benefits and Risks

Benefits:

- Increases confidence in the pension systems by increasing transparency.
- Helps standardize alternative investment fee and expense reporting.

Risks:

- Potential for lower investment returns because of the inability of retirement systems to invest with private equity firms that refuse to agree to the disclosure requirements.

Attachments

Attachment 1 – Assembly Bill 2833 (Cooley), As Amended April 12, 2016
Attachment 2 – Legislative History
Attachment 3 – Support and Opposition

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