CalPERS

Investment Committee
Agenda Item 4f

December 18, 2017

Item Name: Report on Alternative Investments (AB 2833)

Program: Investment Compliance & Operational Risk

Item Type: Information Consent

Executive Summary

State legislation enacted in 2016 (Assembly Bill 2833, or AB 2833) requires California public retirement systems, including CalPERS, to report on certain fees, expenses, and carried interest paid in connection with alternative investment vehicles (AIVs) in which the systems invest. The report must be presented at least once annually at a meeting open to the public. Attachment 1 is the inaugural report produced by CalPERS pursuant to AB 2833.

Strategic Plan

This item is required by statute and not a specific product of the CalPERS Strategic Plan.

Investment Beliefs

This agenda item touches on several CalPERS Investment Beliefs, and in particular:

- 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

AB 2833 (Cooley) was introduced during the 2016-17 Legislative session for the stated purpose of increasing the transparency of fees paid by California public investment funds to alternative investment vehicles. The legislation was sponsored by State Treasurer John Chiang, and signed by Governor Brown on September 14, 2016.

During the legislative drafting process, CalPERS made numerous drafting suggestions and the final bill reflects some of CalPERS' input. One CalPERS drafting suggestion, however – that the 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 – was not adopted. This would have made the bill consistent with CalPERS' historical reporting for the private equity program, and the failure to incorporate that change, in our opinion, results in an ambiguity regarding what is intended to be included in (a)(1) and (a)(2) of Government Code § 7514.7. To address this ambiguity, CalPERS has provided alternative figures since reasonable minds may differ regarding the legislation's intent. We hope over time to clarify the intent of the legislation.

Finally we note that, given differences in legal investment structures, some differences exist in the information available for the real assets program as compared to private equity. Specifically, the dollar amount of cash profit received on a fiscal year basis for real assets is simply the net cash outflows from the AIV for the year.

Analysis

The AIVs in which CalPERS invests are typically limited partnerships, limited liability companies, or similar limited liability vehicles in which the investment would take the form of an ownership interest in the AIV. Monies remitted by CalPERS *to the AIV* can therefore be expected to take the form of capital contributions, and not fee or expense payments *per se*. The obligation to pay management fees and expenses typically runs from the AIV to the fund manager, and not from the individual LPs, whose obligation, as spelled out in the AIV agreement, is to provide a specified amount of capital to the AIV to fund its investments and operations. In those rare instances where the LPs have been required to remit fees directly to the fund manager or its related parties, these payments were accounted for as capital. Accordingly, the vast majority of fees and expenses paid to the fund managers are funded only indirectly by the LPs, out of capital contributions made either pursuant to a capital call or, in some cases, by being netted against a distribution.

The legal relationships that dictate the characterization of the various money flows involved in these investments, as outlined above, have provided the context for our analysis of AB 2833. Staff's interpretation of and corresponding reporting under AB 2833 represents a good faith effort to honor both the spirit as well as the letter of the law based on the plain language of the statute. We have in some instances opted to disclose more than we think technically required. (See, for example, "Supplemental" column 17 of Attachment 1.)

INVO staff will work with stakeholders, other California public pension plans, and our investment partners as we continue to implement AB 2833 and continue our role as a leader in investment transparency in the private asset classes. INVO staff may in the near future propose certain technical clarifying amendments in an effort to encourage consistent and meaningful disclosure by the California public retirement systems that are subject to the law.

Budget and Fiscal Impacts

Not applicable.

Benefits and Risks

Not applicable

Attachments

Attachment 1 – CalPERS Alternative Investment Vehicle Fee & Expense Disclosure Report
Attachment 2 – Explanatory Notes
Attachment 3 – Assembly Bill 2833
Attachment 4 – Senate Bill 439 (adding California Government Code §6254.26)

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