



Board of Administration

Agenda Item 9c1

November 18, 2020

Item Name: State Legislative Proposal: Public Disclosure of Private Debt Records

Program: Legislation

Item Type: Action

Recommendation

Sponsor legislation to establish disclosure parameters within the California Public Records Act (PRA) for private debt investments managed directly by CalPERS team members.

Executive Summary

This proposal creates a disclosure framework that will facilitate efforts for the CalPERS Investment team to directly manage private debt investments. The proposed language is consistent with existing law for externally managed private debt investments and the recently enacted disclosure requirements for public banks. The proposed disclosure requirements balance existing industry expectations and the need for transparency in CalPERS investment activities. The proposed bill language is included as Attachment 1.

Strategic Plan

This proposal supports the CalPERS Strategic Plan goal to strengthen the long-term sustainability of the pension fund while cultivating a high-performing, risk-intelligent, and innovative organization.

Investment Beliefs

This proposal supports CalPERS Investment Belief 7, that CalPERS will take risk only where there is a strong belief that it will be rewarded for it, and Investment Belief 8, that costs matter and need to be effectively managed.

Background

Private Debt as an Investment Strategy

The Opportunistic Strategies (OS) Division was established in 2016 by the executive management team of the Investment Office to invest in a wide variety of public and private investments. Its broad mandate identifies opportunities perceived to be substantially

undervalued. The program is also permitted to establish innovative portfolios that do not necessarily “fit” within one of the existing asset classes.

A private debt investment strategy involves direct lending to a public or private issuer seeking funds for operations, growth, or other purposes. Private debt strategies include, but are not limited to, direct lending to a borrower, fund investments made through an external manager, and asset-based lending. Unlike fixed income investments, private debt is typically not traded on an exchange. The CalPERS investment portfolio benefits from private debt investments because they provide the opportunity to earn a higher yield and return in many cases, combined with the ability to achieve additional diversification.

According to a February 2019 report by the Principles for Responsible Investment Association, there is estimated to be over \$600 billion allocated to private debt investments by institutional investors, with the most active investors being pension funds, endowments, and insurance companies. In 2020 alone,

- The California State Teacher’s Retirement System (CalSTRS) has allocated \$1 billion to an alternative asset manager that will include opportunistic credit and diversified lending strategies.
- A Canadian public pension fund (that manages a \$333 billion pension plan) will allocate 4 percent of total fund holdings to private debt allocations.
- The Los Angeles Fire & Police Pensions has added a 2 percent (of its \$24.9 billion pension plan) private credit allocation.

Private Debt Market Expectations

Investors and borrowers are aware that some portion of their business information will be subject to PRA disclosure if they are engaging in investment or lending opportunities with public pension systems and public banks. To that end, state law includes specific provisions guiding what information is subject to disclosure and what information is not subject to disclosure under the PRA.

For externally managed alternative investment vehicles, CalPERS and the University of California sponsored legislation, Senate Bill (SB) 439 (Simitian), Chapter 258, Statutes of 2006, to clarify the disclosure requirements. Disclosure of certain investment data, particularly company-level information, is generally regarded by the financial industry as proprietary or trade secret. At the time SB 439 was introduced, many alternative investment firms were hesitant to accept capital from California-based public pension systems without adequate protections from public disclosure of sensitive and proprietary information about underlying investments, putting California public pension funds at a competitive disadvantage.

CalPERS acknowledged then, as it does now, the legitimate interest of the public in knowing how public monies are invested as well as the obligation to be responsive to information requests. SB 439 ensured that the public would be provided the data it needed to evaluate the performance of fund managers while protecting confidential financial information of individual, privately owned portfolio companies.

In 2019, Assembly Bill (AB) 857 (Chiu), Chapter 442, Statutes of 2019, was enacted to authorize local governments to create public banks. Among the provisions of this law, the PRA was amended to provide specific protections for borrowers’ information. AB 857 specified that the PRA provisions of the bill “balances the interests of a public bank in keeping certain

important information confidential with the interest of the public in accessing information concerning the conduct of the people's business.”

These code sections in the PRA establish statutory expectations of disclosure for borrowers' information in the private debt market, when those agreements are managed either by an external manager or by a public bank. Both sections are tailored to govern slightly different types of agreements and transactions; however, there are commonalities in both.

Common Elements of Government Code Sections 6254.26 and 6254.35

Government Code section 6254.26 governs the disclosure of information related to alternative investment vehicles, including private equity and externally managed private debt investments. Government Code section 6254.35 governs the disclosure of information related to financial decisions made by public banks.

Both code sections state that the following information is not subject to disclosure under the PRA:

- Propriety due diligence materials
- Investment agreements, loan agreements, and all related documents
- Records containing information regarding portfolio positions in which the alternative investment fund or public bank invests
- Specified financial statements
- Specified meeting materials
- Capital calls and distribution notices

Both sections state that the following information is subject to disclosure under the PRA:

- The name and address of the alternative investment vehicle or recipient of a public bank's investment
- Performance metrics for investments

The current law for both code sections are included in Attachment 2.

Analysis

Proposed Disclosure for Internally Managed Private Debt Investments

For private debt investments that are managed directly by CalPERS team members, the proposal specifies that the following information is not subject to disclosure under the PRA:

- Due diligence materials that are proprietary to the public investment fund, any participating underwriting syndicate, the borrower, or any of the borrower's constituent owners or guarantors.
- Private loan agreements and all related documents.
- Personal or business identifying information contained in records that would disclose the identities of any constituent owners of the borrower, regardless of whether the constituent owner is a person or legal entity.
- Quarterly and annual financial statements of the borrower or its constituent owners.
- Materials relating to collateral pledged in support of the private loan.

- Meeting materials of creditors' committees.

Further, the proposal specifies that the following information is subject to disclosure under the PRA:

- The name and address of each borrower.
- The dollar amount of each private loan made to each borrower by the public investment fund since inception.
- The annualized time-weighted return of each private loan.
- For each private loan, the aggregate amount of undrawn loan commitments.
- The amount of principal and interest payments made to the public investment fund by each borrower since the inception of the loan.
- For each private loan, whether the loan has been in default for six months or longer.

The proposal also specifies that externally managed private debt investments would remain subject to disclosure requirements and restrictions under Government Code sections 6254.26 and 7514.7.

Consistent Structure and Framework

While private debt investments are not new, existing California PRA laws do not explicitly address private debt investments that are able to be managed internally by CalPERS team members. Although existing provisions of the PRA may be combined to protect borrowers' financial information, a specific statutory structure is necessary to effectively internally manage and engage in the private debt market. CalPERS and prospective borrowers need a disclosure structure that is clear in statute and consistent with existing law for internally managed private debt investments.

To ensure consistency, this proposal is modeled after Government Code sections 6254.26 and 6254.35. The proposal identifies investment information that is subject to disclosure or not subject to disclosure under the PRA and draws on these sections of current law to ensure that items of disclosure (or not) are substantively consistent. As such, the proposal is intended to maintain the balance established in current law between the necessary public disclosure of CalPERS investments and the necessity of protecting borrowers' financial information.

By providing predictability and consistency within the recommended proposal, CalPERS will be able to engage in this investment space.

Potential Proposal Opposition

During the last legislative cycle, the CalPERS Board approved sponsoring AB 2473 (Cooper) which would have established disclosure requirements within the PRA regarding borrower's information related to private loan investments by CalPERS and CalSTRS. Due, in part, to the significantly altered COVID-19 legislative calendar, this bill was not heard in the second house policy committee. This proposal utilizes the same bill language except that the bill has been narrowed to apply only to CalPERS.

In response to concerns raised, CalPERS team members would like to re-iterate that the following information remains disclosable to the public under the proposed bill language:

- Any currently disclosable record remains disclosable to the public.

- Any document to perfect CalPERS' status as a creditor, including documents related to collateral, are already public and remain public.
- Multiple performance metrics of any private loan agreement, including return on investment and defaulted loans, are disclosable.
- The name and address of the borrower for any private loan agreement are disclosable.

Furthermore, the proposal would not change the Board's authority that has been established by the California State Constitution. The CalPERS Board reviews and approves portfolio performance, asset allocation, investment transactions, and investment management performance. The Board also establishes investment strategies and policies, and under the Board's direction, the Investment Office carries out the daily activities of the Investment Program.

Budget and Fiscal Impacts

Administrative Costs/Savings:

Unknown potential savings associated with the use of internal versus external investment managers to execute this investment strategy.

Benefits and Risks

Benefits:

- Improves the ability of CalPERS to access private debt investment opportunities.
- Balances the competing interests in preserving industry trade secrets and respecting the public's right to access to investment information and evaluate the performance of CalPERS investments.
- Potential decline in litigation arising from public records requests due to greater certainty as to the legal standard for disclosure.

Risks:

- Potential media and stakeholder objections to not disclosing some financial information of possible future borrowers from CalPERS.

Attachments

Attachment 1 – Proposed Bill Language

Attachment 2 – Government Code sections 6254.26 and 6254.35

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