BILL NUMBER: AB 2833 (Cooley) as amended April 12, 2016

SUMMARY

AB 2833 requires every California public pension or retirement system to require its alternative investment vehicle fund managers and related parties to make specified disclosures regarding fees and expenses for each alternative investment vehicle. It also requires this information to be disclosed at least once annually in a report presented at a meeting open to the public. The bill applies to contracts entered into or changed on or after January 1, 2017.

BOARD POSITION

Support, if amended to ensure disclosure is consistent with the fiduciary responsibilities of the board and to apply only to new contracts entered into on or after January 1, 2017. The board's general investment objectives include maintaining the trust of the participants and public by managing the investment program in such a manner that will enhance the member and public's confidence in the CalSTRS Investment Program and minimize costs by aggressively monitoring and controlling management fees, trading costs and other expenses.

REASON FOR THE BILL

The investment portfolios of California's public pension plans require certain levels of returns to fund constitutionally guaranteed benefits for government workers. Both management and carried interest payments to general partners decrease the net returns on the portfolio. According to the author, if net returns of the portfolio are reported to pension plans without specific disclosure of the amount of fees paid to general partners, public pension plans and the public have no means of assessing whether the amount of compensation paid to private equity managers or hedge fund managers is appropriate.

ANALYSIS

Existing Law:

Under the provisions of Section 17 of Article XVI of the California Constitution, as amended by Proposition 162 of 1992, the CalSTRS board has plenary authority and fiduciary responsibility over the investment of retirement plan assets and is required to discharge its duties solely in the interests of the members and beneficiaries for the exclusive purpose of providing benefits. The board must invest the assets of the plan with the care, skill and diligence of a prudent person engaged in a similar enterprise so as to maximize the investments and minimize the risk of loss. When considering investments, the preservation of principal and maximization of income is the primary and underlying criteria for the selection and retention of securities.

The Public Records Act delineates which records and information regarding alternative investments in which public investment funds invest are and are not subject to disclosure. Records not subject to disclosure consist of:

- Due diligence materials that are proprietary to the public investment fund or the alternative investment vehicle.
- Quarterly and annual financial statements of alternative investment vehicles.
- Meeting materials of alternative investment vehicles.
- Records containing information regarding the portfolio positions in which alternative investment funds invest.
- Capital call and distribution notices.
- Alternative investment agreements and all related documents.

Information subject to disclosure includes:

- The name, address and vintage year of each alternative investment vehicle.
- The dollar amount of the commitment made to each alternative investment vehicle by the public investment fund since inception.
- The dollar amount of cash contributions made by the public investment fund to each alternative investment vehicle since inception.
- The dollar amount, on a fiscal yearend basis, of cash distributions received by the public investment fund from each alternative investment vehicle.
- The dollar amount, on a fiscal yearend basis, of cash distributions received by the public investment fund plus remaining value of partnership assets attributable to the public investment fund's investment in each alternative investment vehicle.
- The net internal rate of return of each alternative investment vehicle since inception.
- The investment multiple of each alternative investment vehicle since inception.
- The dollar amount of the total management fees and costs paid on an annual fiscal yearend basis, by the public investment fund to each alternative investment vehicle.
- The dollar amount of cash profit received by public investment funds from each alternative investment vehicle on a fiscal year-end basis.

This Bill:

Specifically, AB 2833:

- Defines terms as follows:
  - "Alternative investment" as an investment in a private equity, venture, hedge or absolute return fund.
  - "Alternative investment vehicle" as the limited partnership, limited liability company or similar legal structure through which a public pension or retirement system 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 to a fund manager or general partner, including allocations of alternative investment vehicle profits received by a fund manager in consideration of having waived fees that the fund manager might otherwise have been entitled to receive.

  - "Portfolio positions" as individual portfolio investments made by the alternative investment vehicle.
- Stipulates that every public pension or retirement system shall require its alternative investment vehicles, in contracts entered into or changed on or after January 1, 2017, to make the following disclosures at least annually on a form prescribed by the system:
  - The fees and expenses the retirement system pays directly to the alternative investment vehicle, the fund manager or related parties.
  - The fees and expenses that are paid from the alternative investment vehicle, including carried interest, to the fund manager or related parties.
  - The 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.
  - Any additional information already required to be disclosed under the Public Records Act in regards to alternative investments.
- Requires the information to be disclosed at least once annually in a report presented at a meeting open to the public.

LEGISLATIVE HISTORY

SB 439 (Simitian, Chapter 258, Statutes of 2005), under the Public Records Act, required public disclosure of some information regarding investment performance and protected the confidentiality of some proprietary information.

PROGRAM BACKGROUND

Investment cost reporting and monitoring requirements are governed by the CalSTRS Investment Policy and Management Plan. As the controlling policy document for CalSTRS investments, the plan establishes the framework for meeting CalSTRS' investment objectives. The third investment portfolio objective after return and risk is to minimize the cost of investments. CalSTRS staff strives to operate the plan in the most effective lowest cost manner. As such, an investment cost report has been presented annually to the Investment Committee for more than 10 years. In November 2015, the committee requested that staff develop a proposal to track all expense and fees, including those that are amortized, capitalized or netted from the investment before CalSTRS receives the return and continue to work with industry associations to standardize private asset cost reporting and transparency. In response, staff has developed a project plan to track all costs not previously included in the annual cost report.

The November 2015 Cost Report delineated costs that were reported and deducted from the gross investment return to produce the final NET investment performance number, including the expenses and fees that were amortized or deducted from CalSTRS return. These returns are in essence received net of some costs before being included in the overall gross return. As a result, the reported gross return has some costs already deducted. The committee expressed an interest in tracking and measuring those fees to provide greater transparency of these netted costs, which will result in CalSTRS having a higher pure gross overall return and the same true net return from the CalSTRS investment activity.

The majority of costs that would be included in the cost report under the project are from the partnership structure primarily in Private Equity, Real Estate, Infrastructure, Innovations and Risk and Corporate Governance. The terms and conditions of the fees, expenses and profit sharing splits are aggressively negotiated by CalSTRS staff at the start of the investments, and are set in the terms of the partnership document. Staff also closely monitors each individual partnership, including their costs, fees and expenses at the partnership level. While each partnership has an audited annual financial statement, the net costs and expenses are not delineated by each respective limited partner. As a result, the information must be obtained one partnership at a time through direct engagement. This has proven to be a lengthy and time consuming process at other funds, resulting in some peers having to estimate these costs.

CalSTRS is fully committed to transparency and public disclosure as demonstrated by delivering past cost reports and commencing the Investment Cost Project. By receiving detailed information, the board can further provide appropriate direction to staff as decisions are made to achieve the desired rate of return at a prudent level of risk. CalSTRS staff is currently able to negotiate favorable fees, expenses and profit sharing splits with high-performing managers.

Even though AB 2833 seeks to drive fees down, *fund-by-fund* disclosure could result in some managers choosing to forgo California public pension plan partnerships and instead accept commitments from other investors without the same requirements. CalSTRS Private Equity portfolio, which, since its inception in 1988, has performed better than any other investment segment, is most vulnerable as it maintains a unique approach with a highly diversified portfolio that includes not only large buyout and large distressed debt funds but also venture capital, equity expansion, small buyout and small special situation funds. Better performing private equity funds that are oversubscribed and more selective about limited partners are more likely to be found in the smaller end of these markets. In addition, managers may not offer favorable fees to CalSTRS if those lowered fees are disclosed to the public, including other investors. Given the potential impact to investment decisions, amendments are recommended to ensure disclosure is consistent with the fiduciary responsibilities of the board.

In addition, as a limited partner CalSTRS may not be able to participate in all changes to contracts after they are established. Therefore, it is recommended that AB 2833 be amended to apply only to new contracts entered into on or after January 1, 2017. By limiting the required disclosure of this information to new contractual relationships, the administrative costs due to engagement and contract negotiation would be significantly reduced.

FISCAL IMPACT

Program Cost – Consultants have estimated that the combined annual costs to the fund could be $200 million in higher fees or $400 million in lower return for the two areas most affected by the bill, Risk Mitigation Strategies and Private Equity. However, the actual level of costs depends on the response to this bill from managers in those asset classes.

Administrative Costs/Savings – With the retrospective nature of certain provisions in the bill, additional engagement, contract negotiation and data collection are required, entailing significant administrative costs in excess of $500,000.

SUPPORT

State Treasurer John Chiang (Sponsor)
American Federation of State County and Municipal Employees Local 2399 (Sponsor)
California Federation of Teachers

OPPOSITION

None known.

ARGUMENTS

Pro: Provides transparency.

Aligns with CalSTRS contribution to the Institutional Limited Partners Association (ILPA) new reporting standards.

Con: Favorable fee negotiations may potentially be restricted.

Investment returns may potentially be lower due to CalSTRS' inability to invest with private equity firms and hedge fund managers that refuse to agree to disclosure requirements.

Limited partners do not necessarily control changes to contracts.

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