California's Legislature Puts Additional Disclosure Pressure on Fund Managers with the Passage of AB 2833

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On August 24th, the California Legislature approved Assembly Bill No. 2833 (AB 2833), which is now headed to Governor Jerry Brown's desk for signature. If Governor Brown signs the bill, as is expected, all public pension plans in California (including CalPERS, CalSTRS, 1937 Act retirement systems, University of California Retirement System, and independent retirement systems) will be required to make specific disclosures of fees, expenses, gross and net rate of return, and carried interest charged by alternative investment vehicles.

The legislation is intended to increase the transparency behind the fees paid by public pension plans to alternative investment vehicles and the fund managers. As many institutional investors are aware, due to the lack of transparency and secrecy surrounding alternative investments, it can be challenging for investors to determine and track the exact amount of fees paid to the fund managers and the funds. Any overpayments of fees and fund expenses cut into the returns needed to support the public pension plan and its beneficiaries. In recent years, there has been a strong push by institutional investors, the Securities Exchange Commission (SEC), and the Institutional Limited Partners Association (ILPA) to increase the transparency around the fees and expenses. With AB 2833, California is placing itself among the forefront of those supporting further efforts to better align the interests of public pension plan investors with fund managers by insisting upon greater fee transparency.

I. Existing Law

Under the California Public Records Act (California Government Code Sections 6250 et seq.) (CPRA), public pension plans already are required to disclose certain financial information related to their alternative investments (defined under CPRA and AB 2833 as investments in private equity funds, venture funds, hedge

funds or absolute return funds). The definition of alternative investment is the same in both CPRA and AB 2833, although there is no universal agreement on the scope of CPRA definition of alternative investments and whether such definition includes private equity real estate. Currently public pension plans subject to CPRA must disclose the following fund-level information: (i) the fact that pension plan is an investor in the alternative investment fund; (ii) the name, address and vintage year of the alternative fund; (iii) the dollar amount since inception of the pension plan's commitment and contributions made by pension plan; (iv) the fiscal year-end dollar amount of the alternative investment fund's distributions received by pension plan and the remaining value of alternative investment fund's assets attributable to the investment by pension plan in the alternative investment fund; (v) the net internal rate of return of the alternative investment fund since inception; (vi) the investment multiple of the alternative investment fund since inception; (vii) the dollar amount of total management fees, and expenses paid by the pension plan on an annual fiscal year-end basis; and (viii) the annual fiscal year-end dollar amount of cash profit pension plan has received from the alternative investment fund.

II. Additional Reporting Under AB 2833

AB 2833's new reporting requirement has two essential elements. First, it requires that alternative investment vehicles provide certain information regarding the fees paid by investors. Second, it requires public pension plans to disclose the information provided by the alternative investment vehicle on an annual basis at a meeting open to the public. Under the new rule, alternative investment vehicles must specifically provide annually the following information: (i) the fees that the public pension plan pays directly to the alternative investment vehicle, the fund manager or related parties; (ii) the public pension plan's pro rata share of the fees that are paid from the vehicle to the fund manager or related parties; (iii) the public pension plan's pro rata share of the carried interest paid to the fund manager; (iv) the public pension plan's pro rata share of the aggregate fees and expenses paid by all of the portfolio companies held by the alternative investment vehicle to the fund manager; and (v) the information already required to be disclosed under CPRA. To the extent that fees are paid from the vehicle to the fund manager, the public pension plan is permitted to calculate this value based on the other information required to be disclosed by the alternative investment vehicle. The public pension funds will not be reimbursed by the State for the cost and expense to the plans of complying with the legislation.

Under the terms of AB 2833, all contracts between public pension plans and alternative investment vehicles entered into on or after January 1, 2017, or contracts permitting public pension plans to increase their commitments to existing alternative investment vehicles entered into after January 1, 2017, will be subject to the new reporting requirements. Additionally, with respect to contracts entered into before January 1, 2017, public pension plans will be required to undertake reasonable efforts to obtain the information required by AB 2833.

III. Impact on Public Pension Plans

With the passage of AB 2833, California's public pension plans will greatly increase their ability to access the fee information needed to make investment decisions directly impacting its beneficiaries. AB 2833 further strengthens California's public pension plans' ability to push for increased transparency and streamlined reporting. Many public pension plans, in an effort to obtain increased transparency, have been pushing alternative investment vehicles to use the ILPA's Fee Reporting Template published earlier this year, which, in our view, when completed properly by fund managers actually captures an even greater level of financial information important to institutional investors than the combined disclosure requirements of AB

2833 and CPRA. On the other hand, alternative investment vehicles have historically resisted providing additional information regarding their management and other fees; often regarding such information as trade secrets that would harm their competitive advantage in the marketplace if the information were to be made public by the investors. One advantage of a statewide legislative mandate is that unwilling fund managers will no longer be able to pick and choose among California public pension plan investors based upon their relative willingness to push for increased fee disclosures. However, as much as institutional investors want more transparency, many still remain concerned that with the passage of legislation such as AB 2833, fund managers of highly over-subscribed alternative vehicles may be reluctant, or even refuse, to admit California public pension plans as investors into their funds, particularly when the California public pension plan investment would represent only a small percentage of the total amount already raised by the fund manager.

IV. Conclusion

California has once again taken the lead on passing ground-breaking legislation. It seems likely that other states will follow in adopting similar disclosure laws. The SEC also has been focused on how fund managers have disclosed (or not) their fees to investors. With such growing awareness regarding the lack of transparency in management fees, we expect that more states and more institutional investors will decide to follow California's lead. Moreover, the fund managers of alternate investment vehicles also may become more willing to accept greater transparency if they begin to view the advantage of adopting the uniform ILPA Fee Reporting Template as a lesser evil than being forced to comply with multiple inconsistent state fee disclosure mandates. The full consequences of California's mandated additional disclosures remain to be seen. It seems unlikely that the larger fund managers will completely abandon the California market as a result of the mandate, especially with respect to CalPERS and CalSTRS, which are the two largest public pension plans in the U.S. However, it's unclear whether the smaller California public pension plans will be excluded from certain alternative investments with fund managers less accustomed with or resistant to complying with expanded fee disclosures that have not yet become a nationwide norm.