

SENATE JUDICIARY COMMITTEE
Senator Thomas Umberg, Chair
2021-2022 Regular Session

AB 386 (Cooper)
Version: June 29, 2021
Hearing Date: July 13, 2021
Fiscal: Yes
Urgency: No
AWM

SUBJECT

Public Employees' Retirement Fund: investments: confidentiality

DIGEST

This bill creates a disclosure exemption under the California Public Records Act that will enable direct private lending by the California Public Employees' Retirement System (CalPERS).

EXECUTIVE SUMMARY

CalPERS is the largest public pension fund in the United States and, as a California state body, is subject to the CPRA. This means that, while CalPERS can operate like a private investment fund in some ways, its investment activity is constrained by the CPRA unless the Legislature approves an express exemption.

CalPERS—in an effort to hit its goal of a 7 percent investment return per year—has recently begun putting some of the fund monies into the private debt market, which is generally a market of entity-to-entity lending wherein the lender makes a return through the interest rate on the loan. CalPERS is already investing in this market through external firms, which charge substantial fees that eat into the return on investment. CalPERS believes it can invest in this market just as competently in-house, enabling it to put the money it would have spent on fees into investments. According to CalPERS, however, it cannot attract worthwhile private debt borrowers without an exemption under the CPRA to keep certain lending-related documents and information confidential.

This bill would grant CalPERS that exemption. The bill provides that specific information and documents obtained or created in connection with a loan extended directly by CalPERS—including borrower due diligence materials, loan agreements, and financial statements of the borrowers or its constituent owners—are exempt from disclosure under the CPRA. While some of this information, such as due diligence

information that included trade secrets, might already be confidential under the CPRA, some of the bill would clearly be subject to disclosure without this bill. The bill also provides that certain information relating to the loan must be disclosed, such as the identity of the borrower, the dollar amount of each loan, and the amount and principal repaid under each loan. The bill's supporters believe the bill gives them adequate information to assess the risk CalPERS is taking on, and to determine whether CalPERS' lending activity is consistent with its fiduciary duties. The opponents believe that the disclosures are insufficient and that only full disclosure of the loan agreements will provide adequate public information. Both CalPERS and the opponents agree that, if loan agreements must be disclosed, CalPERS will effectively be unable to attract its preferred borrowers.

In order to provide the public with additional information about CalPERS' lending activity, and to give the Legislature an opportunity to revisit the question of whether this bill strikes the proper balance between confidentiality and disclosure, the author has agreed to two amendments. First, the amendments will add to the list of required disclosures the identities of the constituent owners of the borrower, allowing the public to better determine who the ultimate beneficiaries of the loans are. Second, the bill will be amended to impose a five-year sunset, so that private loans extended on or after January 1, 2027, will not be subject to the bill's CPRA exemptions. At that point, if CalPERS wishes to continue making private loans, it will have to seek reauthorization from the Legislature, and the Legislature will be able to determine whether CalPERS' track record justifies doing so.

This bill is sponsored by CalPERS and is supported by a number of active public employee organizations. The bill is opposed by organizations of retired public employees, certain environmental groups, the City of Pasadena, and the Howard Jarvis Taxpayers Association. This bill was passed by the Senate Labor, Public Employment and Retirement Committee with a vote of 4-0.

PROPOSED CHANGES TO THE LAW

Existing law:

- 1) Affirms that the people have the right of access to information concerning the conduct of the people's business, and, therefore, the meetings of public bodies and the writings of public officials and agencies shall be open to public scrutiny. (Cal. Const., art. I, § 3(b)(1).)
- 2) Requires that any statute, court rule, or any authority that limits the right of public access shall be adopted with findings demonstrating the interest protected by the limitation and the need for protecting that interest. (Cal. Const., art. I, § 3(b)(2).)

- 3) Establishes the CPRA, which reaffirms that access to information concerning the people's business is a fundamental and necessary right of every person in this state, and generally establishes the procedures for the disclosure of public records and certain exemptions to the disclosure requirement. (Gov. Code, tit. 1, div. 7, ch. 3.5, §§ 6250 et seq.)
- 4) Exempts from disclosure under the CPRA certain records regarding a public investment fund's "alternative investments" (meaning an investment in a private equity fund, venture fund, hedge fund, or absolute return fund), including proprietary due diligence materials and investment agreements, unless the information has already been publicly released by the keeper of the information, from public disclosure. Other information, including the name of the investment vehicle, the dollar value of the investment, earnings on the investment, the net internal rate of return of the investment, and the dollar amount of cash profit received by the public investment fund, is expressly subject to disclosure (Gov. Code, § 6254.26.)
- 5) Requires every public investment fund to require each alternative investment vehicle in which it invests to make specified disclosures at least annually, and to disclose that information at least once annually in a report presented in an open meeting to the public. (Section 7514.7.)
- 6) Provides that the retirement board of a public pension or retirement system has the sole and exclusive fiduciary responsibility over the assets of the system, and the sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. (Cal. Const., art. XVI, § 17(a).)
- 7) Authorizes the Legislature to, by statute, prohibit certain investments by a retirement board of a public pension system where it is in the public interest to do so. (Cal. Const., art. XVI, § 17(g).)

This bill:

- 1) Adds section 6254.22 to the Government Code, and defines the following terms:
 - a) "Constituent owner" is a person or legal entity that maintains a direct or indirect ownership interest in the borrower or one of its guarantors or sources of collateral for the loan, including, among others, a stockholder, member, or partner.
 - b) "Private loan" means a loan made pursuant to or evidenced by a loan agreement, debt instrument, or other evidence of indebtedness, if that lending arrangement is exempt from registration as a security under federal securities laws.
 - c) "Public investment fund" means CalPERS.

- 2) Provides that, notwithstanding the CPRA or any other law, CalPERS need not disclose the following records regarding an internally managed private loan made directly by CalPERS unless the information has already been publicly released by the keeper of the information:
 - a) Due diligence materials that are possessed by the public investment fund or that are proprietary to any participating underwriting syndicate, the borrower, or any of the borrower's constituent owners or guarantors.
 - b) Private loan agreements and all related documents.
 - c) Quarterly and annual financial statements of the borrower or its constituent owners.
 - d) Meeting materials of creditors' committees.
- 3) Provides that the following information contained in records of private loans described in 2) are subject to disclosure under the CPRA and shall not be considered a trade secret or otherwise exempt from disclosure:
 - a) The name and address of each borrower.
 - b) The dollar amount of each private loan made to each borrower by CalPERS since inception.
 - c) The annualized time-weighted return and duration of each private loan.
 - d) For each private loan, the aggregate amount of undrawn loan commitments.
 - e) The amount of principal and interest payments made to CalPERS by each borrower since the inception of the loan.
 - f) For each private loan, whether the loan has been in default for six months or longer and any public records related to the default that are in the possession of CalPERS and another public agency and that are open to inspection or copying upon request of the public made to the other agency.
- 4) Provides that records related to a public investment fund's indirect funding of a private loan via a fund or other type of externally managed investment vehicle shall remain subject to the CPRA exemption and annual reporting requirements for alternative investments.

COMMENTS

1. Author's comment

According to the author:

While private debt investments are not new, existing CPRA laws do not explicitly address private debt investments that are able to be managed internally by CalPERS staff. Although existing provisions of the CPRA 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. 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 bill is modeled after existing law. It identifies investment information that is subject to disclosure or not subject to disclosure under the CPRA and draws on existing law to ensure that items of disclosure are substantively consistent.

This bill maintains the balance established in existing law between the necessary public disclosure of CalPERS investments and the necessity of protecting borrowers' financial information.

2. The private debt market and CalPERS' stated need for the bill

Private debt investments are really just party-to-party loans. A fund lends money to a borrower in exchange for repayment with interest; assuming the borrower repays the debt, the fund makes a profit. Private loans carry more risk, and more potential reward, than investments like bonds. The private loan market has been steadily increasing since 2008, and is currently worth around \$900 billion.¹

For borrowers, features of the private loan market may make it a more enticing source of funds than a traditional financial lender. Private lenders may provide more flexibility than more tightly regulated entities such as banks, e.g., by accepting alternative collateral sources or relaxing lending standards. Borrowers may also appreciate the secrecy that can come with a private loan. For companies that do not want to disclose certain lending terms – such as the collateral for the loan or background financial information – a private loan can be a preferred source of funds. Lenders, in turn, can often obtain a better interest rate, and therefore a higher rate of return, if they are willing to maintain the confidentiality of their borrowers' information.

CalPERS already invests in private loans as part of its portfolio. But because of the CPRA and California's constitutional right to access public records, CalPERS is unable to invest in these loans directly; it can do so only through an outside private fund manager. Using a fund manager means that CalPERS is not involved in the decision of which borrowers to lend to, or on what terms. According to CalPERS, these outside fund managers cost CalPERS \$150 million in fees for every \$1 billion invested over a five-year period. The intent of this bill is to enable CalPERS to bring these loan investments in-house so that CalPERS can redirect the amounts it currently spends on fees into actual investments. The bill accomplishes its goal by creating an exemption under the CPRA for certain information CalPERS would obtain from a borrower in the course of issuing a private loan, thereby allowing CalPERS to tap into the segment of

¹ Mackenzie, *Performance test looms for \$900bn private loan market*, Financial Times (Jan. 14, 2021), <https://www.ft.com/content/8b829e7e-8074-4e8e-ab99-ab7d4ebbb151> [last visited Jul. 9, 2021].

private loans that is conditioned on confidentiality. As a result, however, the public would have significantly less access to, and insight into, CalPERS' investment activity in this space.

3. The competing interests at play in CalPERS' interest in the private loan market

This is the second bill CalPERS has sponsored in order to gain approval for this private lending activity. The first, AB 2473 (Wood, 2020), died in the Senate Labor, Public Employment and Retirement Committee. That Committee's analysis of this bill, incorporated by reference here, succinctly summarizes the stakeholder conflict over CalPERS' investment strategy underlying this bill:

Last year, we also noted that much of what is driving the push for this bill is CalPERS' strategy to bring private debt investment activity in-house to avoid substantial fees charged by external managers. We also identified the pressure on CalPERS to seek innovative strategies, some would say risky strategies, to reach its 7 percent investment return objective that is critical to determining current and future contributions to the fund by California public employers and public employees. To quickly remind readers, if CalPERS doesn't achieve the 7 percent return over the long-term, public employers and public employees must chip in more money into the fund to ensure that it will be able to pay future pensions.

[T]he composition of the bill's supporters and opponents makes perfect sense from the perspective of their relative interests. Active employees and public employers may be more concerned (more, not only) with having to pay more now than about some undefined potential risk in the future. They may believe that even if the fund sustains damage by future private lending, state or federal governmental support will mitigate the damage perhaps like the Federal Reserve, Congress, and the state support today's economy from the pandemic's damage. They also have more time, in a sense, for the fund to recover should it encounter difficulties. However, if they have to pay more into the fund now, that requirement will squeeze both employers' budgets and employees' opportunities to improve compensation, a disturbing prospect if inflation does arrive. Finally, they may simply believe CalPERS' loan and lend program is an excellent cyclical opportunity that should not be wasted.

Retirees, on the other hand, may be more sensitive to the risk of loss the fund could experience if innovative investment strategies fail spectacularly. Certainly, they have witnessed spectacular financial disasters in their long lifetimes; as well as spectacular frauds as recently as the one that sent billions of dollars in government controlled unemployment funds into the hands of criminal syndicates; and their fair share of public and pension officials promising them a sure win (think long-term care insurance). They may have no interest in potential compensation augmentations that they will not receive. They may regret that municipal budgets get pinched but their primary concern is probably that the fund that sends them

their pension warrant every month is stable, healthy, and secure from the many interests that seek to siphon off its capital. They may be less concerned (not unconcerned, but less concerned) that a more conservative investment strategy will produce lower investment returns that may result in long-term funding challenges. As of now, after all, the fund is currently likely to outlast them (provided no one blows it up with an innovative investment strategy).

The bill's opponents also argue that CalPERS' track record does not entitle it to the benefit of the doubt when it comes to the fund's integrity. In the last five years, one former CalPERS CEO was sent to prison for taking bribes from a former CalPERS Board member;² one CalPERS CFO resigned after reports that he overstated his investment experience on his resume;³ and one CalPERS CIO resigned after an ethics complaint alleged he had approved a \$1 billion deal with a financial firm in which he was a shareholder.⁴ This bill is, in essence, a request from CalPERS to be able to invest with more secrecy and less oversight; these high-profile ethical lapses do not lend themselves to CalPERS' request to "just trust us" with public employees' and retirees' money.

4. This bill makes the implicit policy choice to allow CalPERS to directly invest in the private lending market without full public oversight

According to CalPERS, maintaining the confidentiality of certain loan terms is a prerequisite to participating in segments of the private debt market: if CalPERS cannot promise that certain loan terms – particularly loan covenants – will remain private, the best borrowers will go elsewhere. Thus, while this bill is facially a bill to create a CPRA exemption, the bill requires the Legislature to make a policy choice as to whether CalPERS should be able to directly invest in the private loan market without full oversight by the public.

The California Constitution affirms that the public has the right of access to information concerning the conduct of the people's business, and requires that the meetings of public bodies and the writings of public officials and agencies generally be open to public scrutiny.⁵ This right is codified in the CPRA's procedures for accessing documents and writings of public agencies.⁶

² Kasler, *Former CalPERS chief sentenced to prison in bribery scandal*, Sacramento Bee (May 31, 2016; updated Jun. 1, 2016), <https://www.sacbee.com/article80982407.html> [last visited Jul. 9, 2021].

³ Ashton, *Pension fund's CFO 'no longer works' for CalPERS after hiring review*, Sacramento Bee (May 21, 2018), <https://www.sacbee.com/news/politics-government/the-state-worker/article211610184.html> [last visited Jul/ 9, 2021].

⁴ Kasler, *CalPERS' chief's resignation follows ethics complaint, allegations over \$1 billion deal*, Sacramento Bee (Aug. 10, 2020), <https://www.sacbee.com/news/politics-government/the-state-worker/article244855187.html> [last visited Jul. 9, 2021].

⁵ Cal. Const., art. I, § 3(b)(1).

⁶ Gov. Code, tit. 1, div. 7, ch. 3.5, §§ 6250 et seq.

CalPERS' decision to make investment decisions also has a constitutional element: the California Constitution provides that CalPERS' Board has the sole and exclusive fiduciary responsibility over the assets of the system and to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries.⁷ The Board's discretion is not plenary, however: the California Constitution also grants the Legislature the authority to prohibit, by statute, certain investments by a retirement board of a public pension system where it is in the public interest to do so.⁸ The Legislature's power to prohibit certain CalPERS investments by statute necessarily implies the power to prohibit certain CalPERS investments by refusing to pass statutes necessary to enable investments, where the Legislature concludes it is in the public interest to do so. It is therefore proper for the Legislature to consider whether enacting a CPRA exemption that will allow CalPERS to invest in private loans with confidential terms is in the public interest.

The competing policy goals presented by this bill – giving CalPERS the tools it believes it needs to fulfill its commitments to its members, versus protecting the public's constitutional right of access to information concerning the people's business – are both valid, and in a sense irreconcilable. According to CalPERS, allowing full transparency into its loan terms would be tantamount to prohibiting them from investing in this space, because the best borrowers will not agree to those terms. And the bill does, as currently in print, contain disclosure exemptions that appear uncontroversial: provisions in the bill that authorize the borrowers' due diligence materials and financial information to remain private are consistent with existing CPRA exemptions, and Committee staff is unaware of any opposition that believes this level of public insight into the *borrowers* is necessary.

At the same time, however, the bill's provisions making specified information public do not provide the people with complete insight into the decisions *CalPERS* is making. The bill still withholds all loan documents, meaning the public will not be able to know on what terms loans are offered; the bill's provisions making the duration, interest rate, and amount of the loan will not give the public information about, e.g., what constitutes an event of default, what agreements have been made with respect to acceleration or forbearance, or terms relating to the collateral. The public's limited access to information will also make it more difficult, if not impossible, for the public to uncover conflicts of interest or other violations of the fiduciary duties owed to CalPERS members.

Rather than give CalPERS carte blanche to enter the private debt market going forward, the author has agreed to add a five-year sunset to the bill. Unlike a traditional sunset, the provisions will be repealed as to *future* loans only. Loans made during the five-year window will remain subject to the bill's privacy provisions – borrowers likely would

⁷ Cal. Const., art. XVI, § 17(a).

⁸ *Id.*, art. XVI, § 17(g).

not borrow from CalPERS if their privacy guarantees were at risk of becoming public in five years, which would defeat the purpose of this trial period.

5. Amendments

As discussed above, the author has agreed to amend the bill to (1) add a five-year sunset so that the bill's CPRA exemptions will not apply to loans made on or after January 1, 2027, unless the Legislature decides to extend them; and (2) add to the list of expressly required disclosures the identities of the borrower's constituent owners. The term for disclosing the identities of constituent owners will clarify that, if the borrower is publicly traded, CalPERS need only disclose the identities to the extent they are required to be disclosed under the Securities Exchange Act of 1934 and related regulations,⁹ which require the disclosure of the classes of beneficial, controlling, and insider owners whose interests would be significantly benefitted by CalPERS' lending.

6. Arguments in support

According to bill sponsor CalPERS:

The CalPERS board of Administration voted to sponsor this legislation to maintain the balance established in existing law between the necessary public disclosure and protecting borrowers' financial information. To ensure transparency and accountability, the bill requires disclosure of the borrower's name and address, the amount of the loan, the weighted return of the loan, the amount of any undrawn dollars, the amount of principal and interest paid, and whether the loan is in default for more than six months for each private loan managed directly by the CalPERS investment team. For externally managed private debt loans, none of this information is available to the public.

For each \$1 billion invested with an external firm, the current market standard costs up to \$150 million in base and incentive fees over a five-year period. Bringing these investments in-house would allow CalPERS to avoid these fees, ensure greater public transparency, and help the fund meet its long-term investment goals.

7. Arguments in opposition

According to bill opponent Retired Public Employees' Association:

The Retired Public Employees' Association (RPEA) is strongly opposed to AB 386, a bill proposed by CalPERS staff to exempt a new category "private loan" from the requirement of Article I, section 3 of the California State Constitution

⁹ 15 U.S.C. § 78a et seq.

that, “The people have the right of access to information concerning the conduct of the people’s business, and therefore, the meetings of public bodies and the writings of public officials and agencies shall be open to public scrutiny,” as implemented by the California Public Records Act (CPRA, G.C. 6250 and following).

RPEA was pleased that the author and CalPERS have accepted amendments to delete CPRA exemptions for constituent ownership of the borrower and collateral pledged from the bill, but we are troubled that CalPERS management still seek to limit public disclosure of loan terms to very basic information. Of particular concern is that CalPERS staff testified that they have particular concern about exempting loan covenants from disclosure under the CPRA. In our subsequent meeting with CalPERS staff, they were unable to articulate which specific covenants might expose constitutionally-protected privacy interests of borrowers. However, staff made explicit that the strategy [that] CalPERS wishes to pursue is to extend subscription lines of credit to Private Equity firms with whom CalPERS already partners through Alternative Investment vehicles...

While RPEA agrees that CalPERS should seek innovative investment strategies through which they might safely boost returns in order to protect the members from contribution increases and the beneficiaries from benefit cuts, we are strongly opposed to the current legislation because it goes beyond protecting the legitimate privacy interests of borrowers and attempts to hide from public view deals with borrowers with whom CalPERS has – to put it mildly – a recent history of troubling conflicts of interest.

SUPPORT

CalPERS (sponsor)
California Association of School Business Officials
California County Superintendents Educational Services Association
California Professional Firefighters
California School Employees Association
California Special Districts Association
California State Association of Counties
League of California Cities
Rural Counties Representatives of California

OPPOSITION

350 Bay Area Action
350 Silicon Valley
California State Retirees
City of Pasadena

Fossil Free California
Howard Jarvis Taxpayers Association
Peace and Freedom Party of California
Retired Public Employees' Association

RELATED LEGISLATION

Pending Legislation:

AB 890 (Cervantes, 2021) requires, until January 1, 2028, the Board of Administration of the Public Employees' Retirement System and the Teachers' Retirement Board to provide reports to the Legislature, commencing March 1, 2023, and annually thereafter, on the status of achieving objectives and initiatives, to be defined by the boards, regarding participation of emerging managers or diverse managers responsible for asset management within each retirement system's portfolio of investments. AB 890 is pending before the Senate Appropriations Committee.

Prior Legislation:

AB 2473 (Cooper, 2020) was substantially similar to this bill and would have exempted from CPRA disclosure specified records regarding an internally managed private loan made by CalPERS, and would have extended the same exemption to private loans made by the California State Teachers' Retirement System. AB 2473 died in the Senate Labor, Public Employment and Retirement Committee.

AB 857 (Chiu, Ch. 442, Stats. 2019) authorized the formation of a corporation as a "public bank," organized as either a nonprofit mutual benefit corporation or a nonprofit public benefit corporation for engaging in the commercial banking business or industrial banking business that is wholly owned by a local agency, as specified, local agencies, or a joint powers authority; the bill exempted specified information and records of a public bank, and related decisions of the directors, officers, and managers of the public bank, from the CPRA's disclosure requirements, including records related to alternative investments of the bank, as specified, and an investment agreement, loan agreement, deposit agreement, or a related document.

SB 439 (Simitian, Ch. 258, Stat. 2005) exempted from disclosure certain investment data and information related to alternative investments made by public retirement systems, including company-level information.

PRIOR VOTES:

Senate Labor, Public Employment and Retirement Committee (Ayes 4, Noes 0)
Assembly Floor (Ayes 53, Noes 10)
Assembly Appropriations Committee (Ayes 10, Noes 5)

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Assembly Judiciary Committee (Ayes 6, Noes 0)

Assembly Public Employment and Retirement Committee (Ayes 7, Noes 0)
