PUBLIC INVESTORS, PRIVATE FUNDS, AND STATE LAW

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Public pension plans in the United States invest hundreds of billions of dollars in private funds. As pension underfunding problems have deepened across the nation in recent years, public plans have dramatically increased their exposure to these lightly-regulated vehicles. This has raised concerns about whether the trustees and officials running state and local plans—often targets of academic criticism for poor management practices—adequately protect pension interests when they invest in this market.

This Article considers the role of state law in this new era of massive investment by public plans in private funds. State pension law has historically focused primarily on the internal governance of public plans by imposing fiduciary duties on plan trustees and officials and setting up guardrails on the decisions that they make. However, after controversial practices in private funds were exposed in the mid-2010s, the California state legislature moved in a more aggressive direction by directly regulating certain terms in the private fund contracts entered into by California public plans. This approach, which many states took steps to follow or seriously considered following, focused on fee transparency concerns, but it could easily be expanded to regulate any aspect of private fund contracts.

After identifying some of the distinctive challenges associated with this approach, I argue that state efforts to regulate private fund contracts directly have limited potential to compensate for ineffective governance within public plans. Challenges include the fact that states lack direct authority over private fund managers, widespread discriminatory treatment of private fund investors through "side letters," diversity in the size of public plans in each state, and volatility in the fundraising market for private funds, among others.

[*]Associate Professor, BYU Law School. For helpful comments and discussions, I am thankful to Joan Hemenway, Alan Palmiter, Usha Rodrigues, Hillary Sale, Gladriel Shobe, Bob Thompson, Anne Tucker, Andrew Verstein, and participants in the "Markets and Regulation: The Shifting Context of Transactional Practice" program at the 2020 AALS Annual Meeting, the "New Voices in Business Law" program at the 2020 AALS Annual Meeting, the BYU Winter Deals Conference, and the Rocky Mountain Junior Scholars Conference. Thank you also to John Geilman and Iantha Haight for providing excellent research assistance. All errors are my own.

In light of these and other challenges, I also argue that the explosive growth of public pension investment in private funds calls into question some of the basic assumptions on which private fund policy has long been based, raising important questions for federal securities law.

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INTRODUCTION

State and local pension plans across the United States face massive underfunding problems.[1] As these underfunding challenges have deepened, public plans have dramatically increased their exposure to private funds[2] in

[1] *See* Sarah Krouse, *The Pension Hole for U.S. Cities and States is the Size of Germany's Economy*, WALL ST. J. (July 30, 2018), https://www.wsj.com/articles/the-pension-hole-for-u-s-cities-and-states-is-the-size-of-japans-economy-1532972501; *The State Pension Funding Gap: 2017*, PEW CHARITABLE TRUSTS ISSUE BRIEF (June 27, 2019), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/06/the-state-pension-funding-gap-2017 ("Overall in 2017, states had 69 percent of the assets they needed to fully fund their pension liabilities—ranging from 34 percent in Kentucky to 103 percent in Wisconsin. In addition to Kentucky, four other states—Colorado, Connecticut, Illinois, and New Jersey—were less than 50 percent funded, and another 15 had less than two-thirds of the assets they needed to pay their pension obligations.").

[2] *See State Public Pension Funds Increase Use of Complex Investments*, PEW CHARITABLE TRUSTS REPORT (Apr. 12, 2017), https://www.pewtrusts.org/-/media/assets/2017/04/psrs_state_public_pension_funds_increase_use_of_complex_investments.pdf (showing that public pension plans more than doubled their allocations to "alternative" investments—including private equity funds, hedge funds, and private real estate funds—in less than a decade, from 11 percent of assets in 2006 to 25 percent of assets in

what many view as a risky effort to increase expected returns.[3] Their investments in these funds—which include private equity funds and hedge funds[4]—are largely unregulated. Instead of providing the kinds of mandatory investor protections found in investments like mutual funds[5] and publicly-traded corporations,[6] U.S. law shows great deference to the contractual arrangements between private fund managers and their investors.[7] Virtually every term is up for negotiation in a private fund contract.

2014); Jean-Pierre Aubry, Anqi Chen & Alicia H. Munnell, *A First Look at Alternative Investments and Public Pensions*, CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE (July 2017), http://crr.bc.edu/wp-content/uploads/2017/06/slp_55.pdf [hereinafter *Alternative Investments and Public Pensions*, Aubry, Chen & Munnell] (noting data showing that public pension plans' allocation to alternative investments increased from 9 percent in 2005 to 24 percent in 2015).

[3] *See, e.g.*, Aleksandar Andonov, Rob Bauer & Martijn Cremers, *Pension Fund Asset Allocation and Liability Discount Rates*, 30 REV. FIN. STUD. 2555 (2017) (showing that U.S. public pension plans with a higher level of underfunding per participant invest in riskier assets including private funds); Huixin Bi & Trenton Herriford, *Examining the Recent Shift in State and Local Pension Plans to Alternative Investments*, Kansas City Federal Reserve Bank: Main Street Views (Sept. 27, 2017) ("Against the backdrop of pervasive underfunding, many state and local pension plans have increasingly turned to alternative investments such as private equity, hedge funds, and real estate in recent years."); Lina Lu, Matthew Pritsker, Andrei Zlate, Kenechukwu Anadu & James Bohn, *Reach for Yield by U.S. Public Pension Funds*, FIN. AND ECON. DISCUSSION SERIES, FED. RES. BOARD, WASHINGTON D.C. (June 6, 2019), https://www.federalreserve.gov/econres/feds/files/2019048pap .pdf (finding that about one-third of the total risk taken on by public pension plans is attributable to under-funding and low risk-free rates); *Basic Legal Protections Vary Widely for Participants in Public Retirement Plans*, PEW CHARITABLE TRUSTS BRIEF (Nov. 21, 2017), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/11/basic-legal-protections-vary-widely-for-participants-in-public-retirement-plans [hereinafter *Protections Vary in Public Plans*, 2017 Pew Brief] ("In recent decades, public pension funds, in a bid to boost returns, have shifted funds away from low-risk, fixed-income investments . . . to a greater reliance on equities and alternative investments.").

[4] *See Alternative Investments and Public Pensions*, Aubry, Chen & Munnell, *supra* note 2 (showing that over 66 percent of public pension investments in "alternative" investments in 2015 were directed to private equity and hedge funds).

[5] *See* Lyman P. Q. Johnson, *Protecting Mutual Fund Investors: An Inevitable Eclecticism*, RESEARCH HANDBOOK ON MUTUAL FUNDS (Oct. 1, 2018) (noting that the Investment Company Act of 1940 "remains the regulatory heart of the investor protection objective" in the mutual fund setting).

[6] *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("[The] fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation . . . must be guided.").

[7] *See, e.g.*, DEL. CODE ANN. tit. 6, § 17.1101(c) (2018) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.").

Long after this shift toward private funds had gained momentum, controversial practices were exposed that raised concerns about whether public plans were adequately protecting the interests of their beneficiaries in this highly contractarian setting. Private fund investors were criticized for agreeing to one-sided terms[8] and for tolerating an environment of weak transparency and governance rights.[9] Most controversial of all, private fund managers were found to be charging various types of fees, sometimes in the millions to tens of millions of dollars,[10] without providing specific disclosures of those fees. In most cases, these disclosure failures were enabled by weak disclosure standards in private fund agreements.[11] Given the public's heavy investment in public pension plans, which invest the retirement savings of public servants and are typically backed by taxpayers,[12] and the management problems that have been documented in many public plans,[13] these revelations prompted serious concerns.

The California state legislature responded with an aggressive strategy. Rather than allow public plan staffs to continue negotiating fee disclosure requirements with private fund managers, California passed a law setting

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[8] For example, investors were found to be granting total waivers of private fund managers' fiduciary duties under state partnership law. *See* Eileen Appelbaum & Rosemary Batt, *Fees, Fees and More Fees: How Private Equity Abuses Its Limited Partners and U.S. Taxpayers*, Center for Economic and Policy Research Report at 12 (May 2016) [hereinafter Appelbaum & Batt, *How Private Equity Abuses Its Limited Partners*] ("Analyses of Limited Partnership Agreements have also uncovered clauses that specifically allow private equity firms to waive their fiduciary responsibility towards their limited partners—leading to serious conflicts of interest.").

[9] *See* Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014) [hereinafter Bowden, *Spreading Sunshine in Private Equity*] ("[M]ost limited partnership agreements do not provide [investors] with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager. . . . Lack of transparency and limited investor rights have been the norm in private equity for a very long time.").

[10] *See* Ludovic Phalippou, Christian Rauch & Marc Umber, *Private Equity Portfolio Company Fees*, 129 J. FIN. ECON. 559 (2018) (finding in a sample of private equity buyouts with an average total enterprise value of $1.9 billion that the average portfolio company fees paid were $31 million over the life of the investment (including average monitoring fees of $14 million and average transaction fees of $17 million)).

[11] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 (noting that broadly-worded fund agreements "created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors").

[12] *See infra* note 92 and accompanying text.

[13] *See infra* Section I.C.1.

forth specific minimum disclosure requirements that managers must agree to in private fund contracts if they want to accept money from public plans in the state.[14] Whereas state law has historically focused primarily on regulating the internal governance of public plans by imposing fiduciary duties on plan trustees and setting up guardrails on their discretion, this law, which went into effect in 2017, sought to regulate directly one of the key terms in the private fund contracts that their public plans were entering into.[15] After the passage of California's fee disclosure law, some states took steps to follow California's lead, and several others seriously considered doing so.[16]

This Article examines the role of state law in this new era of massive investment by public plans in private funds.[17] After outlining the traditional state law approaches to regulating public plans, I discuss factors that led California to adopt a more aggressive approach toward imposing regulations on private fund contracts. I then consider the potential merits of states adopting this direct approach in today's new era—not just in the area of fee transparency, but with respect to any controversial private fund contract term that state legislatures are concerned about—followed by the challenges (which are significant).

I identify two potential benefits that the direct regulation of private fund contracts can offer. First, it allows a state legislature to intervene when public plan staffs fail to demand adequate contractual terms in the free market. Even though public plan employees and trustees owe fiduciary duties to plan beneficiaries,[18] critics have accused them of suffering from conflicts of interest that lead to poor management.[19] Some have also argued that public pension staff members are sometimes simply in over their heads, due to legal limits on compensation arrangements that can make it more difficult for

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[14] *See infra* Section II.B.

[15] *See infra* Section II.B. While this is not the first time that states have passed laws requiring certain terms to be adopted in private fund contracts, it marks a more direct and aggressive approach than has historically been the norm.

[16] *See infra* notes 160–66 and accompanying text.

[17] The rise of public pension investment in this largely unregulated environment has caused concern among many critics. *See, e.g.*, Gary Rivlin, *A Giant Pile of Money: How Wall Street Drove Public Pensions Into Crisis and Pocketed Billions in Fees*, THE INTERCEPT (Oct. 20, 2018); Jay Bowen, *Pension Funds Chased Alternative Investments After the Crisis. They Missed the Bull Market.*, BARRON'S (Aug. 26, 2019); Matt Taibbi, *Looting the Pension Funds*, ROLLING STONE (Sept. 26, 2013).

[18] For a discussion of the limited effectiveness of fiduciary duties in public pension plans, *see infra* Sections II.A.1 and III.B.4.

[19] *See infra* Section I.C.1.

public plans to recruit and retain top-quality staff members.[20] By passing a law, a state legislature can effectively do an end run around public plan staffs, setting forth the disclosure terms and/or substantive terms the legislature thinks are necessary to ensure that their private fund investments are adequately protected. Any such improvements in terms will benefit not only the public servants whose retirement savings are invested in private funds, but also state taxpayers, who generally bear most of the risk when a public plan fails due to poor performance.[21]

A second potential benefit is forced coordination. Buyers in any market can seek to increase their bargaining power and decrease competition by coordinating their activities.[22] By passing a direct law, a state legislature can force all of the public plans in a state to demand the same term, effectively prohibiting them from breaking rank and accepting weaker terms.[23]

As noted above, however, several distinctive challenges in this market can make the benefits of direct regulation extremely elusive. First, because state legislatures lack direct authority over private fund managers, they do not have very strong "sticks" to compel managers to comply with state laws

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[20] *See, e.g.*, Dyck, Manoel & Morse, *Outraged by Compensation: Implications for Public Pension Performance*, working paper available at http://faculty.haas.berkeley.edu/morse/research/papers/DyckMorseManoel.pdf and https://digitalassets.lib.berkeley.edu/etd/ucb/text/MartinsBarbosaFortesManoel_berkeley_0028E_18718.pdf (finding that constraints on public plan compensation negatively impact fund performance); Christine Williamson, *Pension Funds Face Challenge in Recruitment*, PENSIONS & INVESTMENTS (April 1, 2019), https://www.pionline.com/article/20190401/PRINT/190409985/pension-funds-face-challenge-in-recruitment ("[T]he compensation differential between pension fund investment management and [private sector] money managers is an ever-present issue in recruiting top talent."); Arleen Jacobius, *Public CIO Pay Getting Renewed Attention*, PENSIONS & INVESTMENTS (July 23, 2018), https://www.pionline.com/article/20180723/PRINT/180729976/public-cio-pay-getting-renewed-attention ("[P]ublic pension plan [chief investment officers] make a fraction of what they could make at a corporate pension fund, endowment, foundation or money management firm."); Madison Marriage, *Pension Pay Dilemma Becomes Acute*, FIN. TIMES (Feb. 7, 2015) ("Generous executive pay at pension schemes is controversial, especially when members face reductions in benefits.").

[21] *See* Paul Rose, *Public Wealth Maximization*, 2018 UNIV. ILL. L. REV. 891, 894 (2018) [hereinafter Rose, *Public Wealth Maximization*] ("[O]ther parties—namely, the government and taxpayers—bear almost all of the risk should a public fund fail. In practice, individual participant claimants function more like senior creditors with fixed claims that have little real risk that they will not be received."); Katelin P. Isaacs, CONG. RESEARCH SERV., 98-810, FEDERAL EMPLOYEES' RETIREMENT SYSTEM: BENEFITS AND FINANCING 11 (2015), https://fas.org/sgp/crs/misc/98-810.pdf (noting that the "ultimate guarantors of government pensions are the taxpayers").

[22] *See infra* note 182 and accompanying text.

[23] *See infra* Section III.A.3.

that require stronger contract terms. Even after a law is passed, managers will only be subject to that law if they choose to accept money from a public plan in that state. If managers want, they can "freeze out" public plans from that state or penalize them by taking away benefits in areas not covered by the law.[24]

Second, the market for public pension investments in private funds is characterized by two features that complicate the drafting of any state law designed to regulate a private fund contract term: diversity and discrimination.[25] This market is diverse because most states have a wide range of local and state plans, with some managing tens to hundreds of billions of dollars and others managing a tiny fraction of that amount.[26] It is also very common for managers to provide differential treatment to each plan as part of the fundraising process, with managers negotiating a different "side letter" with each plan.[27] As a result, any law that sets forth a single standard can have a highly differential impact on public plans of differing sizes within the same state, with some getting frozen out, others losing valuable side letter benefits, and others being shielded from negative effects altogether.[28] State laws that establish a single standard are thus blunt instruments for helping public plans, and any coordination benefits from forcing the plans in a single state to demand a uniform term are likely to be weak.

Third, timing considerations add another layer of complexity, since an important factor in drafting this kind of state law will necessarily be the general balance of bargaining power between private fund investors, on one hand, and private fund managers, on the other, at the time of the legislation. In a cyclical market like the fundraising market for private funds, a law that is appropriately calibrated to reflect the bargaining power of a state's public plans in one year may be off-balance in another year, compounding the blunt instrument problem described above.[29]

[24] *See infra* Section III.B.1.

[25] *See infra* Section III.B.2.

[26] *See infra* note 190.

[27] *See* William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. REG. 67, 103-07 (2020) [hereinafter Clayton, *Private Equity Negotiation Myth*] (discussing the various forms of differential treatment commonly found in private funds).

[28] This dynamic is quite different than, for example, state regulations on consumer products that are primarily purchased by a broad base of individual retail consumers. *See infra* note 192 and accompanying text.

[29] *See infra* Section III.B.3.

Fourth, even though state law can be used to demand contract terms that require greater disclosure about plan investments, there is often very little that public plan beneficiaries can do to act on that information. Public servant beneficiaries are typically locked into their plans, which means that they cannot "vote with their feet" and exit when they are dissatisfied with how a plan is being managed. Moreover, even though public plan staff members and trustees owe fiduciary duties to beneficiaries, for various procedural reasons, it is usually very difficult for beneficiaries (or anyone else) to enforce those duties.[30] More disclosure, thus, may not be very impactful.

Lastly, even if the challenges above did not exist, state governments still may not be very good at intervening to regulate private fund contracts in ways that will improve public plan performance.[31] Research shows that political interference in pension management has historically been correlated with underperformance, not improved performance,[32] prompting some top-tier global public pension systems to make plans as independent as possible from government influence.[33] Expanding the use of state law to support public

[30] *See infra* Section III.B.4.

[31] *See infra* Section III.B.5.

[32] *See, e.g.*, Daniel Bradley, Christos Pantzalis & Xiaojing Yuan, *The Influence of Political Bias in State Pension Funds*, 119 J. FIN. ECON. 69 (2016) [hereinafter Bradley, Pantzalis & Yuan, *Influence of Political Bias*] (finding that local political connection bias is stronger for state pension funds with a higher percent of politically affiliated trustees and that states with more influential politicians in Congress tend to invest more heavily in politically connected local firms); Aleksandar Andonov, Yael V. Hochberg & Joshua D. Rauh, *Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds*, 73 J. FIN. 2041 (2018) [hereinafter Andonov, Hochberg & Rauh, *Political Representation and Governance*] ("In the public pension context, the presence of politicians on boards appears to work against pension funds' primary objective of delivering the benefits promised to the participants as efficiently as possible for taxpayers."); Simon C.Y. Wong, *Public Pension Funds Perform Better When They Keep Politics at Bay*, HARV. BUS. REV. (July 19, 2016) ("Interference by elected officials—from imposition of local economic development obligations to excessive constraints on head count and compensation that impede recruitment of talented staff—has contributed to poor investment choices, higher total costs, diminished organizations, and disappointing performance . . . ."); Simon C.Y. Wong, *Public Pension Funds Perform Better When They Keep Politics at Bay*, HARV. BUS. REV. (July 19, 2016), https://hbr.org/2016/07/public-pension-funds-perform-better-when-they-keep-politics-at-bay.

[33] *See* Chris Butera, *Why Canada's Pension Plans are in Such Good Shape*, CHIEF INVESTMENT OFFICER (July 26, 2018), https://www.ai-cio.com/in-focus/shop-talk/canadas-pension-plans-good-shape/ ("Canadian plans instead follow a structure free of government intervention, only having to go through their boards."); *The Evolution of the Canadian Pension Model: Practical Lessons for Building World-Class Pension Organizations*, The World Bank Group (2017) [hereinafter "*The Evolution of the Canadian Pension Model*, World Bank"] ("Independent governance . . . is perhaps the primary characteristic of the Canadian pension model. Although many of the public pension

plans would thus constitute a step in the opposite direction of what many view as current industry best practice for public pension management.

For all of these reasons, policymakers concerned about public pension investment in private funds should not view this direct approach as a substitute for effective internal governance within public plans. Over the years, reform proposals in this area have included changes to make the fiduciary duties of pension managers more workable and more enforceable,[34] changes to increase the independence of public plan managers from political influence,[35] changes to make pension manager compensation more competitive with the private marketplace,[36] caps on the amount of money that public plans can invest in private funds, and changes to public pension accounting conventions, among others.[37] More aggressive state regulation of private fund contracts cannot be expected to eliminate, or even substantially diminish, the need for these kinds of reforms.

Subject to these limits, when states do pass a law to regulate the terms of private fund contracts entered into by public plans, I argue that there are steps they can take to make that law more effective, including sensitizing the law to individual plans' bargaining power and incorporating sunset requirements.[38] I show how these proposals could have made the recent fee transparency legislation passed by California and other states more effective.[39]

I also show how this Article's analysis has important implications for the ongoing debate over whether public pension regulation should be federalized. Federal regulation of private fund contracts would avoid many of the disadvantages that apply to the aggressive state law approach discussed in this Article. In fact, prior to the passage of California's legislation, state

funds have government as a sponsor or contributor, funds operate at arm's length of governments and sponsors and are overseen by independent boards that have a fiduciary duty to the plan members . . . ."); Joel Kranc, *Pensions With Independence*, INVESTMENTS & PENSIONS EUROPE (Feb. 2012) ("[Canada's] model allows for independent boards to oversee the pension funds in question without political interference. These boards are made up of knowledgeable members with economic and investment backgrounds. They are not considered 'lay boards' as is often the case.").

[34] *See infra* Section IV.A.

[35] *See infra* Section IV.A.

[36] *See infra* Section IV.A.

[37] *See infra* Section IV.A.

[38] *See infra* Section IV.B.

[39] To be clear, even if a state passes an MFN law, they would still retain the option of passing more aggressive legislation with respect to a particular standard at a later time.

treasurers across the country actually wrote a jointly-signed letter to the SEC requesting that the agency use its authority to require greater disclosure of fees and expenses by private fund managers.[40] This Article's analysis shows why these state actors had a strong incentive to do so and lends additional support to calls to federalize aspects of the regulation of public pension plans.

Finally, I conclude by taking a step back to look at the bigger picture. The massive growth of public pension investment in private funds has led to an extraordinary demographic shift in the industry's population of investors. I argue that this shift calls into question some of the basic assumptions on which private fund regulatory policy has long been based. As more and more of the industry's capital comes from public plans, many of which are severely underfunded, it has become increasingly unclear whether two central goals of the investor qualification rules under federal securities law—investor sophistication and ability to bear economic loss[41]—are actually being met by the current rules. In a world where so many public plans are seriously underfunded, many plans actually seem very poorly positioned to sustain economic loss from failed investments. Furthermore, given the challenges discussed throughout this Article with using state law to regulate these plans and the conflicts of interest inherent in many public pension systems, it is also fair to question whether the goal of ensuring sophistication is always met when public plans invest. I discuss the implications of this problem and propose a potential update to the federal securities laws to address it.[42]

This Article proceeds as follows. Part I provides an overview of private fund regulation and identifies some of the policy concerns raised when public pension plans invest in private funds. After describing the traditional state law approaches to regulating public pension plans, Part II discusses factors that motivated California to adopt a more aggressive approach and responses by other states in recent years. Part III discusses the potential benefits of using state law more aggressively to regulate the private fund contracts that public plans enter into, and identifies several distinctive challenges with realizing those benefits. In Part IV, I argue that this approach should not be viewed as a substitute for more fundamental reforms to address internal governance

[40] *See* Timothy W. Martin, *States, Cities to Ask SEC to Beef Up Disclosures for Private-Equity Firms*, WALL ST. J. (July 21, 2015) ("Around a dozen comptrollers and treasurers from New York to California want the SEC to demand private-equity funds make disclosures of fees and expenses more frequently than they do now, according to a copy of the letter reviewed by the Wall Street Journal.").

[41] *See infra* note 249 and accompanying text.

[42] *See infra* Section IV.D.

problems within public plans and consider other important policy implications arising from the rapid growth of public pension investment in private funds. Part V concludes.

I. CONCERNS RAISED BY PUBLIC PENSION INVESTMENT IN PRIVATE FUNDS

A. Freedom of Contract in Private Funds

Private fund managers[43] invest other people's money for a fee. They typically raise money by pooling the capital of many investors into a single fund, which is usually organized as a limited partnership[44] and governed by a privately-negotiated limited partnership agreement.

Conflicts of interest in private funds stem from the separation of ownership and control in the private fund structure.[45] Managers are typically given broad control over how they invest their investors' money. With this control, private fund managers can be incentivized to engage in self-dealing conduct. They might, for example, invest less time and effort than they would if they were managing their own money, or seek to enrich themselves at the expense of their investors. Manager self-dealing could also take the form of secretly charging excessive fees and expenses, or keeping the best investment opportunities for personal investment rather than allocating them to the fund, among any number of other kinds of sub-optimal conduct.

Both state partnership law and federal securities law take a hands-off approach to these conflicts and generally do not provide investors with mandatory protections. This approach is evident in the two statutes that have long been the most important authorities in private fund regulation: the Delaware Revised Uniform Limited Partnership Act (the "Delaware L.P.

[43] To avoid unnecessary complexity, I will use the term "manager" throughout this Article, even when terms like "sponsor" or "adviser" or "general partner" might technically be more correct. For similar reasons, I will also use the term "investor" throughout this Article, even when the term "limited partner" might be more technically correct.

[44] Because funds are usually structured as limited partnerships, investors are "limited partners," and the manager acts through a "general partner" that has authority to control the fund.

[45] *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (describing the relationship between investor and manager as one "under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent").

Act")[46], and the federal Investment Advisers Act of 1940 (the "Investment Advisers Act").[47] Delaware is the jurisdiction in which the vast majority of private funds are established as limited partnerships,[48] and the Delaware L.P. Act explicitly states that its guiding policy is "to give maximum effect to the freedom of contract and to the enforceability of partnership agreements."[49] Investors can (and often do[50]) even agree to contractually modify, or waive entirely, the default fiduciary duties owed to them by private fund managers under the Delaware L.P. Act.[51] Similarly, the Investment Advisers Act is primarily a disclosure-based statute that avoids setting forth substantive requirements that managers must abide by.[52] As such, even though private fund managers have fiduciary duties to their investors under the Investment Advisers Act, these duties can largely be satisfied by mere disclosure of conflicts and other risks.[53] While the Securities and Exchange Commission

[46] DEL. CODE ANN. tit. 6, § 17.1101 (2018) et seq.

[47] 15 U.S.C. § 80b-1 et seq.

[48] *See* Robert Schwartz, *Delaware as a Location for Private Funds: The Why and the What*, BLOOMBERG BNA WORLD SECURITIES LAW REPORT (2012) (reporting that 75 percent of U.S.-based hedge funds are formed in Delaware).

[49] *See* DEL. CODE ANN. tit. 6, § 17.1101(c).

[50] *See* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (2015) [hereinafter Strine & Laster, *Siren Song*] ("Among the hallmarks of [alternative entity] agreements are broad waivers of all fiduciary duties, including the duty of loyalty."); Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Entities*, 38 DEL. J. CORP. L. 53, 61 (2013) (finding that 58 percent of the publicly-traded limited partnership agreements reviewed eliminated all fiduciary duties).

[51] *See, e.g.*, DEL. CODE ANN. tit. 6, § 17.1101(d) ("To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing." Note, however, that the more limited implied contractual covenant of good faith and fair dealing cannot be waived under Section 18-1101(c) of the Delaware Limited Liability Company Act.).

[52] 15 U.S.C. § 80b-1.

[53] *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 196 (1963) (citing United States v. Miss. Valley Generating Co., 364 U.S. 520 (1961)) (holding that investors must "be permitted to evaluate overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest."); Andrew Ceresney, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (Mar. 12, 2016) (transcript available at https://www.sec.gov/news/speech/private-equity-enforcement.html)

(the "SEC") has authority to enforce the terms of the Investment Advisers Act, in practice this authority does not allow them to do very much.[54]

Given the centrality of these two statutes, the regulation of private funds has largely been controlled by the two bodies that have authority to amend them, the Delaware state legislature and Congress. In 2004, the Delaware legislature explicitly confirmed its commitment to freedom of contract[55] and has not shown any signs of changing that position. And while Congress passed legislation in the wake of the financial crisis of 2008 expanding the universe of private fund managers that are required to register with the SEC, that legislation did nothing to change the Investment Advisers Act's contractarian approach. Interpretive guidance issued by the SEC in 2019 on the fiduciary duties of investment advisers did little to change the agency's fundamental approach to regulating managers of private funds.[56]

Traditional private fund policy is thus firmly rooted in classical contract theory, which holds that unrestricted freedom of contract[57] between parties that possess similar bargaining power, skill, and knowledge of relevant market conditions maximizes individual welfare and promotes the most efficient allocation of resources in the marketplace.[58] This policy approach

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(indicating that managers must "disclose sufficiently specific facts such that the client is able to understand the [manager's] conflicts of interest and business practices, and can give informed consent to such conflicts or practices"). As a result, if a manager has disclosed certain risks and investors have not negotiated for contractual protections against those risks, the investors generally will be exposed to those risks without any protection from federal fiduciary duties.

[54] The SEC's authority is generally limited to policing fraud and enforcing the terms of the contracts between private fund managers and their investors.

[55] Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701, 705–06 (2011) ("In 2004, the General Assembly amended section 18-1101 of the Delaware Limited Liability Company Act to permit members to abolish—not simply modify—fiduciary duties themselves and liabilities flowing from those duties.").

[56] *See* SEC Rulemakings and Interpretations Addressing Investment Adviser and Broker-Dealer Standards of Conduct and Disclosure Obligations, Simpson Thacher & Bartlett LLP client memorandum, http://www.stblaw.com/docs/default-source/memos/firmmemo_06_20_19.pdf ("For investment management firms that only advise private investment funds and other institutional clients, the SEC Releases should have a limited effect on their businesses.").

[57] For foundational work on the doctrine of freedom of contract, *see generally* Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553 (1933); Roscoe Pound, *Liberty of Contract*, 18 YALE L. J. 454 (1909).

[58] *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 72 cmt. b (1981) ("Bargains are widely believed to be beneficial to the community in the provision of opportunities for freedom of individual action and exercise of judgment and as a means by which productive energy and product

assumes that private fund investors will contract for protections that are more effective and efficient than the law would dictate in a mandatory regime.[59]

B. Problems with Freedom of Contract in Private Funds

Unfortunately, experience suggests that the assumptions underlying this contractarian approach may not always hold true. Private fund agreements, also called "limited partnership agreements" (or "LPAs"), set forth the primary contractual protections for investors in a private fund. Over the years, these documents, particularly private equity fund LPAs, have been criticized by many as deficient.[60] One critic has gone so far as to say that private equity LPAs create an "incredibly hospitable environment for opportunistic managerial behavior."[61] Among other things,[62] private equity

are apportioned in the economy. The enforcement of bargains rests in part on the common belief that enforcement enhances that utility.").

[59] In an effort to ensure that investors can fend for themselves in this contractarian space, the federal securities laws limit who can and cannot invest in private funds. Under the Securities Act of 1933, all of a fund's investors typically must be "accredited investors" meeting certain net worth thresholds (generally $5 million for certain entities and $1 million for individuals). *See* 17 CFR 320.501(a) for the formal definition of "accredited investor." Under the Investment Company Act of 1940 (the "Investment Company Act") all of the fund's investors must be "qualified purchasers" who satisfy a different set of net worth thresholds (generally $25 million for certain entities and $5 million for individuals). *See* Section 3(c)(7) of the Investment Company Act (which allows a fund to raise an unlimited amount of money from an unlimited number of investors if they are all "qualified purchasers"). Alternatively, the Investment Company Act of 1940 allows a private fund to operate as long as it has fewer than 100 investors. *See* Section 3(c)(1) of the Investment Company Act (which imposes no sophistication requirements as long as the fund has fewer than 100 investors). Various other exemptions to the Investment Company Act exist, but these are the most commonly used. Furthermore, if managers want to charge incentive-based compensation, their investors must also meet the "qualified client" standard set forth in Rule 205-3 of the Investment Advisers Act, which currently requires entities and natural persons to have a net worth of at least $2.1 million or an investment with the manager of at least $1 million.

[60] Since investors' capital is locked in to private equity funds for much longer periods of time than hedge funds, greater concerns typically arise relating to sub-optimal contractual protections in private equity LPAs than hedge fund LPAs, since hedge fund investors will often be able to protect themselves through exit. *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L. J. 1228, 1253 (2014) (noting that the prevailing ethos in hedge funds is that "if a fund investor wishes to change how her money is managed, she should just redeem").

[61] *See* James C. Spindler, *How Private is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 309, 331 (2009).

[62] *See* Clayton, *Private Equity Negotiation Myth*, *supra* note 27 (setting forth a detailed description of critiques of private equity LPAs).

LPAs have been criticized for waiving and otherwise limiting managers' fiduciary duties to their investors under state limited partnership law[63]; for seeking to satisfy managers' fiduciary duties under federal law by providing generic and all-encompassing disclosures[64]; for requiring investors to agree to non-disclosure provisions that prevent them from sharing fund agreements with any third parties[65]; for requiring investors to indemnify managers for liabilities resulting from an extremely broad array of conduct, including criminal acts committed by managers[66]; for giving managers excessive discretion when it comes to valuing assets, selecting investment strategies, and mitigating conflicts of interest[67]; for failing to give investors enough information to engage in meaningful monitoring of fund managers after they

[63] *See* Appelbaum & Batt, *How Private Equity Abuses Its Limited Partners, supra* note 8. *See also* Strine & Laster, *Siren Song*, *supra* note 50 (arguing that because of fiduciary duty waivers, investors in alternative entities "are either required to become diligent and expert readers of alternative entity agreements, which may involve the expenditure of material costs for legal advice, or to blindly accept the risks of investing in asset classes where no dependable protection against self-dealing and other conflict of interests exists").

[64] *See* Comment Letter from the Institutional Limited Partners Association to the SEC, dated Feb. 12, 2019 (https://ilpa.org/wp-content/uploads/2019/02/2019.2.12-ILPA-Member-Letter-on-Fiduciary-Duty-Submission-Copy.pdf); Press Release from the Institutional Limited Partners Association, dated Feb. 12, 2019 (https://ilpa.org/wp-content/uploads/2019/02/ILPA-35-LPS-Urge-SEC-to-Take-Action-on-Fiduciary-Duties-Press-Release-2.12.19.pdf) ("The SEC has increasingly permitted private equity advisers to limit their fiduciary obligations under the Advisers Act by permitting vague, all-encompassing disclosure of conflicts of interest.").

[65] *See* Gretchen Morgenson, *Behind Private Equity's Curtain*, N.Y. TIMES (Oct. 18, 2014) ("[I]n exchange for what they hope will be hefty returns, many pension funds have signed onto a kind of omerta, or code of silence, about the terms of the funds' investments."); Madison Marriage & Chris Newlands, *Pension Funds Forced to Sign Non-Disclosure Agreements*, FIN. TIMES (Oct. 26, 2014) ("Anger has erupted over the practice of asset managers coercing pension funds into signing non-disclosure agreements. . . . Critics believe the non-disclosure agreements allow fund managers to overcharge some of their pension clients significantly."); Gretchen Morgenson, *The Deal's Done, But Not the Fees*, N.Y. TIMES (May 24, 2014) (quoting SEC official Andrew Bowden as saying that "in some instances, investors' pockets are being picked").

[66] *See* Yves Smith, *CalPERS, CalSTRS, Other Investors Have Indemnified Private Equity Criminal Conduct*, Naked Capitalism (Mar. 29, 2017), https://www.nakedcapitalism.com/2017/03/calpers-calstrs-other-investors-have-indemnified-private-equity-criminal-conduct-even-though-fiduciary-counsels-say-no.html (noting that LPA indemnification provisions "indemnify the fund manager . . . against certain types of criminal conduct").

[67] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 ("We've also seen limited partnership agreements lacking clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.").

have invested in a fund[68]; and for failing to provide investors with sufficient information about how the fund is using subscription credit lines to borrow money that investors are obligated to pay back.[69] Perhaps most controversial of all, in the years following the financial crisis, the SEC found that due to weak disclosure requirements in LPAs, managers had been charging many fees without giving investors sufficient disclosure of the nature of the fees either before or after they were charged.[70] Over the years, these criticisms have raised concerns among scholars,[71] regulators,[72] judges,[73] state government officials,[74] and investors[75] alike.

[68] *See infra* notes 129 and 130 and accompanying text.

[69] Chris Cumming, *Pensions Don't Always Track How Much is Borrowed Against Their Names*, WALL ST. J. (May 5, 2019) ("'Private-equity firms generally don't give details on subscription-line usage unless investors ask for them. Even then, fund managers don't always give the information they're asked for,' said Jennifer Choi, managing director at the Institutional Limited Partners Association.").

[70] *See infra* Section II.B.1.a.

[71] *See, e.g.*, Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSPECTIVES 147 (2009); Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 285 (2010); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1904 (2018) [hereinafter Magnuson, *Public Cost of Private Equity*]; Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. CORP. L. STUDIES 59 (2012) [hereinafter Morris & Phalippou, *New Approach to Regulating Private Equity*]; Appelbaum & Batt, *How Private Equity Abuses Its Limited Partners*, *supra* note 8.

[72] *See infra* Section II.B.1.a.

[73] *See, e.g.*, Strine & Laster, *Siren Song*, *supra* note 50 ("Given the reality that many of the accredited investors who invest in non-public alternative entities are themselves fiduciaries, such as pension funds who invest on behalf of ordinary Americans who depend on those investments for their retirement, these detriments cannot be shrugged off as something only incurred by the affluent and thus not a public policy concern.").

[74] *See, e.g.*, Letter to SEC Chair Mary Jo White from treasurers and/or comptrollers from California, Nebraska, Wyoming, South Carolina, Washington D.C., Oregon, Rhode Island, New York State, New York City, Virginia, Vermont, and Missouri (July 23, 2015), https://www.sec.gov/rules/petitions/2015/petn4-688.pdf [hereinafter Treasurers and Comptrollers Letter to SEC] ("We (state treasurers and comptrollers) believe increased disclosure transparency will provide limited partners with a stronger negotiating positions, ultimately resulting in more efficient investment options. We have a fiduciary obligation to achieve these goals, and therefore assert that greater private equity fee disclosure standards are in the public interest.").

[75] *See, e.g.*, Letter to SEC Secretary Brent Fields from the Institutional Limited Partners Association and signed by 33 pension investment officials (Feb. 12, 2019), https://ilpa.org/wp-content/uploads/2019/02/2019.2.12-ILPA-Member-Letter-on-Fiduciary-Duty-Submission-Copy.pdf ("Strong fiduciary duties are the foundation of the vibrant private markets in the United States. . . . Unfortunately, LPs have been facing significant resistance in their efforts to retain

C. Public Pension Investment in Private Funds

In today's marketplace, the investor type that collectively invests the greatest amount of money in private funds is public pension plans.[76] One driver behind public plans' shift toward private funds in recent years[77] has been the underfunding challenges facing public plans in the United States.[78] According to one recent estimate, state and local plans across the country are underfunded—which refers to the amount by which their future obligations exceed their current assets—by approximately $5.2 trillion.[79] These underfunding problems have been severely exacerbated by the COVID-19 pandemic.[80]

As this underfunding problem has deepened, many plans have resorted to riskier, higher-yielding investments to seek to make up for growing funding shortfalls,[81] leaving more and more taxpayer-backed plans increasingly dependent on the performance of private funds.[82] Research shows that when compared with private pension funds in the United States and with pension plans in Canada and Europe, public pension plans in the United States tend to invest more of their capital in risky assets like private funds.[83]

meaningful fiduciary protections while investing in the private equity market on behalf of themselves or their beneficiaries.").

[76] *See* 2018 Preqin Global Private Equity and Venture Capital Report 73 (showing that public pension plans are the largest investors in private equity funds with the exception of funds of funds, representing 35 percent of all capital in the asset class) [hereinafter 2018 Preqin Global Report]; Preqin Hedge Fund Spotlight 14 (Feb. 2018) (showing that public pension plans are the largest investors in hedge funds, representing 22 percent of all capital in the asset class).

[77] *See supra* note 2.

[78] *See supra* note 1.

[79] *See* Chuck DeVore, *$5.2 Trillion of Government Pension Debt Threatens to Overwhelm State Budgets, Taxpayers*, FORBES (May 31, 2019) (citing figures from pensiontracker.org).

[80] *See* Michael R. Glass & Sean H. Vanatta, *The Next COVID-19 Victim? Public Pension Funds*, WASH. POST (Apr. 17, 2020); Mary Williams Walsh, *Coronavirus is Making the Public Pension Crisis Even Worse*, N.Y. Times (Apr. 2, 2020).

[81] *See supra* note 3.

[82] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 ("To the extent private equity advisers are engaged in improper conduct, it adversely affects the retirement savings of teachers, firemen, police officers, and other workers across the U.S.").

[83] *See* Andonov, Bauer & Cremers, *supra* note 3 ("Our results suggest that, over time, U.S. public pension funds have become the biggest risk-takers among pension funds internationally.").

1. Pension Management Problems

Public pension plans are typically operated by city, county, and state officials and staff employees who are overseen by a board of trustees. Thus, by prioritizing freedom of contract, private fund policy effectively leaves pension staff—the people who manage the plan's activities—to oversee negotiations with fund managers for contractual protections. This contractual freedom raises a few potential concerns about the management of public plans.

First, as agents for pension beneficiaries, the interests of public pension staff and trustees are not always aligned with the interests of beneficiaries. Accordingly, instead of using the contractual flexibility afforded by the law to negotiate for terms that will optimize the welfare of plan beneficiaries, pension staff might be incentivized to negotiate in ways that will maximize their own personal welfare. Because public pension plans are subject to greater constraints on employee compensation than most private institutions, it can be harder for them to craft compensation arrangements that align employees' incentives with the interests of plan beneficiaries.[84] This agency conflict is illustrated in Figure A below.[85]

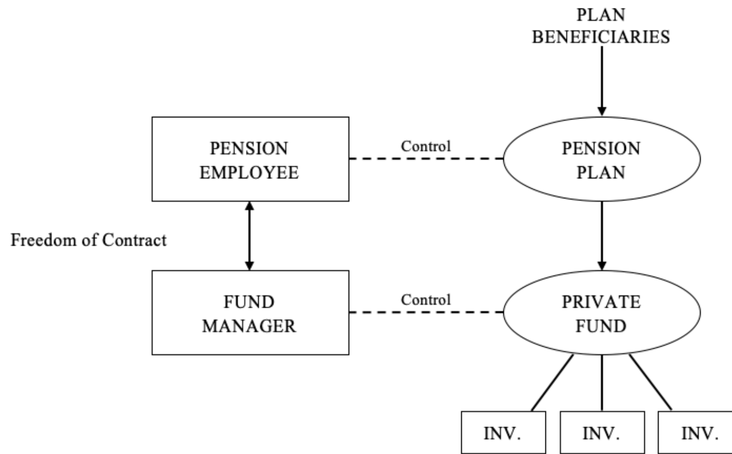

Figure A

[84] *See supra* note 20.

[85] Note that while private funds typically have many investors, Figure A has been simplified to show only a single plan.

Research supports the idea that pension employees' personal career interests sometimes lead them to take actions that do not optimize returns for plan beneficiaries.[86] Studies have found that, in order to protect their jobs, pension employees sometimes engage in obfuscatory activities to deflect responsibility for poor performance.[87] Though these strategies are often costly to the pension plan, they help pension employees avoid negative personal consequences. Pension employees have also been shown to invest excessively in actively-managed funds because these funds (as opposed to passive investments like index funds) need to be monitored by an employee at the pension plan, helping to support the perceived need to have pension staff in the first place.[88] Research has also shown that political conflicts of interest can infect pension employees' investment decisions, with pension staff and trustees showing a bias toward investing in politically-connected companies to the detriment of plan performance.[89]

The problems discussed above are mild cases. Far more extreme forms of self-interested behavior—including bribery, pay-to-play schemes, and other

[86] To the extent that this is true, such actions raise the question whether some public plan trustees and officials are breaching their fiduciary duties to plan beneficiaries. *See infra* Section II.A.1 for a discussion of these fiduciary duties.

[87] *See, e.g.*, Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J. LAW & ECON. 463, 472 (1996) (finding that institutional investor employees show a willingness to allow value to be transferred to fund managers in complex ways that are difficult for outsiders and superiors to detect, but not in ways that can be more easily observed and scrutinized); Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, *The Structure and Performance of the Money Management Industry*, *BROOKINGS PAPERS ON ECONOMIC ACTIVITY, MICROECONOMICS*, 339–79 (1992) [hereinafter Lakonishok, Shleifer & Vishny, *Money Management Industry*] (finding significant underperformance by pension plans attributable to agency problems, including actions taken by pension employees to shift responsibility for poor performance).

[88] *See* Lakonishok, Shleifer & Vishny, *Money Management Industry*, *supra* note 87 (arguing that "those in charge of the plan must show that they are doing some work to preserve their position").

[89] *See, e.g.*, Bradley, Pantzalis & Yuan, *Influence of Political Bias*, *supra* note 32 (finding that the more politically-affiliated trustees on a public plan board, the more the fund shifts toward risky asset allocations); Andonov, Hochberg & Rauh, *Political Representation and Governance*, *supra* note 32 (finding that representation on public plan boards by state officials is negatively related to plan performance).

kinds of corruption by pension trustees and staff[90]—have been well-documented in the pension context.[91]

There are thus multiple layers of conflict when public pension plans invest in a private fund. One layer exists between the fund manager and the pension plan, and another layer exists between the pension manager and the pension beneficiaries.[92] Adding to the concern is yet another layer of conflict—one between pension beneficiaries, on one hand, and taxpayers, on the other hand. Even when a public plan is poorly-managed, beneficiaries typically bear little risk of actually losing their benefits, as taxpayers will typically be required to bear the losses—either by paying higher taxes or losing other tax-funded services.[93] This diminishes beneficiaries' incentive to monitor public plan staff, which diminishes public plan staffs' incentive to monitor private fund managers. Moreover, because the negative consequences resulting from sub-optimal pension management often do not materialize until many years in the future, elected officials with finite tenures sometimes have diminished incentives to take action to deal with pension management problems.

Incentive problems like these offer one explanation for why so many state pension plans face underfunding problems.[94] Even setting aside these

[90] *See, e.g.*, Brendan Pierson, *N.Y. Pension Fund Manager Charged with Taking Bribes Pleads Guilty*, REUTERS, Nov. 8, 2017; Matthew Dolan, *Jury in Detroit Pension Case Convicts Former Treasurer, 2 Others*, WALL STREET J., Dec. 8, 2014; *Former CEO of CalPERS is Sentenced to Prison for His "Spectacular Breach of Trust"*, L.A. TIMES, May 31, 2016; Marc Lifsher, *New York State Pension Fund Trustee Pleads Guilty to Taking Bribes*, L.A. TIMES, Oct. 7. 2010); *Guilty Plea in Fraud Case Tied to New York Pension*, N.Y. TIMES, Dec. 4, 2009; CHRISTOPHER B. TOBE, KENTUCKY FRIED PENSIONS: A CULTURE OF COVER-UP AND CORRUPTION (2013).

[91] *See* Paul Rose, *Public Fund Governance and Private Fund Fees*, 2016 Private Fund Report: Public Pension Plans and Private Funds—Common Goals, Conflicting Interests, http://conference.lowellmilkeninstitute.law.ucla.edu/Private-Fund-Conference2016.pdf [hereinafter Rose, *Public Fund Governance*] ("Corruption in public pension funds is not new or confined to transactions with private funds.").

[92] *See* Morris & Phalippou, *New Approach to Regulating Private Equity*, *supra* note 71 ("[A] second level of agency conflict is possible *within* an LP's organization. . . . Agency conflicts within investor organizations, then, are one possible explanation for why qualified investors accept suboptimal contracts."); Dana M. Muir, *Decentralized Enforcement to Combat Financial Wrongdoing in Pensions: What Types of Watchdogs are Necessary to Keep the Foxes Out of the Henhouse?*, 53 AMER. BUS. L.J. 33, 34 (2016) ("In pension plans, a variety of intermediaries and service providers stand between the participants and the investment products in which their money is invested. Not surprisingly, agency problems abound . . .").

[93] *See supra* note 21.

[94] *See supra* note 1.

conflicts of interest, public plans face other challenges as well. Limits on compensation can make it more difficult for public pension plans to recruit and retain talented employees.[95] Moreover, because trustee positions in public pension plans are often granted by political appointment, there is a high likelihood that these positions will be filled by people who are politically well-connected but inexperienced when it comes to investing.[96] For these reasons, pension officials and staff may sometimes simply be less competent than the financial managers in the private sectors, even if they are operating in good faith.[97]

2. Coordination Challenges

Public pension plans also face coordination issues that can affect the quality of the terms in fund agreements.[98] As noted above, in a typical private fund, the capital contributions of many investors are pooled together into a single fund that is managed by the fund manager. If investors were to collectively demand high-quality protections, private fund managers would likely find it difficult to refuse them. But private fund investors have trouble coordinating—either formally or informally—in this way.

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[95] *See supra* note 20 and accompanying text.

[96] *See* Andonov, Hochberg & Rauh, *Political Representation and Governance*, *supra* note 32; David Hess & Gregorio Impavido, *Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence*, PUB. PENSION FUND MGMT. 9 ("In the United States, unresolved agency problems based on self-interest often involve politically motivated actions, commonly when politically appointed or ex officio trustees make decisions not to further the beneficiaries' interests but to improve their own situation."); Yves Smith, *'Alpha Wolves in the Henhouse': California's Multibillion-Dollar Private-Equity Boondoggle*, N.Y. MAG. (Dec. 13, 2018), http://nymag.com/intelligencer/2018/12/what-is-calpers-new-private-equity-business-model.html ("Unfortunately, all around the U.S., including at CalPERS, public pension fund board seats are usually elected or patronage positions and they too often go to people with no expertise — or worse, to people with expertise as well as major conflicts of interest. This stands in contrast to other countries, like the Netherlands, where public pension fund board members are selected from public workers who must pass investment competency tests.").

[97] *See Protections Vary in Public Plans*, 2017 Pew Brief, *supra* note 3 ("U.S. public pension plans—particularly those whose trustees have limited financial experience—can be ill-equipped to make these types of investment decisions, which can have a negative impact on fund performance.").

[98] While this is an issue that affects all private fund investors, it is worth pointing out here specifically. Even though public pension plans share in common the fact that they are managing public money, they do not attempt to work together to maximize joint public pension profits. Rather, they are effectively in competition with each other for investment opportunities.

One reason coordination is difficult is the extremely common industry practice of granting "side letters" to investors in private funds. Side letters contain terms that are specific to the recipient of the side letter, and they can modify certain terms of the LPA in their application to that investor.[99] Side letters enable investors to negotiate for certain "individualized" benefits that will only be enjoyed by the recipient of the side letter.[100]

Accordingly, rather than grant every term to all of the investors in a fund, managers often have the option of granting terms in side letters to a select group of the fund's investors. In addition, when large investors can negotiate for fee discounts or other side letter benefits that the fund's other investors do not receive, they may be less motivated to demand strong LPA terms in the first place.[101] Side letter benefits thus reduce investors' incentive to coordinate with each other when they invest in private funds.

II. PUBLIC PENSIONS AND STATE LAW

As stewards of public retirement funds, the trustees and officers of public pension plans in each state are subject to laws that do not apply to other types of private fund investors. Public plans are established under laws that grant authority to civil servants to oversee public funds and that also place restrictions on their activities.[102] Historically, these state laws have focused primarily on the internal governance of public plans by imposing fiduciary duties and guardrails that regulate the conduct of plan staff but otherwise leave them with discretion to negotiate private fund contract and side letter terms. Occasionally, state law has also taken a more direct approach by regulating certain limited aspects of private fund contracts directly.

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[99] *See* Mark C. Dempsey & Kristin M. Rylko, *Developing Side Letter Issues*, MAYER BROWN (2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2015/03/developing-side-letter-issues/files/developing_side_letter_issues/fileattachment/developing_side_letter_issues.pdf.

[100] The syndicated bank loan market offers a contrasting example. When a group of banks participates in a syndicated loan, typically one bank will serve as a lead arranger who bargains on behalf of the other banks participating in the syndicated loan. *See* Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, 9 J. FIN. INTERMEDIATION 404, 407–08 (2000).

[101] *See* Clayton, *Private Equity Negotiation Myth*, *supra* note 27 at 70–71 (arguing that "bargaining power can actually make large investors less sensitive to the quality of fund agreement terms because it enables them to negotiate for individualized benefits that offset the harm caused by weak protections.").

[102] *See generally* JUN PENG, ST. & LOC. PENSION FUND MGMT. 16–17 (2009).

A. State Law Approaches to Regulating Public Plans

1. Internal Plan Governance: Fiduciary Duties and Guardrails

Fiduciary duties have been referred to as the "centerpiece" of the standards that govern the internal governance of public plans across states.[103] The fiduciary duties that apply to plan trustees and staff[104] are based on old trust law doctrines that originated nearly two hundred years ago.[105] While the exact requirements vary from state to state, plan trustees are generally required to abide by the traditional trust law duties of prudence and loyalty.[106] The standard of prudence has evolved gradually over time, with the Restatement (Third) of Trusts requiring trustees to administer the trust as a prudent person would with "reasonable care, skill, and caution" and, if they possess special facilities or skills, to use those skills.[107] Elements of the fiduciary standard in the Employee Retirement Income Security Act of 1974 ("ERISA"), the federal statute that regulates the administration of private pension plans, have also been incorporated by many states.[108]

Commentators have criticized these fiduciary duties for various reasons. Some have argued that states impose an inconsistent patchwork of fiduciary duties, and that many state standards lack important core elements.[109] Others have argued that the trust-based approach to fiduciary duties simply does not reflect the economic realities of public pension plans, thus undermining the

[103] *See* Natalya Shnitser, *Trusts No More: Rethinking the Regulation of Retirement Savings in the United States*, B.Y.U. L. REV. 630, 647 (2016) [hereinafter Shnitser, *Rethinking the Regulation of Retirement Savings*].

[104] Senior staff members are typically considered fiduciaries of a public plan. *See* NASRA 2019 Overview of Public Pension Plan Governance ("[H]igh-level staff are considered fiduciaries to the plan.").

[105] *See* Rose, *Public Wealth Maximization*, *supra* note 21 at 896 (noting that the fiduciary duties of public pension officials are based on long-standing trust doctrines tracing back to the 1830 case *Harvard College v. Armory*).

[106] *See* Shnitser, *Rethinking the Regulation of Retirement Savings*, *supra* note 103.

[107] *See* RESTATEMENT (THIRD) OF TORTS § 77 (AM. LAW INST. 2003).

[108] *See* Rose, *Public Wealth Maximization*, *supra* note 21 at 900 (noting that many states apply ERISA's prudent man standard to public plans and often look to ERISA to fill gaps in the state law).

[109] *See Protections Vary in Public Plans*, 2017 Pew Brief, *supra* note 3 ("Pension experts largely agree on what fiduciary provisions should include, but codification varies widely from state to state.").

effectiveness of the governance of public plans,[110] while others have argued that the fiduciary standards are simply too weak to support the governance load of complex public plans.[111] Even ignoring these substantive concerns, some have also argued that there is often no practical way to enforce these fiduciary duties due to procedural obstacles.[112]

In addition to principles-based fiduciary duties, state law also commonly imposes specific restrictions that serve as guardrails on the activities of public plan trustees and officers. For example, state laws often impose affirmative diversification requirements on their public plans,[113] as well as general limitations on asset classes deemed too risky or speculative for the state's public plans.[114] Importantly, while these kinds of restrictions place limits on the freedom that plan officials and trustees have to operate, they typically do not dictate a particular outcome. Within these constraints, public plan officials still generally retain flexibility and discretion to make decisions on behalf of the plan. These laws do not require them to obtain specific terms or concessions from any private fund managers that they might invest in; rather, it leaves the negotiation of specific terms to the plan staff's discretion.

State laws have largely focused on this internal approach to regulating public pension investments over the years. By imposing fiduciary duties and placing limited restrictions on the discretion of plan trustees and officials, this approach seeks to give trustees and staff appropriate incentives and put guardrails in place to help them use their discretion effectively.

[110] *See* Shnitser, *Rethinking the Regulation of Retirement Savings*, *supra* note 103 at 629 ("The mismatch between the legal framework and the parties' economic interests has undermined the effectiveness of trust-based governance for public pensions.").

[111] *See* Rose, *Public Wealth Maximization*, *supra* note 21 at 922 ("The core problem with this structure is that fiduciary duties alone are much too slender a support to carry the governance load of a public fund, particularly in the context of public funds that carry political risks.").

[112] *See infra* Section III.B.4.

[113] *See Protections Vary in Public Plans*, 2017 Pew Brief, *supra* note 3 (noting that 39 states have adopted diversification requirements).

[114] *See* James R. Copland & Steven Malanga, *Safeguarding Public-Pension Systems: A Governance-Based Approach*, Manhattan Institute Report (Mar. 2016), https://media4.manhattan-institute.org/sites/default/files/R-JCSM-0316.pdf ("[A] majority of states have some sort of 'legal list' statute that limits certain investment choices by state or municipal pension plans—from total prohibitions on equity investments to prohibitions on types of investments deemed too speculative . . .").

2. Laws That Regulate Private Fund Contracts Directly

As noted above, investments in private funds are highly contractual. If a state legislature feels strongly about a particular term in private fund contracts, they have the option of taking a more direct approach and passing a law that requires the adoption of that term in any private fund contracts entered into by the state's public plans. If private fund managers are unwilling to grant the term, they will be legally barred from accessing money from public plans in the state. This could be a preferred approach if, for example, the legislature is skeptical about whether pension staff will be able to (or be incentivized to) demand the term themselves, possibly due to conflicts of interest, weaknesses in their fiduciary duties, or challenges with coordinating with other investors.[115] Unlike the internal approach described above, these laws are more than mere guardrails; they take away plan trustees' and officials' discretion with respect to the relevant contract term. If plan trustees and officials decide to invest in a private fund, they have no choice but to demand the required term from the fund manager, regardless of whether they think it is a valuable term or not.

Placement agent laws offer one common example. These laws require public plans to receive a written confirmation from the private fund manager that no placement agents were employed to solicit the investor's money. Passed in response to investigations into corrupt "pay-to-play" practices in the late 2000s involving the use of placement agents in connection with public plans, these laws specifically require that plan staff receives such a written confirmation before they are eligible to invest in a private fund.[116] If a private fund manager wants money from any public plans in a state that has passed this kind of law, it has to provide the term, either in the fund contract or in the public plan's side letter.[117]

Laws that control public plans' exposure to the underlying businesses that a private fund invests in provide a different example. These statutory limitations differ from the risk-oriented investment limitations described

[115] *See generally* Section I.C.

[116] *See* Dempsey & Rylko, *Developing Side Letter Issues*, *supra* note 99 ("[A] growing number of governmental authorities have taken measures to restrict the use of placement agents and curb so-called 'pay-to-play' abuses. . . . A common manifestation of such regulations requires a fund to represent and warrant to a government investor that it did not use a placement agent to obtain such government investor's investment and that no benefit was paid or promised to the government investor's employees, affiliates or advisors to obtain its investment.").

[117] *Id.*

above[118] in that their primary purpose is usually to achieve political or social objectives, rather than maximize plan returns.[119] While this kind of law typically will not explicitly state that a particular contract term must be granted, in practice an investor will need to demand certain contractual rights from private fund managers in order to comply. In this case, investors will typically need to receive a contractual "excuse" right that authorizes them to opt out of certain investments (such as, for example, gun, tobacco, or pornography investments) that the fund participates in. Thus, even when a law does not explicitly state that a particular contract or side letter term is required, it is possible for it to have the same effect as a law that does explicitly regulate private fund contract terms.

B. Fee Transparency Laws: Aggressive State Regulation of Private Fund Contracts

The direct laws discussed immediately above do not tend to be hotly contested items. In recent years, however, the marketplace has seen experimentation with a more aggressive approach to regulating private fund contracts. Following criticism by the SEC and the media of controversial fee and expense practices across the industry, California passed a law that dramatically increased the minimum fee disclosure terms that private fund contracts must provide to California plans.[120] This law was a particularly aggressive version of the direct approach to regulation described above. Some state legislatures followed California's lead, and several others seriously considered doing so, in an effort to rein in fees which have been

[118] *See supra* notes 113 and 114 and accompanying text.

[119] *See, e.g.*, Eugene Kontorovich, *Illinois Passes Historic Anti-BDS Bill, as Congress Mulls Similar Moves*, WASH. POST, May 18, 2015 (noting that a wave of legislation preventing public plans from investing in companies that boycott Israel had swept states throughout the nation); James Comtois, *Massachusetts Introduces Legislation Requiring MassPRIM to Divest from Gun Manufacturers*, PENSIONS & INV. (Mar. 16, 2018); Heather Gillers, *CalPERS' Dilemma: Save the World or Make Money?*, WALL STREET J., June 16, 2019 (noting that in the aftermath of the Sept. 11, 2001 terrorist attacks, more than 20 states passed laws that could compel their pension funds to divest from Sudan, Iran, or other governments considered by the U.S. to be sponsors of terrorist activity).

[120] David T. Jones, Michael F. Mavrides, Christopher M. Wells & Anthony M. Drenzek, *New California Law Requires Increased Private Fund Fee and Expense Disclosure*, THE NAT'L L. REV. (Oct. 2, 2016), https://www.natlawreview.com/article/new-california-law-requires-increased-private-fund-fee-and-expense-disclosure.

described as "obscene"[121] and "grossly unreasonable"[122] by prominent figures in the industry.

1. Precipitating Events

a. The SEC's Damning Critique

In the years following the financial crisis of 2008, the SEC launched an industry-wide examination "sweep" of the private funds industry. The goal was for the SEC to establish an expanded presence within the industry[123] following the passage of the Dodd-Frank Act, which gave the agency authority to perform examinations on a much wider universe of fund managers.[124] Because the fund documents for private equity funds, hedge funds, and other private funds are almost never publicly-filed, the SEC's newly-expanded authority gave it an opportunity to become more familiar with the unique issues surrounding the business models employed by private funds.

The SEC's findings did not reflect well on private fund managers or their investors. In the area of private equity funds, the SEC observed in 2014 that managers were regularly charging investors fees and expenses that were not

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[121] Lizzy Gurdus, *Interview with Warren Buffett, Chairman and CEO of Berkshire Hathaway Inc.*, CNBC (Feb. 27, 2017 9:37 AM), https://www.cnbc.com/2017/02/27/buffett-hedge-funds-fees-border-on-obscene.html ("[Hedge fund fees] make a lot of people rich, and it's going to make very few investors rich," "[It] borders on obscene.").

[122] DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT (2005) ("Some part of the failure of buyout managers to produce risk-adjusted returns stems from the inappropriate fee structure. . . . The large majority of buyout funds fail to add sufficient value to overcome a grossly unreasonable fee structure.").

[123] *See* Mark Wyatt, *Private Equity: A Look Back and a Glimpse Ahead,* U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html (May 13, 2015) ("OCIE [the SEC's Office of Compliance, Inspections and Examinations] commenced the Presence Exam Initiative in October 2012 in response to the Dodd Frank provisions requiring the registration of many advisers to private equity funds. We designed the initiative to quickly establish a presence in the private fund industry and to better assess the issues and risks presented by these unique business models.").

[124] *See* Title IV, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (eliminating the "private adviser" exemption to registration requirements under the Investment Advisers Act, which had the effect of requiring all but a small minority of private fund managers to register with the SEC and become subject to the SEC's examination authority).

adequately disclosed.[125] One way they did this was by charging fees to the "portfolio companies" owned by the fund, rather than the fund itself, which made them more difficult to track.[126] Perhaps most alarming of all, the SEC indicated that its examination unit had identified violations of law or material weaknesses in controls relating to the payment of fees and expenses in over 50% of the managers that they examined.[127]

The SEC also presented troubling observations about institutional investors in private equity funds. Specifically, the agency observed that institutional investors in private equity funds had tolerated an environment where "lack of transparency and limited investor rights ha[d] been the norm . . . for a very long time."[128] Institutional investors were also accused by the SEC of taking an extremely lax approach to monitoring managers after they invested in a fund.[129] And perhaps most concerning of all, the SEC also noted that even if investors wanted to monitor a fund manager's activities during the life of a fund, they would not have been able to do so, since the LPAs negotiated by investors do not provide them with enough information to perform this kind of basic monitoring.[130] Finally, the SEC also reported that institutional investors regularly granted managers broad discretion in LPAs to charge fees and expenses that were not specifically discussed at the time the LPAs were negotiated.[131] These "hidden" payments were often made

[125] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 (noting that broadly-worded fund agreements "created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors").

[126] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 ("[A] private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services . . . or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company . . . or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.").

[127] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 ("When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.").

[128] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9.

[129] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 ("While investors typically conduct substantial due diligence *before* investing in a fund, we have seen that investor oversight is generally much more lax *after* closing.") (emphasis in original).

[130] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 (noting that most fund agreements "do not provide [investors] with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager").

[131] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9.

by a fund's portfolio companies to the manager or affiliates of the manager and were never specifically disclosed to investors in the fund.[132]

The SEC expressed hope that its examination findings would prompt institutional investors "to request more and better disclosure about the fees and expenses that they pay."[133] But all in all, the agency's comments were a sweeping rebuke of common practices throughout the private equity industry, and they pointedly questioned the vigilance of institutional investors in working to protect themselves from being exploited by fund managers. As the largest institutional investors in the industry,[134] these criticisms raised clear concerns about the management of public pension plans and the wisdom of increasing their allocation to private equity funds by so much in recent years.

b. CalPERS' Failure to Track Fees

Not long after the SEC's comments, another highly public controversy followed. This controversy centered on CalPERS (the California Public Employees' Retirement System), the largest public pension plan in the United States,[135] for failing to track some of the most significant fees that it had paid to private equity fund managers over multiple decades.

This controversy was precipitated when the pension plan's chief operating investment officer was asked at a CalPERS investment committee meeting how much CalPERS had paid to private equity fund managers in "carried interest" payments over the years.[136] Carried interest is a form of incentive compensation made to a fund manager based on the performance of the fund, and it commonly constitutes a very significant portion of the overall fees paid to the manager.[137] In a response that shocked many industry

[132] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9.

[133] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9.

[134] *See* 2018 Preqin Global Report, *supra* note 76.

[135] *See* CalPERS Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2014, https://www.calpers.ca.gov/docs/forms-publications/cafr-2014.pdf (noting that CalPERS was the nation's largest public pension fund with over $300 billion in assets).

[136] Alexandra Stevenson, *CalPERS's Disclosure on Fees Brings Surprise, Scrutiny*, N.Y. TIMES (June 25, 2015) [hereinafter Stevenson, *CalPERS's Disclosure Brings Scrutiny*].

[137] *See* Dan Primack, *Following Criticism, CalPERS Asks Private Equity Funds for Profit Data*, FORTUNE (July 1, 2015) [hereinafter Primack, *Following Criticism*] (reporting that CalPERS "sent out emails to all of its private equity fund managers, asking for the amount of carried interest paid—and, separately, the amount of carried interest accrued—by CalPERS since the inception of each private equity fund.").

observers, CalPERS' chief operating investment officer indicated that they could not answer this question, largely because CalPERS had not even been *tracking* these payments.[138]

Unsurprisingly, when word of this response was publicized, negative coverage in the news media followed.[139] To limit the damage, CalPERS responded by making special requests to managers of some of the funds in which it had invested to obtain information about its historical carried interest payments.[140] CalPERS eventually reported that, among the active funds in which the plan was then invested, it had paid $3.4 billion in carried interest to fund managers.[141] But even this massive sum failed to reflect the full amount of carried interest paid by CalPERS, since it was limited to the plan's active investments and revealed nothing about fees paid to funds in which the plan no longer held an active interest.[142]

These revelations were a public relations black eye not only for CalPERS, but for public pension plans across the country. If the country's largest pension plan could not be relied on to monitor one of the most substantial fees that it pays to private fund managers, why would anyone expect other pension plans to do better?

[138] *See, e.g.*, Stevenson, *supra* note 136 ("[A] senior executive of the California Public Employees' Retirement System, the country's biggest state pension fund, made a surprising statement: The fund did not know what it was paying some of its Wall Street managers. Wylie A. Tollette, the chief operating investment officer, told an investment committee . . . that the fees CalPERS paid to private equity firms were 'not explicitly disclosed or accounted for. We can't track it today.'").

[139] *See, e.g.*, *id.*; Dale Kasler, *CalPERS Tries to Get Handle on Management Fees*, SACRAMENTO BEE (July 2, 2015) ("[T]he California pension fund doesn't know how much it pays the firms that run its private equity investments—the roughly $30 billion CalPERS has plowed into businesses that aren't traded on any stock exchange."); Dan Primack, *CalPERS Again Falls Short on Private Equity Oversight*, FORTUNE (June 26, 2015) ("CalPERS is once against showing signs of dysfunction."); Mike Lucas, *'Carried Interest' the Comic Strip*, WALL STREET J. (Sept. 4, 2015), https://blogs.wsj.com/privateequity/2015/09/04/carried-interest-the-comic-strip-30/ (showing a comic strip mocking CalPERS for failing to track carried interest payments to private fund managers).

[140] *See* Primack, *Following Criticism, supra* note 137.

[141] *See* Dan Primack, *CalPERS (Finally) Details Its Private Equity Manager Profits*, FORTUNE (Nov. 24, 2015) ("[CalPERS] reports that its *active* private equity fund managers have realized $3.4 billion in profit-sharing between 1990 and June 30, 2015. . . . CalPERS only released data for *active* funds, as opposed to all of the private equity funds in which it has invested since 1990.")(emphasis added).

[142] *See id*.

2. Possible Explanations for Weak Fee Transparency

There are a few possible explanations for why public pension staffs might have failed to negotiate for clear disclosure of the fees their plans were paying to fund managers. One possibility is that they were simply incompetent or naïve. As noted above, public pension employees are generally paid less than private sector investment managers in the United States,[143] so perhaps they simply did not understand the enormous impact that the relevant fees had on their plans' returns. Or they may simply have trusted that managers would not charge an unfair level of fees if left unmonitored.

More cynically, as some have argued, pension employees may have been intentionally trying to hide the fact that their plans were paying unjustifiably high fees to private fund managers.[144] Consistent with research showing that pension managers sometimes prioritize their career interests over the interests of pension beneficiaries,[145] pension staff may have thought that their jobs would be in jeopardy if the public knew how much money their plans were paying to private fund managers.

Less cynically, it alternatively may have been the case that fund employees *wanted* to receive better fee disclosure but lacked the bargaining power to obtain it (or believed they lacked it). Private fund managers can benefit from avoiding robust disclosure of their fees—they may, for example, have wanted to make it difficult for investors to compare their fees with other managers' fees, thereby reducing competitive fee pressure, or they may have wanted to avoid public scrutiny of their lavish fees and business model. Of course, for this to be true, managers would have needed strong bargaining power vis-à-vis the universe of potential investors in their funds. They would

[143] *See supra* note 95 and accompanying text.

[144] *See, e.g.*, Stevenson, *CalPERS's Disclosure Brings Scrutiny*, *supra* note 136 (quoting former SEC lawyer and pension fraud investigator, Edward A. H. Siedle, as follows: "The money manager knows to a penny what the fees are. The only explanation is that the pension fund has chosen not to ask the question because, from an accounting and legal perspective, those numbers have to be readily available. They are intentionally not asking because if the fees were publicly disclosed, the public would scream. . . . How is it that the largest and supposedly most sophisticated investor in the pension world ignored this issue for the last 10 years?"); Alison Vekshin, *CalPERS Carried Interest Data May Hold 'Shock Value' for Public*, BLOOMBERG NEWS (Oct. 7, 2015) [hereinafter Vekshin, *CalPERS Carried Interest Data May Hold 'Shock Value' for Public*] (quoting Professor Victor Fleischer as saying, "You have to worry that if you're CalPERS, what the response is going to be. At the end of the day, this is public money that's being invested.").

[145] *See supra* notes 87 and 88 and accompanying text.

need to be willing to say "no" to investors that demand stronger disclosures and let them walk away.

The explanations above are not mutually exclusive. The correct answer for why pension employees failed for so many years to demand stronger fee disclosures could be a mix of all of the above, and the answer could be different for each public plan. Given the private nature of fund documents, this is a difficult question to test empirically.

3. Regulating Private Fund Contracts: Fee Transparency Laws

The events above helped prompt many states to consider using state law to regulate private fund contracts more aggressively.[146] Rather than allow public pension staffs to continue negotiating with private fund managers for fee disclosures, this kind of legislation sets forth mandatory contractual disclosure rights that private fund managers must grant if they want to raise capital from any of the pension plans located in a state.

The California state legislature has been the most prominent actor in this fee transparency movement, passing legislation in 2016 that imposed disclosure requirements on private fund managers accepting capital from the state's pension plans.[147] Since California's legislation, Assembly Bill No. 2833 ("AB 2833"), went into effect in 2017, if a private fund manager wants to raise capital from a public plan located in California, it has to provide annual disclosures of the fees, expenses, and carried interest paid by the plan to the fund, to the manager, and to any "related parties" of the manager.[148] In addition, AB 2833 requires managers to disclose the public plan's pro rata share of any fees and expenses paid by portfolio companies held by the fund to the manager or any of its related parties.[149] After they receive this

[146] In addition to California, states that considered and/or enacted fee transparency legislation include Kentucky, Illinois, Arizona, New Jersey, and Rhode Island, among others. *See infra* notes 160–162 and 164–166.

[147] AB 2833 Sec. 7514.7. This legislation received significant media attention. *See, e.g.*, Dawn Lim, *California Fee-Transparency Bill Awaits Governor's Signature*, WALL STREET J. (Aug. 26, 2016); Jessica Floum, *New Private Equity Law Doesn't Go Far Enough, Critics Say*, S.F. CHRON. (Sep. 26, 2016) [hereinafter Floum, *New Law Doesn't Go Far Enough*]; James Rufus Koren, *CalPERS' Private Equity Fees Under the Microscope*, L.A. TIMES (July 8, 2016) [hereinafter Koren, *CalPERS' Fees Under the Microscope*]; Sam Sutton, *CalPERS and the Hassle of Full Transparency*, PE HUB NETWORK (July 18, 2016) [hereinafter Sutton, *Hassle of Full Transparency*].

[148] AB 2833 Sec. 7514.7(a)(1)-(3).

[149] AB 2833 Sec. 7514.7(a)(4).

information from private fund managers, public plans in California are then required to disclose it annually to the public.[150] California's pension plans include the two largest public plans in the country, CalPERS and CalSTRS (the California State Teachers Retirement System).[151]

AB 2833 went through multiple revisions before it was approved by the California legislature.[152] Interestingly, many public pension managers and employees in California were strongly opposed to the legislation.[153] Concerned that tough requirements would lead managers to penalize them by shutting them out of their funds or in other ways,[154] California public pension managers lobbied to weaken requirements found in the original version of the bill.[155] The final version was less rigorous than what the bill's sponsors originally proposed in a few ways. Whereas the bill initially required managers to report the *total* amount of all of these fees, it was amended to require that managers only provide each public plan with the *pro rata* amount applicable to that specific plan's investment in the fund.[156] Because private fund investments are often held simultaneously by various funds and "co-investors," critics argued that it is difficult to use this pro rata figure to draw conclusions about the total scale of portfolio company fees being charged by

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[150] AB 2833 Sec. 7514.7(b) ("Every public investment fund shall disclose the information provided pursuant to subdivision (a) at least once annually in a report presented as a meeting open to the public.").

[151] *See Funded Status of the Largest U.S. Public Pension Funds*, PENSIONS & INV. (Feb. 5, 2018) [hereinafter *Funded Status of Largest U.S. Public Pension Funds*] (showing that CalPERS manages $336 billion in assets and CalSTRS manages $216 billion in assets).

[152] *See* Koren, *CalPERS' Fees Under the Microscope*, *supra* note 147.

[153] *See id.*; Floum, *New Law Doesn't Go Far Enough*, *supra* note 147.

[154] *See The Fee-Reporting Debate Takes a Detour*, PRIV. FUND CFO (May 23, 2016), https://www.privatefundscfo.com/the-fee-reporting-debate-takes-a-detour/ ("[A]dopting AB 2833 as is would lead to increased costs and, says CalPERS, lower investment returns due to retirement systems being precluded from backing private equity firms that refuse to agree to the disclosures.").

[155] *See, e.g.*, Arleen Jacobius, *Some Public Funds Uneasy with Fee Disclosure*, PENSIONS & INV. (Sept. 5, 2016), https://www.pionline.com/article/20160905/PRINT/309059987/some-public-funds-uneasy-with-fee-disclosure (noting that "[i]n California, pension plans large and small opposed the legislation, urging lawmakers to soften the requirements"); Sutton, *Hassle of Full Transparency*, *supra* note 147 (noting that "CalPERS staff fought to diminish the level of disclosure GPs would have had to provide under draft versions" of AB 2833); Marine Cole, *LACERS Opposes California Fee Reporting Bill*, PRIV. EQUITY INT'L (May 25, 2016) (noting opposition to AB 2833 by the Los Angeles City Employees' Retirement System).

[156] *See* Floum, *New Law Doesn't Go Far Enough*, *supra* note 147 ("Because the bill requires only the disclosure of public pension funds' share of the fees, private fund managers will not have to disclose the full extent of the profit they make from managing retirees' savings.").

the manager.[157] Critics of the final bill also argued that the definition of "related party" in AB 2833 was modified in a manner that makes it easy for managers to structure payments to affiliated parties so they can avoid reporting obligations.[158] While some of the bill's early backers were disappointed by these changes,[159] AB 2833 nevertheless marked a significant move towards a much more aggressive use of state law to regulate private fund contracts.

Several other states followed California's lead by passing their own versions of fee transparency laws, including Kentucky,[160] New Jersey,[161] and

[157] *See* Open letter from former CalPERS trustee Michael Flaherman to Chair of California Senate Committee on Public Employment and Retirement (June 26, 2016), https://www.nakedcapitalism.com/wp-content/uploads/2016/06/Michael-Flaherman-AB-2833-letter-signed.pdf ("Because of how private equity firms operate, it is clear that one cannot conclude anything about the scale of a related party transaction with a portfolio company from simply knowing one's pro rata share of the transaction cost. Clearly, that is the private equity industry's goal in amending AB 2833 in this fashion, to keep investors in the dark about the full scope of their related party transactions with portfolio companies and the profits they derive from them."); Sutton, *Hassle of Full Transparency*, *supra* note 147 ("Private equity firms use several investment vehicles to buy portfolio companies. An LP could know its pro-rata share of fees as an LP in a single fund, but lack of insight into other vehicles would make it impossible to determine the total fees and expenses charged portfolio companies.").

[158] *See* Yves Smith, *California Treasurer Chiang's Private Equity Transparency Three Card Monte*, Naked Capitalism, https://www.nakedcapitalism.com/2016/06/california-treasurer-chiangs-private-equity-transparency-three-card-monte.html ("AB 2833 has gaping holes that will allow general partners to structure related party payments to escape reporting. The bill . . . has a very long and complicated definition of what constitutes a related party. It is inferior to shorter and more comprehensive definitions in earlier drafts.").

[159] *See, e.g.*, Neil Weinberg & Darrell Preston, *California Pensions to Say More on Fees, But Critics Persist*, BLOOMBERG NEWS (Sept. 15, 2016) ("'The law is a big disappointment relative to what was possible in terms of transparency improvements," said Michael Flaherman, a former member of the CalPERS board who consulted with the legislation's backers early on. Flaherman withdrew his support for the bill after it was amended.").

[160] *See* Kentucky Senate Bill 2 (2017), https://legiscan.com/KY/text/SB2/2017; Joe Sonka, *Outgoing Senator Says Pension Transparency Law a Net Positive, Despite Heavily Redacted Contracts*, INSIDER LOUISVILLE (Nov. 30, 2018), https://insiderlouisville.com/government/state/outgoing-senator-says-pension-transparency-law-a-net-positive-despite-heavily-redacted-contracts/ [hereinafter Sonka, *Outgoing Senator Says Pension Transparency Law a Net Positive*].

[161] *See* New Jersey Assembly Bill 4704 (2018), https://legiscan.com/NJ/text/A4704/id/1567984; Robert Steyer, *Chris Christie Signs Bill Requiring Stress Tests, Fee Transparency at State Pension Funds*, PENSIONS & INV. (Jan. 8, 2018), https://www.pionline.com/article/20180108/ONLINE/180109864/chris-christie-signs-bill-requiring-stress-tests-fee-transparency-at-state-pension-funds.

Rhode Island.[162] These laws, which were subjected to the same kind of opposition from pension employees that was observed in California,[163] are generally less rigorous than AB 2833.[164] Other states also introduced legislation but failed to garner enough support to pass it, including Arizona[165] and Illinois.[166] The Illinois bill, introduced in 2016 and praised by some commentators for being stronger than any of the bills considered by other states (including California), was particularly prominent.[167] However, the

[162] *See* Rhode Island House Bill 5923 (2017), http://webserver.rilin.state.ri.us/BillText17/HouseText17/H5923.pdf; James Comtois, *Rhode Island General Assembly Passes Bill Requiring Transparency From Managers*, PENSIONS & INV. (Sept. 20, 2017), https://www.pionline.com/article/20170920/ONLINE/170929974/rhode-island-general-assembly-passes-bill-requiring-transparency-from-managers.

[163] *See, e.g.*, Neil Weinberg & Darrell Preston, *Look Who's Coming to Private Equity's Defense on Fee Secrecy*, BLOOMBERG NEWS (Aug. 25, 2016), https://www.bloomberg.com/news/articles/2016-08-25/look-who-s-coming-to-private-equity-s-defense-on-fee-*secrecy* (“Many state pension funds have come out against the disclosure bills because they fear the legislation will reduce their investing options, with private equity firms electing to refuse their business rather than open up their contract.”); Travis Waldron, *The 2019 Election that Should Have Hedge Funds and Wall Street Worried*, HUFFINGTON POST (April 28, 2019) (“Kentucky lawmakers . . . passed a pension reform law meant to bring transparency to Kentucky Retirement Systems' practices. The law passed unanimously, but at the last minute, two of its most important provisions disappeared. One would have required full fee disclosure; another would have mandated an open bidding process for pension investment contracts.”).

[164] The Rhode Island law, for example, requires only that the state's investment commission obtain the applicable fee information on a “best effort basis.” The Kentucky law has a carve-out allowing significant redactions. *See* Sonka, *Outgoing Senator Says Pension Transparency Law a Net Positive*, *supra* note 160.

[165] *See* “State Pension Fund Bills Don't Get a Hearing: Representative Athena Salman's Bills Would Cut Hefty Fees,” Arizona House Democrats News Release (Feb. 15, 2018), https://www.azhousedemocrats.com/post/state-pension-fund-bills-don-t-get-a-hearing-rep-salman-s-bills-would-cut-hefty-fees.

[166] *See* Illinois House Bill 6292 (introduced in 2016), http://www.ilga.gov/legislation/fulltext.asp?DocName=09900HB6292sam001&GA=99&LegID=95843&SessionId=88&SpecSess=0&DocTypeId=HB&DocNum=6292&GAID=13&Session=.

[167] *See* Yves Smith, *Tough Private Equity Transparency Bill in Illinois Focuses on Indefensible Contract Terms, Beats California Bill on Fee Disclosure Requirements*, Naked Capitalism (May 4, 2016), https://www.nakedcapitalism.com/2016/05/tough-private-equity-transparency-bill-in-illinois-focuses-on-indefensible-contract-terms-beats-california-bill-on-fee-disclosure-requirements.html (arguing that Illinois HB 6292, the proposed Illinois fee transparency bill, not only had more detailed coverage of fee disclosure requirements than California's AB 2833, but it also required disclosure in important related areas such as indemnification provisions, clawback provisions, and management fee waivers); *Will Illinois Pass the Toughest Alternative Investment Fund Fee Disclosure Bill Yet?*, McGuireWoods client memorandum (Oct. 21, 2016),

Illinois bill failed to achieve approval in both houses[168] after running into heavy opposition from the state's public pension plans.[169] In Pennsylvania, a fee transparency bill is currently under review by the state legislature,[170] and it has similarly faced opposition from the state's public pension plans.[171]

4. Questions Raised

The net impact of these fee transparency laws is difficult to measure. Since AB 2833 went into effect, California public pension plans have been receiving more fee disclosure than they were previously receiving, but some California plans have also reported that they have been turned away from investing in private funds as a result of the laws.[172] Looking more broadly,

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https://www.mcguirewoods.com/Client-Resources/Alerts/2016/10/Illinois-New-Alternative-Investment-Fund-Fee-Disclosure-Bill.aspx.

[168] *See* Arleen Jacobius, *California Funds Feel Private Equity Shock*, PENSIONS & INVESTMENTS (May 14, 2018), https://www.pionline.com/article/20180514/PRINT/180519947/california-funds-feel-private-equity-shock [hereinafter Jacobius, *California Funds Feel Private Equity Shock*] ("Other states have tried but failed to pass transparency legislation for their pension funds alternative investments. A tough 2016 Illinois bill passed the Senate but failed to pass the state house before the legislative session ended.").

[169] Sam Sutton, *The Battle of Illinois: Lawmakers, Pension Officials Square Off Over PE Transparency*, PE HUB NETWORK (Sept. 13, 2016), https://www.pehub.com/buyouts/the-battle-of-illinois-lawmakers-pension-officials-square-off-over-pe-transparency/ ("Staff at the $34 billion Illinois Municipal Retirement Fund and Teachers' Retirement System of Illinois balked at the bill's requirements, arguing that disclosing that level of information could result in state pensions being shut out of top-shelf PE funds. Reaction among staff at smaller, underfunded Chicago retirement systems was muted or negative.").

[170] *See* Katie Meyer, *House Members Launch Plan to Make PA Pensions More Transparent*, WSKG (Oct. 30, 2019), https://wskg.org/news/house-members-launch-plan-to-make-pa-pensions-more-transparent/. The original legislation in Pennsylvania covered more than just fee transparency but has been weakened in material ways to gain support in the Pennsylvania house. *See* Preeti Singh, *Pennsylvania Pensions Get Breathing Room on Disclosures*, PRIVATE EQUITY INTERNATIONAL (Nov. 20, 2019), https://www.privateequityinternational.com/pennsylvania-pensions-get-breathing-room-on-disclosures/ ("The bill passed [the house] with a single amendment, shaving off the provision that required the two pension systems to make public unredacted marketing materials, including proposed fee terms, prospectuses, staff and consultant investment memoranda, subscription agreements, investment management agreements, contracts, side letters and annual investor reports of alternative investment vehicles.").

[171] *See* Chris Cumming, *Pennsylvania Fee-Transparency Bill Faces Resistance From Pensions*, WALL ST. J. (Dec. 2, 2019).

[172] *See* Jacobius*, California Funds Feel Private Equity Shock, supra* note 168 ("New transparency requirements and a seller's market for private equity investments are putting California

while fee disclosure practices across the industry have improved generally, these industry-wide improvements have been gradual. Many believe that private equity's transparency problem is far from resolved.[173]

This raises some important questions. What good has California's direct regulation of fee transparency terms in private fund contracts accomplished? What are the harms? Looking more broadly, can state legislatures use state law to regulate other controversial terms in private fund contracts directly? For example, could they be used to prohibit the waiver of managers' fiduciary duties to public plans? Could they be used to narrow the scope of public plans' indemnification obligations, to prohibit the use of non-disclosure agreements against public plans, or to give investors greater voice in resolving governance questions? Should they? These questions are more than just theoretical, given the ongoing nature of the fee transparency movement[174] and the ongoing push for reforms in other areas of the industry as well.[175]

public pension funds at a disadvantage when seeking to invest. CalSTRS and the Los Angeles Fire & Police Pension Plan are just two of the asset owners whose general partners have declined their commitments, citing the state's new law.").

[173] *See, e.g.*, 2018 Preqin Global Report, *supra* note 76 (reporting survey results showing that investors cited transparency as being the second most important area where the interests of managers and investors could be better-aligned); Comment Letter from the Institutional Limited Partners Association to the SEC, Apr. 30, 2018, https://ilpa.org/wp-content/uploads/2018/04/ILPA-Letter-to-Chairman-Clayton-on-PE-Regulation-4.30.18.pdf ("The private equity market continues to face a lack of transparency around the true cost of a private equity investment."); Simon Clark, *Investors Urge Private-Equity Industry to Improve Transparency*, WALL ST. J. (Jan. 7, 2020), https://www.wsj.com/articles/investors-urge-private-equity-industry-to-improve-transparency-11578409754 [hereinafter Clark, *Investors Urge Transparency*].

[174] *See supra* note 173.

[175] The Institutional Limited Partners' Association ("ILPA"), the trade association for investors in private funds, has sent the SEC a series of letters over the past two years highlighting other reforms that they would like to see. These include, among others, requiring fund managers to explicitly disclose the standard of care they owe to the fund and investors, and limiting managers' ability to get "pre-clearance" of conflicts of interest through vague disclosures made before the life of a fund. See Comment Letters from the Institutional Limited Partners Association to the SEC, dated April 30, 2018, August 6, 2018, November 12, 2018, and February 12, 2019 (https://ilpa.org/wp-content/uploads/2018/04/ILPA-Letter-to-Chairman-Clayton-on-PE-Regulation-4.30.18.pdf, https://ilpa.org/wp-content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf, https://ilpa.org/wp-content/uploads/2018/12/ILPA-Follow-Up-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-11.21.18.pdf, https://ilpa.org/wp-content/uploads/2019/02/2019.2.12-ILPA-Member-Letter-on-Fiduciary-Duty-Submission-Copy.pdf). Even more ambitiously, some scholars have advocated for changes to private equity compensation, for giving more robust voting and

III. STATE REGULATION OF PRIVATE FUND CONTRACTS: BENEFITS AND CHALLENGES

While this approach has potential to address certain concerns when public plans invest in private funds, legislation that directly regulates the private fund contract terms entered into by public plans is also subject to several distinctive challenges. Below, I discuss some of the benefits associated with using state law more aggressively to regulate the content of the private fund contracts, and I also identify challenges that can make it difficult to realize those benefits in practice.

A. Potential Benefits

1. Demanding Strong Disclosure

As discussed above, public plan trustees and staff have fiduciary duties to the beneficiaries of the plans they oversee.[176] However, without information about how a plan is being managed, including information about the plan's investments, it is difficult to make assessments about whether public plan managers are satisfying those duties.

Following the SEC's examination sweep, one of the SEC's strongest criticisms had to do with the light disclosure that private funds were providing their investors—not only in the area of fees, but more broadly as well.[177] While a lack of disclosure clearly makes it difficult for pension staff to monitor private fund managers, it can also have the curious effect of insulating them from criticism for doing their jobs poorly. If outside observers are not aware of undesirable activities taking place within private funds, then they will be unable to criticize public plan staff for failing to keep such activities in check. This conflict of interest has been held out as one of the reasons why many pension employees lobbied against the passage of fee transparency laws and sought to weaken their terms.[178]

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governance rights to fund investors, for eliminating the preferential treatment of investors, for requiring the use of standardized fund agreement terms, and for requiring more robust disclosure regarding the companies owned by private funds, among other things. See Morris and Phalippou, *New Approach to Regulating Private Equity, supra* note 71; *Magnuson, Public Cost of Private Equity, supra* note 71.

[176] *See supra* Section II.A.1.

[177] *See supra* Section II.B.1.a.

[178] *See* Floum, *New Law Doesn't Go Far Enough*, *supra* note 147 ("'My guess is our staff and (the state teachers' pension fund) were carrying water for the industry, because quite frankly they

Now that the California state legislature has used the force of law to demand more robust disclosure about the fees charged by private fund managers[179], more information is available with which to evaluate whether California public plan managers are paying excessive fees. State law could similarly be used to force private fund managers to provide greater information in other areas as well. With more information, not only are private fund managers more accountable to the public plans that invest in their funds, but public plan staffs are also more accountable to beneficiaries and to the outside world if that information shows that they are not adequately monitoring private fund managers. To the extent that public plan managers have conflicts of interest that cause them to prefer weak disclosure, being able to use the force of law to obtain this information—instead of relying on public plan managers to demand it from private fund managers—could be a valuable tool.

2. Demanding Strong Substantive Terms

Beyond disclosure, state law also gives state legislatures the ability to step in and demand better substantive terms if pension staffs are doing an unsatisfactory job negotiating for those terms in the free market. They could, for example, use the force of law to stop private fund managers from modifying their fiduciary duties, narrow the indemnities granted to private fund managers, reject non-disclosure limitations, or demand enhanced rights to terminate private fund managers, among countless other substantive terms. If public plans do suffer from agency problems,[180] competency problems,[181] or other issues, having the ability to use the force of law to demand better terms when pension staff fails to do so could also be valuable.

ended up getting too close to the industry and the people they work for,' J.J. Jelincic (director on the CalPERS board of trustees) said."). *See also supra* note 144 and accompanying text.

[179] *See* AB 2833 Sec. 7514.7.

[180] *See supra* Section I.C.1. (As previously noted, research has shown that pension employees tend to be more likely to accept costly terms when they are complex and difficult for their overseers to evaluate (and therefore unlikely to compromise their job security). *See also supra* note 87.

[181] Public plan staff could, for example, simply not know to demand certain important terms and/or underestimate the amount of bargaining power that the public plan has vis-à-vis private fund managers. *See supra* notes 95–96 and accompanying text.

3. Coordination Benefits

Buyers in any market can seek to increase their bargaining power and decrease competition by coordinating their actions.[182] The more that buyers can act as a unified bloc, the more impactful their coordination will be.

By passing a law that requires a particular term, a state legislature can force the public plans in the state to coordinate in the sense that they are required to demand the same term. In effect, the law prohibits any of those public plans from breaking rank and accepting a weaker version of that term. This benefit, however, is likely to be attenuated by the fact that, as will be discussed below,[183] managers can respond to the law by treating investors discriminatorily.

B. Challenges

1. State Legislatures Cannot Force Managers to Comply

The first challenge with adopting this more aggressive approach is the fact that states' legislatures seeking to regulate private fund contracts lack authority over private fund managers. Because a state legislature's authority is limited to the public plans in its state, when a state passes this kind of law, private fund managers will only become subject to that law if they accept money from a public plan in that state.[184] This means that managers are likely to take the law's requirements into account when they negotiate with that state's plans. They will assess the losses associated with agreeing to the terms required by the law, and consider how much they want capital from the specific public plan with which they are negotiating.

For example, in the case of fee disclosure, complying with a robust law could result in greater scrutiny of the fees charged by the manager, both by the receiving investor and, if the investor turns around and publicly discloses the fees, by the public.[185] Similarly, if a state legislature were to pass a law

[182] *See, e.g.*, Mandeville Island Farms v. Am. Crystal Sugar, 334 U.S. 219 (1948) (establishing that an agreement between California farmers to pay a uniform price for sugar beets violated the federal antitrust laws, notwithstanding the fact that the coordination was among buyers and not sellers).

[183] *See infra* Section III.B.1 and 2.

[184] *See infra* Section III.B.1 and 2.

[185] For example, AB 2833 requires public plans to disclose the information that they receive from private fund managers. *See supra* note 150 and accompanying text. However, the usefulness of this information was diluted when the law was amended to provide only for pro rata, rather than

that prohibits contractual modifications of the manager's fiduciary duties, a manager may lose flexibility to pursue certain profitable investment opportunities due to conflicts of interest and face greater risk of liability if it chooses to comply. A manager would similarly face increased risk of liability if it chooses to comply with a law that prohibits its public plans from granting broad indemnification to managers. Different kinds of losses would result depending on the specific terms that a state legislature chooses to regulate.

After a manager does this analysis, it will lead to one of three outcomes. First, the manager may decide that the losses associated with complying with the law outweigh the benefits of receiving that public plan's investment, and refuse to admit the plan to the fund. This will not be a surprising outcome if compliance is costly, the plan has low bargaining power, and there is high demand for private fund investment opportunities by investors that are willing to forego the term required under that state's law.[186] Second, the manager may decide to admit the plan to its fund. However, because public plans have finite bargaining power, the manager could give that plan less attractive terms in other areas to compensate for the losses from complying with the law. For example, imagine an investor that has enough bargaining power to negotiate for a package of side letter terms (including fee discounts, co-investment rights, disclosure rights, MFN rights, an advisory board position, etc.) that has a certain net expected value to the investor. If a state law is passed that requires a certain term—a particularly strong disclosure term, for example—that will bring the investor an extra $2,000 in value and will result in a $2,000 loss to the manager, it would not be surprising to see the manager reduce the value of the other terms offered to that investor by approximately $2,000 to reflect the investor's true bargaining power. The manager could, for example, offer the plan fewer fee discounts, give it fewer rights to receive co-investment opportunities, refuse to grant it a "most

complete, information about payments made to portfolio companies. *See supra* notes 156 and 157 and accompanying text. *See also* Vekshin, *CalPERS Carried Interest Data May Hold 'Shock Value' for Public*, *supra* note 144 ("Private-equity firms are bracing for CalPERS to disclose their profits from investing the pension's money, the sort of gains that have triggered a debate over why some Wall Street companies pay lower tax rates than most American workers.").

[186] *See Private Equity's Other Transparency Problem*, INSTITUTIONAL INVESTOR (July 8, 2017) ("[W]hile managers may be happy to show off their underlying data to investors, this willingness to disclose investment information does not necessarily extend to the general public. . . . This level of transparency—typically found only at public defined-benefit funds subject to disclosure laws—can be detrimental to investors, who may find themselves locked out of attractive investment opportunities.").

favored nation" right,[187] and/or deny it a seat on the fund's advisory board,[188] among other possible responses. In effect, the term required by the state law may have the effect of simply exhausting a certain amount of the investor's bargaining power, leaving it with less bargaining power to negotiate for other benefits that it otherwise might have been able to obtain.

Third, the manager may choose to admit that plan without decreasing any of the plan's other benefits. This is most likely to happen when the requirements set forth in the law are weak and are not very costly for the manager to comply with. It could also happen when a public plan has unutilized bargaining power—meaning that the plan *could* obtain more benefits in the free market if its staff were to demand them, but the staff either does not recognize the extent of the plan's bargaining power or will not exercise that bargaining power due to agency problems.

Thus, when a state legislature passes a law that regulates the contract terms entered into by public plans, it is difficult to anticipate exactly how private fund managers will respond. The relationship between the public plans and the manager is still governed by freedom of contract, and managers have discretion to respond to the law's requirements however they like.

[187] When an investor has a most favored nation right, it is typically entitled to see the side letters given to investors that have invested an equal or lesser amount in the same fund, and to receive the same rights granted to the investors in those side letters. *See* JAMES M. SCHELL, ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 11.14 [hereinafter SCHELL, PRIVATE EQUITY FUNDS] ("An MFN provision usually requires the Sponsor to provide similarly-situated investors (i.e., those with equivalent Capital Commitments or regulatory circumstances) the opportunity to elect to receive the rights and benefits provided via side letter to other investors in the same Fund.").

[188] Managers of private funds commonly establish "advisory boards" consisting of certain of the fund's investors, which are sometimes given rights to consult with the manager or consent to certain types of transactions. *See* Schell, PRIVATE EQUITY FUNDS § 11.07[8], *supra* note 187 ("From the Limited Partners' perspective, an Advisory Board represents a mechanism for a limited degree of oversight in areas where the interests of the General Partner may not be fully aligned with those of the Limited Partners."). Having a seat on an advisory board can be a valuable way to obtain information about the manager and its operations that other investors do not enjoy. *See* Claire Wilson, *The Power of the LPAC*, PRIVATE FUNDS CFO (Dec. 15, 2017), https://www.privatefundscfo.com/print-editions/december-2017-january-2018-issue/the-power-of-the-lpac/ ("For the investor, membership [in an advisory board] is a way of gaining greater visibility into the fund's operations and access to information that is not otherwise disclosed to investors.").

2. Diversity, Discrimination, and the Blunt Instrument Problem

The market for pension investments in private funds is characterized by two distinctive features that significantly complicate the analysis above. First, in most states, there are state and local public plans numbering in the tens, hundreds, or even thousands.[189] These plans will typically manage a widely-varying volume of assets, with some controlling hundreds of millions of dollars and others controlling tiny fractions of that.[190] Larger plans tend to make much larger investments in each private fund that they invest in, while smaller plans make much smaller investments. This means that some public plans possess significant bargaining power with managers while others have very little, and the rest are somewhere in between. Second, as noted above,[191] managers very commonly deal with public plans on an individual basis, negotiating side letters that provide them with various kinds of customized treatment. As a result, when a state has a large number of plans that collectively manage a large amount of assets, the smaller plans in that state cannot expect to free ride on the bargaining power of the larger plans in the state when a state law is passed. In responding to that law, managers are unlikely to treat all of the public plans in a state as a unified bloc.[192]

Because of this combination of diversity and widespread discriminatory treatment, any law that sets forth a single rule is likely to lead to a differential impact on public plans within the same state. Depending on each plan's individual level of bargaining power, some will be more likely to get frozen

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[189] *See* 2017 Annual Survey of Public Pensions: State and Local Tables, United States Census Bureau, https://www.census.gov/data/tables/2017/econ/aspp/aspp-historical-tables.html (showing that there were 299 state-administered public pension plans and 5,977 locally-administered public pension plans in the United States in 2017).

[190] For example, each of the ten largest public plans in the United States manage over $100 billion in assets. *See Funded Status of Largest U.S. Public Pension Funds*, *supra* note 151 (Most local plans, by contrast, manage an extremely tiny fraction of that amount).

[191] *See supra* Section I.C.2.

[192] By contrast, state regulations on consumer products that are primarily purchased by individual retail consumers, for example, are likely to prompt a very different response. After a state passes a law that imposes stricter regulations on volatile organic compounds in hairspray, for example, hairspray manufacturers are likely to respond by asking, "Do I continue to sell hairspray products in this market or not?" rather than "Do I continue to sell hairspray products to some consumers in this state and not to others?" Because these sellers are unlikely to treat end users of the product discriminatorily, the hairspray consumers in a state will effectively be treated as a bloc after a stricter law is passed in that state. When this dynamic applies for a particular product, it gives large states greater leverage to pass aggressive laws before sellers will stop selling to consumers in their state.

out of funds than others, some will be more likely to lose side letter benefits, and some may not experience negative effects at all.[193] State law can thus be a blunt instrument for demanding stronger contract terms on behalf of all of the public plans in a state.

As a result, if the aggressiveness of the legislation is not calibrated to reflect a particular plan's bargaining power, that plan's managers could have good faith reasons to oppose the passage of a state law that requires stronger terms.[194] Thus, for most state laws, it should not be a surprise to see opposition from public plan staffs, though it may not be easy to tell whether pension managers are acting in good faith or in bad faith.

It is difficult to see how legislation could be crafted to achieve a higher level of coordination. States could pass a law that would require managers to give all of the public plans in the state identical side letter terms, but this would be problematic. While this law would stop managers from treating public plans in the state discriminatorily through side letters, it would likely result in more of the smaller public plans in the state being frozen out entirely. States could seek to address this second issue by requiring that private fund managers accept capital from *all* public plans in the state if it accepts capital from any plan, but this could result in private fund managers freezing out *all* of the plans in the state. At the very least, this approach would likely cause the large public plans in the state—the ones whose performance has the largest impact on the greatest number of beneficiaries in the state—to receive less attractive side letter terms than they would without such rules in place, which would also be an undesirable outcome.

The prevalence of diversity and discriminatory treatment in this industry thus takes away from the potential benefits of state law and discourages follower states from jumping on the bandwagon after an initial state takes action.

[193] This dynamic may help to explain why there was not a larger number of states following California's lead after it passed AB 2833, and also why the follower legislation that was passed was relatively weak compared to California's standard. *See supra* note 164 and accompanying text. If, for example, the state of Maine were to pass a law that was identical to AB 2833, the public plans in Maine would not be acting as a bloc with all of the public plans in California. Large plans like CalPERS and CalSTRS would still be negotiating their own deals in their own side letters, and private fund managers would still be free to freeze out and/or provide weak side letter terms to Maine's public plans in areas not covered by the legislation. Thus, just as public plans within the same state are likely to be dealt with individually even when they are subject to the same state law, public plans in other states are likely to see only limited coordination benefits when their legislatures pass identical follower laws.

[194] *See supra* Section II.B.2.

3. Market Timing

Timing considerations add another layer of complexity to the analysis above. Almost all of the most important financial legislation in U.S. history has been adopted in the midst or aftermath of a crisis or controversy.[195] Fee transparency laws were no different. The momentum toward fee transparency legislation was started by the controversial revelations discussed above,[196] which generated political will in certain states for regulating fee disclosures in private funds.

Thus, an important factor shaping the formation of state laws to protect public plans—one that is exogenous to the underlying problems being addressed—is the broader balance of bargaining power between investors and managers at the time that momentum towards a law builds. If the crisis or controversy sparking political will to regulate private fund contracts happens to occur during a cold fundraising market, public pension plans will have stronger bargaining power generally, which will give state legislatures additional flexibility to pass more aggressive laws. But the opposite is also true—if the crisis or controversy takes place during a hot fundraising market, state legislatures will have less flexibility to pass strong laws because public pensions will have weaker bargaining power across the market generally. Regardless of the state of the market at the time the legislation is passed, there is a good chance that it will be very different five years, three years, or even one year later. Legislation that is passed with an eye toward making the most of public plans' bargaining power at one point in time thus can become outdated quickly.

These market timing issues offer another explanation for why the fee transparency movement failed to produce more robust and wide-ranging changes. The SEC's critiques of private funds and the CalPERS revelations[197] happened to be publicized during one of the strongest growth cycles in the history of the private funds industry.[198] From the period 2012-2017, the "dry powder" in private equity funds, which refers to the capital that has been

[195] *See* Roberta Romano, *Regulating in the Dark*, 1 J. FIN. PERSPECTIVES (2017) [hereinafter Romano, *Regulating in the Dark*] ("Foundational financial legislation is typically adopted in the midst or aftermath of financial crises, when an informed understanding of the crisis is not yet available.").

[196] *See supra* Section II.B.1.

[197] *See id.*

[198] Note that this growth happened primarily in the private equity segment of the private funds industry.

committed to a fund but for which the manager has not yet used to make an investment, grew by 10 percent on average every year, generating a total of $1.8 trillion of dry powder in 2017.[199] This means that bargaining power across the industry was distinctly in favor of private fund managers when fee transparency legislation started to gain momentum.[200] Accordingly, if a state passed aggressive fee transparency legislation, the likelihood of its public plans being frozen out of funds or losing out on important benefits was particularly high during this period. This almost certainly had a diminishing effect on the movement for fee transparency laws.[201]

4. Obstacles to Fiduciary Duty Enforcement Make Information Less Valuable

As the fee transparency experience has shown, state legislatures can pass laws that require private fund managers to give public plans contractual rights to receive better disclosure about the investments they are making.[202] However, in practice, it is unclear what, if anything, public plan beneficiaries

[199] *See The Rise and Rise of Private Markets,* MCKINSEY GLOBAL PRIVATE MARKETS REVIEW 2018 at 19–20 (Feb. 2018); *Can Private Markets Boom if Public Markets Bust?*, EY GLOBAL PE WATCH 2018, https://www.ey.com/Publication/vwLUAssets/ey-can-private-markets-boom-if-public-markets-bust/$FILE/ey-can-private-markets-boom-if-public-markets-bust.pdf ("Since the last economic downturn, private equity has seen record-setting growth. The industry's assets under management, which include unspent 'dry powder' and the unrealized value of current investments, have grown more than 80% over this time period.").

[200] Interestingly, if the controversial revelations relating to private fund practices had been disclosed during the heart of the financial crisis, the opposite dynamic likely would have been observed. Market demand for private fund investments significantly dropped during the financial crisis, which would have given any public plans in the market increased bargaining power. However, the SEC's examination sweep of the industry did not begin until after the financial crisis had passed, and multiple years passed before the SEC announced any findings from those examinations. *See supra* note 123 and accompanying text.

[201] *See, e.g.*, Dominic Diongson, *Playing the Long Game on Transparency*, PRIVATE FUNDS MANAGEMENT (May 18, 2018) ("Because institutional appetite for private equity is strong, GPs can be picky about who they do business with. [An industry insider] estimates that 5-10 percent of GPs are saying no to LPs who want those various fees made public. . . . Taking one's business elsewhere is, particularly in a buoyant fundraising market, a temptingly straightforward solution for GPs who don't want to get granular on fees. . . . It only happens in cycles like we're in right now, where the supply of capital far exceeds the manager's capability of taking it all."); Claire Coe Smith, *Reading the Fee Leaves*, PRIVATE FUNDS MANAGEMENT 17 (Jan. 2016) ("Despite fee transparency having become a top priority in the LP community, a buoyant fundraising market is keeping many terms around fees and expenses firmly put.").

[202] *See supra* Section II.B.

can do with the increased information they receive. Because the public servants who are beneficiaries in these public plans typically do not have the ability to select from among various pension managers or exit the plan midstream, they cannot respond to the receipt of greater information by "voting with their feet." To the contrary, beneficiaries are typically locked in to the defined benefit plan offer by their public employer.

This puts more stress on the fiduciary duties that apply to public plan employees. One benefit, one might logically assume, of increased information disclosure should be that if the staff of a public plan has engaged in sufficiently egregious oversights or failed to monitor the private funds they have invested in, they could be held accountable for breaching their fiduciary duties to beneficiaries. Unfortunately, even this benefit is often empty given the challenges of enforcing fiduciary duties in the public pension plan context.[203] Many states lack a private right of action for public plan beneficiaries, and even in those cases where a right of action exists, beneficiaries seeking to bring a claim often run into sovereign immunity and standing issues.[204] As a result, even if a law successfully generates more information about how a public plan is managed, the practical benefits from that additional information to beneficiaries will often be quite weak.

5. Political Influence Correlated With Underperformance

In order for state laws to bring benefits to public plans, state legislatures must be capable of intervening in the management of public plans in ways that will be beneficial to those plans. But there is one potential problem with this assumption—research shows that political interference with public plans has usually been correlated with *worse* performance, not better performance.[205] When public plans have more politically-affiliated trustees

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[203] *See* Rose, *Public Wealth Maximization*, *supra* note 21 ("[B]ecause public fund fiduciary duties do not have the enforceability of fiduciary duties in private funds, they are even weaker as a governance structure. Other structures must carry the load and help ensure that a fund is managed properly.").

[204] *See* Rose, *Public Fund Governance*, *supra* note 91.

[205] One explanation for these findings may be that state legislatures are susceptible to lobbying and industry capture, as some have argued. *See, e.g.*, Diane Renzulli & The Center for Public Integrity, *Capitol Offenders: How Private Interests Govern Our States*, WASHINGTON: CENTER FOR PUBLIC INTEGRITY (noting that concerns about capture in state legislatures are due to strong interest group power in state politics generally). PAUL TESKE, REGULATION IN THE STATES 201 (2004) ("Capture is more problematic in state capitals than in Washington, D.C., partly because state interest group lobbying environments, although becoming more pluralistic, are still less varied than

on their board, they tend to have longer holding durations in politically-connected companies and make riskier investment allocations,[206] and they are also likely to receive political contributions which cause them to make biased, sub-optimal investment decisions.[207] Pension plan trustees have thus been shown to have short-term incentives that often conflict with the long-term health of the public plans they oversee.[208]

There are differences between the conflicts faced by a state legislature and those faced by politically-connected trustees. But state legislatures arguably suffer from many similar conflicts of interest. As noted above, U.S. taxpayers are ultimately the ones that bear the losses associated with the long-term failure of public plans, and state legislators, like board trustees, are likely to have relatively short-term incentives that do not extend beyond their political tenure.[209] It is not obvious, therefore, that state legislators are in the best position to evaluate the performance of public plan staff and intervene by passing laws that will lead to the strongest long-term performance. In fact, state legislatures, which typically do not have fiduciary duties to the public plans in their state,[210] often receive the most blame for making policy decisions that have contributed to nationwide underfunding problems.[211]

Some of the most successful public plans in recent decades—large plans in the Canadian public pension system[212]—have been built on the principle

at the federal level, because mobile firms may have more political influence over individual states looking for economic development and because some states still do not have adequate legislative and bureaucratic staff to provide an independent source of analysis and implementation capacity.").

[206] *See supra* note 89 and accompanying text.

[207] *See* Andonov, Hochberg & Rauh, *Political Representation and Governance*, *supra* note 32.

[208] *See* Daniel DiSalvo, *The Politics of Public Pension Boards*, MANHATTAN INSTITUTE REPORT, Sept. 2018, https://media4.manhattan-institute.org/sites/default/files/R-DD-0918.pdf ("Ultimately, the incentives of almost all board members consistently point to their favoring short-term policies at the expense of pension plans' long-term health. This includes the politically affiliated as well as the representatives of plan participants and unions.").

[209] *See* Natalya Shnitser, *Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design*, 100 IOWA L. REV. 663 (2015) [hereinafter Shnitser, *Funding Discipline for U.S. Public Pension Plans*] (showing evidence that public plans that give state legislatures discretion over funding decisions are associated with worse funding discipline and unfunded promises).

[210] *See* Shnitser, *Rethinking the Regulation of Retirement Savings*, *supra* note 103 at 670 ("State legislatures . . . do not have any fiduciary obligation to the plan participants or beneficiaries.").

[211] *See* Shnitser, *Funding Discipline for U.S. Public Pension Plans, supra* note 209.

[212] *See Protections Vary Widely for Public Plans*, PEW BRIEF, *supra* note 3 ("Research shows that when compared with private pension funds in the United States and all pension funds in Canada and Europe, U.S. public pension funds underperform by about 50 basis points per year, tend to

of removing government influence from public pension management, not creating more interference.[213] Expanding the use of state law to help public plans would be moving U.S. public plans in the opposite direction of that trend.

These facts, combined with the other challenges identified above, warrant skepticism about the likelihood of greater direct government intervention leading to better results for public plans. Even in a scenario where there is evidence of public plans being sub-optimally managed, it is a fair question whether more government influence is likely to do more harm than good.

IV. POLICY IMPLICATIONS

This Article's analysis has several important policy implications. The proposals and insights discussed below are timely, as public pension plans' massive investment in private funds continues to grow.

invest more in risky assets, and use higher target rates for investment returns."); Chris Butera, *Why Canada's Pension Plans are in Such Good Shape*, CHIEF INVESTMENT OFFICER (July 26, 2018), https://www.ai-cio.com/in-focus/shop-talk/canadas-pension-plans-good-shape/ [hereinafter Butera, *Canada's Plans are in Good Shape*] ("With most of its pension plans at either fully funded status or close to it, Canadians have achieved a balance that the U.S. has only seen in the corporate sector. In fact, some Canadian plans . . . have become overfunded."); Rob Kozlowski, *World Bank Highlights Canadian Pension Model as Ideal System for Emerging Countries to Follow*, PENSIONS & INVESTMENTS (Nov. 22, 2017) [hereinafter Kozlowski, *World Bank Highlights Canadian Pension Model as Ideal System*] ("Canada's largest public pension funds have attracted considerable attention in recent years. Global publications such as the Economist, Fortune, and the Financial Times have highlighted the unique approach and success of these growing public pension institutions. Jurisdictions around the world, including those as financially sophisticate as New York City, have looked to the Canadian approach as a blueprint for pension reform. Delegations from every continent frequently travel to Canada to learn from the country's top public pension organizations.").

But see Malcom Hamilton & Philip Cross, *Risk and Reward in Public Sector Pension Plans: A Taxpayer's Perspective*, FRASER INSTITUTE (2018), https://www.fraserinstitute.org/sites/default/files/risk-and-reward-in-public-sector-pension-plans_0.pdf ("Without disputing the virtues of the Canadian Pension Model, we attribute the success of Canada's public sector defined benefit plans to large public subsidies made possible by practices that are neither admirable nor virtuous: bad accounting, poor governance, imprudent risk taking, and inadequate financial disclosure.").

[213] *See supra* note 33.

A. Regulation of Private Fund Contracts is No Substitute for Effective Internal Governance

This Article's most fundamental policy takeaway is a simple one. Due to the challenges described above, if state policymakers do not trust public plan staff and trustees to make effective investments in private funds, simply passing laws that do an end-run around them is unlikely to lead to strong improvements. For this reason, using state law to regulate private fund contracts is unlikely to serve as an effective substitute for more fundamental reforms to address internal governance problems in public pension plans. Below, I discuss various reforms to internal pension governance that have been proposed by scholars and commentators.

As previously discussed, the fiduciary duties that apply to public pension staff members and trustees have been criticized for various substantive reasons.[214] One obvious policy step toward helping public pension plans make more effective investment decisions would be to impose more effective fiduciary duties to act in the interest of pension beneficiaries. Proposals for reforming the substance of fiduciary duties have included encouraging states to uniformly incorporate all of the fiduciary standards set forth in the Uniform Management of Public Employee Retirement Systems Act of 1997[215] to replacing the existing trust-based fiduciary standard with product-style regulation.[216]

Critics have also argued that these fiduciary duties are often extremely difficult, if not impossible, to enforce.[217] As a result, even if fiduciary standards were flawless in a substantive sense, their impact on the real-world incentives of plan trustees and officers may be quite limited. Scholar Paul Rose has identified a few possible policy responses to improve enforceability: waiving sovereign immunity for public plan officials, explicitly providing plan beneficiaries with a cause of action for breach of fiduciary duties by plan trustees and officers, and creating a politically independent pension fund entity that would clearly not be subject to sovereign immunity.[218]

[214] *See supra* notes 109-12 and accompanying text.

[215] *See Protections Vary in Public Plans*, 2017 PEW BRIEF, *supra* note 3.

[216] *See* Shnitser, *Rethinking the Regulation of Retirement Savings*, *supra* note 103 (proposing "a national system of individual retirement savings accounts to be regulated not by analogy to gift transfers, but increasingly as products subject to safety and standards regulation").

[217] *See supra* Section III.B.4.

[218] *See* Rose, *Public Fund Governance*, *supra* note 91.

Conflicts of interest and political influence within public pension plans have also been found to seriously undermine public plan performance.[219] In Canada, many large public plans are the creations of framework legislation that enshrines the independence of the organization from government in two ways.[220] First, the legislation provides for specific processes and structures (such as the board appointment process and exemption of the organization from government budgeting and procurement rules) that removes political influence from the management of the plan. Second, the legislation is often designed to make it more difficult for future governments to interfere with the organization's structure and governance for short-term political gain (including, for example, by including super-majority approvals and popular votes). State laws seeking to apply a similar model to state and local plans in the United States could be expected to significantly improve the internal governance of public plans.

Scholars have also proposed improving the internal management of public plans by offering better compensation to public plan staff. As noted above, limits on public plan compensation has been found to compromise public plan performance,[221] particularly in light of attractive private sector opportunities available to the pool of potential employees with meaningful investment experience. Scholars have suggested that the performance of public plan officers could be improved by freeing public plans from limitations on paying qualified investment officers and taking steps to insulate officer compensation from political agency costs.[222]

Political and cultural resistance could make it difficult to achieve the reforms described above. Accordingly, states could also consider passing laws that provide more effective "guardrails" to promote more effective investment in private funds by their public plans.[223] One approach would simply be to impose a hard cap on the percentage of a public plan's portfolio that can be invested in private funds.[224] In light of research showing that U.S. public plans have a history of making higher allocations to risky investments

[219] *See supra* note 32 and accompanying text.

[220] *See The Evolution of the Canadian Pension Model*, *supra* note 33.

[221] *See* Dyck, *supra* note 20.

[222] *See id.*

[223] *See supra* Section II.A.1 for a discussion of some "guardrail" laws that states commonly adopt to promote effective management by public plan staffs.

[224] States that already have such caps could consider lowering the cap.

than private pension plans and also public plans in Europe and Canada, such a limitation may be sensible and warranted.[225]

Separately, state policymakers could also rein in one of the perverse incentives that state and local plan managers have to invest in private funds. Under the law of most states, public plans can seek to mask underfunding problems by increasing investments in risky assets like private funds.[226] The accounting rules that apply to most U.S. public plans give them some discretion to discount their future liabilities (these are obligations to pay future pensioners) by the returns that they expect to receive in their investment portfolio.[227] Because risky assets like private fund investments tend to have higher expected returns than more traditional assets like public company stocks and bonds, this gives U.S. public plans a significant perverse incentive to invest a large percentage of their portfolios in assets like private funds. The discretion creates a clear agency conflict for politically-linked trustees and/or officials, who may be incentivized to allocate too much of the plan's capital to private funds in order to hide underfunding problems in their plan. States could mitigate this conflict by adopting a rule more like the

[225] *See supra* note 83 and accompanying text.

[226] *See* Andonov, *supra* note 3, at 2556 ("The reported funding shortfall in pension fund accounting statements depends crucially on the liability discount rate that is used to value the stream of promised benefits. In general, the higher the discount rate that is used, the lower the reported present value of the liabilities and the stronger the pension plan's funding position as reported in the accounting statements.").

[227] *See* Andonov, *supra* note 3, at 2556 ("The regulation of U.S. public pension funds allows considerably more discretion in setting the liability discount rate compared with the regulation of other pension funds."); NASRA 2019 Governance Overview Report, *supra* note 104("[M]ost public retirement system boards have authority to set actuarial assumptions, which are projections about future demographic and economic events used to calculate the cost of the plan and to determine its financial condition. Of all actuarial assumptions, the investment return assumption is the single-most impactful on the cost and funding level of the plan."); *America's Multi-Trillion Dollar Pension Hole*, ECONOMIST (Nov. 16, 2019) ("Public-sector pension schemes are allowed to use the assumed rate of investment return as their discount rate, even though they will still have to pay pensions whether they earn that return or not."). While the standard set forth by the Government Accounting and Standards Board, a public pension accounting standard-setting body whose guidance many states voluntarily choose to follow, was subject to an update that went into effect in 2015, the revised standard has been criticized for doing too little to restrict state managers' discretion in discounting liabilities. *See, e.g.*, Sheila Weinberg, Eileen Norcross, *GASB 67 and GASB 68: What the New Accounting Standards Mean for Public Pension Reporting*, Mercatus Center Policy Brief (June 15, 2017), https://www.mercatus.org/publications/urban-economics/gasb-67-and-gasb-68-what-new-accounting-standards-mean-public-pension (noting that plans still "have significant discretion" in choosing discount rates, and that "reform of the new guidance is needed to ensure the proper measurement and funding of public sector plans.").

approach taken in the Netherlands, where public officials have little discretion in setting discount rates.[228]

B. Improving State Laws that Regulate Contracts Directly

Acknowledging the limitations described above, when states do proceed with passing laws that regulate the contract terms that their public plans enter into, there are certain steps they can take to increase the effectiveness of those laws. I offer two such policy proposals below.

1. Sensitize to Bargaining Power

As noted above, AB 2833 set forth a fixed, absolute standard for all public plans in the state, making them a blunt instrument for responding to mismanagement problems.[229] State legislatures can seek to mitigate this problem by seeking to customize the law to reflect the differing levels of bargaining power of individual public plans in the state. In the case of fee disclosure laws, one way to do this would have been to set forth stricter disclosure requirements for plans with a large amount of assets under management, and incrementally relax the standard for smaller plans. For example, rather than establish a fixed standard, California could have required greater disclosure for larger plans like CalPERS and CalSTRS, which each manage hundreds of billions of dollars, and lesser disclosure for comparatively smaller plans like, for example, the Modesto Irrigation District Basic Retirement Plan or the Concord Retirement System.[230]

This approach would have resembled certain provisions in the federal securities laws that provide for relaxed reporting standards for smaller public companies. Public companies with assets that fall below certain size thresholds can qualify as "smaller reporting companies" under Regulation S-K, which allows them to disclose less information to the public,[231] and as "non-accelerated filers" under Rule 12b-2 of the Exchange Act, which

[228] *See* Mary Williams Walsh, *No Smoke, No Mirrors: The Dutch Pension Plan*, N.Y. TIMES (Oct. 11, 2014) ("Dutch pensions . . . are required to tally their liabilities with brutal honesty, using a method that is common in the financial-services industry but rejected by American public pension funds.").

[229] *See supra Section* II.B.3.

[230] For information about various state and local pension plans in California, see the Transparent California website at https://transparentcalifornia.com/pages/about/.

[231] *See* Smaller Reporting Companies, Securities and Exchange Commission, https://www.sec.gov/smallbusiness/goingpublic/SRC.

reduces the company's audit requirements.[232] There would have been one fundamental difference between these rules and the application of this approach to fee disclosure laws, however. Whereas the relaxed requirements for smaller reporting companies and non-accelerated filers are designed to help the small companies that are *producing* disclosure (by making it less costly to do so), relaxing fee disclosure requirements for smaller plans would help the small public plans that are *receiving* disclosure by exhausting less of their bargaining power so that they can avoid being frozen out of the fund.

Of course, while state legislatures likely would have struggled to set asset threshold levels that perfectly tracked each plan's bargaining power, any kind of graduated approach would likely have made fee disclosure laws a less blunt instrument for seeking better protections. This logic could apply to any private fund contract term that a state legislature might consider regulating.

2. Sunset Requirements

As discussed above, the hot fundraising market for private fund investments likely had a significant diminishing effect on the movement for free transparency legislation.[233] One way state legislatures can address the cyclicality problem is to include a "sunset" provision requiring that any fee disclosure laws be reviewed and reconsidered within a fixed period of time after enactment. Sunsetting is a long-established policy tool used by both Congress and state legislatures.[234] State sunset statutes were particularly popular in the 1970s as a way to reduce red tape and improve the operations of state government agencies, and scholars have generally given positive assessments of the sunsetting initiative from that period.[235]

Professor Roberta Romano has called for including sunsetting requirements in federal crisis-driven financial regulation as a way to ensure that laws that were passed with incomplete information and in the heat of a crisis can be updated or allowed to lapse when legislators have more

[232] *See* Rule 12b-2 of the Securities Exchange Act of 1934.

[233] *See supra* Section III.B.3.

[234] *See generally* Jacob Gersen, *Temporary Legislation*, 74 UNIV. CHIC. L. REV. 247 (2007) (providing an overview of the use of temporary legislation, of which sunset laws are one type); Dan R. Price, *Sunset Legislation in the United States*, 30 BAYLOR L. REV. 401 (1978) [hereinafter Price, *Sunset Legislation in the U.S.*].

[235] *See* Richard C. Kearney, *Sunset: A Survey and Analysis of the State Experience*, 50 PUB. ADMIN. REV. 49, 52–55 (1990); Price, *Sunset Legislation in the U.S.* at 440.

information and better perspective.[236] In many respects, state fee transparency laws, which were passed in response to the controversial practices discussed above,[237] are similar to the kinds of crisis-driven legislation that Professor Romano refers to. However, because fee disclosure laws are also subject to the cyclical bargaining power dynamic described above, sunsetting arguably would have been even more useful for fee transparency laws than the kinds of federal financial regulation that Professor Romano deals with. For example, if AB 2833 had a sunsetting provision, California legislators would have been required to reconsider the legislation again in the future when the market for private fund fundraising has slowed down and when California plans have greater bargaining power with managers. At that point in time, the legislature may be more inclined to reverse the changes that weakened AB 2833 and that many commentators criticized.[238]

Just as importantly, other states, like Illinois,[239] that considered fee transparency legislation but opted not to move forward, might have been more inclined to pass some form of legislation if they had considered including a sunset requirement. Rather than view the legislation as a one-time, all-or-nothing opportunity to improve fee transparency, the Illinois legislature could have gotten comfortable with passing a less demanding law today and preserving for themselves an opportunity to make the law more robust at a future date when Illinois plans had greater bargaining power with managers.

Looking beyond fee transparency laws, if an aggressive state law to protect public plans is passed in a weak fundraising market when investors have strong bargaining power with managers, that law could end up being too aggressive and result in that state's plans being excluded and/or penalized when the fundraising market gets stronger. In this case, a sunset requirement would allow the state legislature to relax the law or even let it lapse altogether after market conditions have changed. Knowing that the laws can be

[236] *See* Romano, *Regulating in the Dark*, *supra* note 195, at 53("The point of sunsetting is to produce a more deliberative drafting process that weeds out the ill-founded from the wise, a reflection impossible to undertake in the heat of a crisis, and not likely thereafter to be willingly undertaken by an agency, given limited time and resources, which work hand in glove with the aforementioned status quo bias to blunt reconsideration.").

[237] *See supra* Section II.B.1.

[238] *See supra* notes 156–58 and accompanying text.

[239] *See supra* notes 166–67 and accompanying text.

revisited, state legislatures could feel empowered to pass more robust laws than they would consider without a sunsetting requirement.

Sunsetting requirements would not have been a complete solution to the challenges that faced fee transparency laws, but they could have helped to alleviate the complexity caused by bargaining power cycles in the private funds market.[240]

C. Federal Regulation of Public Plans

Before any momentum toward state fee transparency legislation gained steam, state treasurers across the country sent a jointly-signed letter to the SEC requesting that the agency use its authority to require greater disclosure of fees and expenses by private fund managers.[241] Given the challenges identified in this Article, it should come as no surprise why states made such a request. To a large extent, federal regulation avoids the challenges discussed above that apply to state law. On one hand, federal regulation could be crafted to apply to all U.S. private fund managers, regardless of what kinds of investors they raise capital from. This would eliminate the incentive that private fund managers have to avoid accepting capital from public plans in states that pass strong laws. Even if the regulation were crafted to apply only to state and local pension investors in the United States, the problems relating to diversity and discrimination[242] would be substantially reduced simply by virtue of the fact that U.S. investors make up such a large percentage of the universe of private fund investors (far more so than any single U.S. state). In other words, the coordination benefits[243] of a federal law for public plans are likely to be much stronger than the coordination benefits of a state law.

Depending on the subject matter of the particular law, federal law could also provide standardization benefits that are less likely to be achieved by state law. Coming back to the fee transparency example, there are many benefits to having a standardized approach to disclosure requirements. If, for example, Illinois, Arizona, and Pennsylvania were to move forward with

[240] Of course, sunsetting requirements demand their own cost-benefit analysis, as they obligate a legislature to incur costs in the future. *See* Romano, *Regulating in the Dark*, *supra* note 195, at 38 (By 1990, enthusiasm for administrative agency sunsetting waned, given the time and cost of reviews."). But for the reasons described above, the benefits of sunsetting state laws that seek to regulate private fund contracts would likely be considerable.

[241] *See supra* note 40 and accompanying text.

[242] *See supra* Section III.B.2.

[243] *See supra* Section III.A.3.

passing fee disclosure requirements that were dramatically different than California's, it would create an inefficient patchwork of standards. This patchwork of standards would be more expensive for private fund managers to comply with. When multiple disclosure standards are being used, it can also make the information less useful and harder for investors to compare. Federal law could avoid both of these problems by mandating a uniform standard for disclosures to public plans.[244]

Currently, federal pension law only applies to private pension plans, which have been subject to the ERISA statute since it was passed in 1974. While efforts have been made to impose more stringent reporting requirements on state and local pension plans at the federal level, no such legislation has been enacted to date.[245] This Article lends further support to the idea of federalizing certain aspects of the regulation of public pension plans.[246]

D. Reassessing Federal Securities Law

In this final section, I take a step back to consider the bigger storyline. As highlighted throughout this Article, an extraordinary demographic shift has occurred in the private fund industry's population of investors. Once a minor player, state and local pension plans have collectively become the largest investor group in the private fund asset class, which itself has become a

[244] In the absence of a federal standard, private market actors have attempted to bring standardization to the private funds marketplace. Such efforts have faced challenges. For example, in 2016 the Institutional Limited Partners Association ("ILPA") released a standardized template for private equity fees that some hoped would be adopted broadly across the market. Voluntary adoption has been disappointing, with only 20% of private fund managers using the template reporting that they planned to use an unmodified version of the template in 2018. *See Fees & Expenses Survey 2018*, PRIVATE FUNDS MANAGEMENT 8 (Nov. 2018). Separately, a private coalition called the AltExchange Alliance sought to find agreement on unified standards, but that effort died in 2018 due to mistrust about the founders' motives. *See* Clark, *Investors Urge Transparency*, *supra* note 173.

[245] *See* the Public Employee Pension Transparency Act (PEPTA), H.R. 6290, 115th Cong. (2017-2018).

[246] *See, e.g.*, Josh Barro, *How Congress Can Help State Pension Reform*, 2012 NAT'L AFF. 92, 102 (2012), http://www.nationalaffairs.com/doclib/20120619_Barro_indiv.pdf; Roger Lowenstein, *The Long, Sorry Tale of Pension Promises*, WALL ST. J. (Oct. 1, 2013), https://www.wsj.com/articles/the-long-sorry-tale-of-pension-promises-1379723751 ("Before we get more Detroits, or more Studebakers, the federal government should enact an ERISA (with teeth) for public employers.").

massive force rivaling the public markets in size and influence.[247] More than any other investor group, the fates of U.S. public pension plans are increasingly tied to the performance of this lightly-regulated asset class.

This shift calls into question some of the basic assumptions on which private fund regulatory policy has long been based. In explaining the purposes behind the "accredited investor" standard,[248] one of the most important legal standards regulating who can participate in private funds under federal securities law, the SEC has highlighted the goals of ensuring investors' sophistication and ability to sustain the risk of economic loss.[249] The accredited investor standard (supplemented by the qualified purchaser standard) seeks to accomplish this by requiring that investors meet net worth requirements.

The rise of public pension investment in private funds casts doubt on whether these goals are, in fact, being met. The notion that U.S. state and local pension plans are capable of sustaining significant risk of economic loss seems particularly suspect. In today's environment where so many state and local public pension plans face severe underfunding problems, many public plans are actually in a very poor position to sustain economic loss from failed investments. Many public pension plans do not have a significant margin for error, but instead appear to be taking a gamble with the retirement savings of teachers, firefighters, and other public servants and with taxpayers' money. Moreover, in light of the significant body of academic evidence suggesting that many public plans suffer from significant management problems and

[247] *See* MacArthur, Burack, De Vusser, Yang & Rainey, *Public v. Private Assets: The Big Switch*, Bain & Co. Report (Feb. 25, 2019), https://www.bain.com/insights/private-multiples-global-private-equity-report-2019/ ("Investors have never been more drawn to the private markets than they are today. . . . The flow of capital into the private markets is unprecedented.").

[248] *See supra* note 59 for a description of the investor qualification rules that apply to private funds.

[249] *See* Comm. on Capital Mkts. Regulation Expanding Opportunities for Investors and Retirees: Private Equity 30 (Nov. 2018),https://www.capmktsreg.org/wp-content/uploads/2018/10/Private-Equity-Report-FINAL-1.pdf [hereinafter "Comm. on Capital Mkts. Regulation 2018 Private Equity Report"] ("[T]here are three distinct, but related policy concerns repeatedly highlighted by Congress and the SEC for establishing the accredited investor standard and qualified purchaser standard: (1) adequacy of disclosure, (2) investor sophistication and (3) ability to bear economic loss/higher risk of the investment."); Securities and Exchange Commission, *Report on the Review of the Definition of "Accredited Investor"* (Dec. 18, 2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf (noting that the accredited investor standard is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment . . . render the protections of the Securities Act's registration process unnecessary").

conflicts,[250] it also seems fair to question whether the goal of ensuring sophistication is always met when public plans invest.

These issues become even more concerning when the challenges associated with using state law to regulate public plans—many of which have been examined at length in this Article—are taken into account.

Furthermore, there are other important ways in which public pension plans are distinctive relative to comparable privately-organized vehicles. It is not uncommon for individual investors to make investments in private "funds of funds" and other "feeder" vehicles that collect the investments of smaller investors for the purpose of making investments in private funds.[251] However, in those vehicles, the underlying investors are typically required to be accredited investors.[252] No such standard applies to the beneficiaries in a public pension plan. Moreover, in these private "feeder" vehicles, investors can eventually choose to exit if they do not like the way that the vehicle is being managed, and the promoter of the vehicle is usually motivated to achieve high performance in order to attract new investors into the vehicle. These market pressures do not exist in most public pension plans because investors are typically locked in, with no chance of exit.

In the context of the public securities market, prominent scholars have called for a tiered system of federal regulation based on each company's level of "publicness."[253] According to Professors Langevoort and Thompson, some companies are public companies because they exceed the maximum number of shareholders under the federal securities laws or they have held a public offering of their shares, but they are nevertheless relatively small and do not leave a significant societal footprint. Others, by contrast, both meet the technical requirements for being a public company and are also systemically important, in the sense that the ripple effects from wrongdoing at the

[250] *See* Pub. L. No. 112–106, 126 Stat. 313 (2012) (setting forth a requirement that companies register under the Securities Exchange Act of 1934 once they exceed 2,000 shareholders of record).

[251] Investors in private equity "funds of funds" generally must satisfy the accredited investor standard, but not the qualified purchaser standard.

[252] *See* American Investment Council Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193322-192491.pdf (noting that the SEC has taken the position that the accredited investor suitability standard for the offering of private funds of funds is needed, notwithstanding the lack of any statute or regulation imposing this limitation).

[253] *See* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013).

company would be quite substantial.[254] Professors Langevoort and Thompson propose imposing a more demanding regulatory regime on public companies that also have a large societal footprint, and a less demanding regime on public companies that do not.

The influx of public pension plan capital into the private funds industry in recent years begs the question whether lawmakers should consider adopting a tiered federal standard for public plans. Like the large public companies in Langevoort's and Thompson's study, private funds with large numbers of public pension investors are likely to have a significant ripple effect on taxpayers and plan beneficiaries—parties that generally do not possess significant wealth—when they engage in misconduct. If recent trends continue, it may be appropriate to update the federal securities laws to apply a different, more rigorous set of access requirements to public pension plans than private parties.

V. CONCLUSION

Public pension plans have dramatically increased their investment in private funds in the wake of widespread underfunding problems. This Article examines the role of state law in this new era where massive public investment in private funds has become the norm. It argues that even though aggressive state regulation of private fund contracts has potential to address certain specific concerns, it has limited ability to compensate for ineffective internal governance in public plans. This Article also argues that public plans' shift to private funds calls into question some of the basic assumptions on which private fund regulatory policy has long been based and considers various implications for the future of private fund policy.

[254] *See id.* at 374 ("When Enron and WorldCom fell, for example, the failures caused much damage to their shareholders and debt holders, to be sure. But the fraud also caused immense pain to employees and retirees as well as billions of dollars of losses to competitors and severe distortions in the regulated markets in which they operated.").