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Is Transparency the Answer? Reconciling the Fiduciary Duties of Public Pension Plans and Private Funds

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Public pension plans manage over \$3 trillion in assets on behalf of millions of state and local government workers across the country. The trustees of such plans (“Trustees”) invest the bulk of these assets into a variety of equities and bonds, with the hopes of earning sufficient returns to finance the retirement of these countless public sector workers. In recent years however, Trustees have grown more creative in selecting their underlying investment allocations. Alternative investments, such as hedge funds and private equity funds for example provide unique opportunities for Trustees to maximize returns, protect against declining markets, and to diversify their underlying portfolios.

Private funds are uniquely situated to provide these benefits to investors. These vehicles can access an entire universe of strategies that are not equally available to their registered counterparts. Most importantly, private funds are exempt from regulatory constraints on leverage and can therefore rely on a plethora of exotic derivatives to pursue “absolute returns” irrespective of market conditions. They also have more freedoms to trade illiquid investments, non-U.S. opportunities, and other innovative financial products that are considered too risky for average investors. Private funds often attract the best managerial talent to take advantage of these broad liberties, leading to yet another attractive feature of these investment vehicles. Studies have estimated that public pension plans account for close to 30% of the aggregate capital invested in alternative assets. Several commentators anticipate that this figure will continue to grow as public pension plans face increasing funding challenges related to market turmoil, swelling life-spans, and the simultaneous retirement of millions of baby-boomers.

While private funds can provide several benefits for public pension plans, they create

distinct challenges for Trustees in terms of administering their fiduciary duties. These duties generally obligate Trustees to act for the exclusive benefit of plan beneficiaries in managing plan assets. Since public pension plans are exempt from the Employee Retirement Income Security Act of 1974 (“ERISA”) and subject to varying degrees of regulation under their respective states, they must consult several sources in determining the precise contours of these duties. Trustees must consistently evaluate state constitutions and statutes, common law, and plan documents. Even still, commonalities emerge particularly with respect to the omnipresent duty of prudence. Under this duty, states often adopt the standard provided under Section 404(a)(1)(B) of ERISA which obligates

fiduciaries to manage the plan “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” This essentially requires that Trustees utilize reasonable expertise and diligence in selecting investment allocations for pension plan portfolios so as to protect beneficiaries from excessive losses.

Carrying out this duty with respect to alternative investments can be quite difficult since private funds are not subject to the same regulatory scrutiny as public equity investments. Although the Dodd-Frank Act has subjected private funds to a degree of regulation under the Investment Advisers Act of 1940 (“Advisers Act”), these entities are still exempt from several layers of federal legislation

such as the Securities Act of 1933 and the Investment Company Act of 1940. Thus, as investors in these private entities, public pension plans are not entitled to detailed disclosures related to private fund strategies and operations. Excluded information can encompass specific position data as well as total exposure to leverage. This limited access to information can make it difficult for Trustees to appropriately evaluate the risks of allocating to alternative assets. This is particularly problematic since regulatory exemptions allow private funds to pursue riskier strategies that could expose pension plans to undue losses. Access to unlimited leverage can significantly enhance returns, but could lead to crippling losses as demonstrated by several infamous hedge fund failures over the past decades. The complexity of private fund strategies can also make it difficult for Trustees to administer the proper expertise needed to evaluate whether they are prudent investments. Alternative strategies can be dynamic in nature where advisers frequently change investment allocations, leading to dynamic measures of risk that are constantly changing over the course of a pension plan’s investment. Valuing

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the underlying assets of such strategies can be equally difficult if they are illiquid in nature and therefore beholden to elaborate, and sometimes inconsistent, valuation calculations.

To protect against fiduciary breaches, Trustees frequently demand enhanced transparency from private funds. They utilize extensive resources in analyzing and scrutinizing this additional information. This prevailing practice is consistent with traditional notions of investor protection which presumes that institutional investors have the resources to appropriately protect themselves against investor protection harms. However, this due diligence process can be quite expensive, especially in the context of evaluating a large range of potential investment opportunities. With the thousands of available private funds, coupled with the heterogeneous nature of the industry, Trustees may not have the resources to sufficiently optimize

their alternative asset selections. Private Fund advisers may also be unresponsive to such disclosure requests so as to protect the proprietary nature of their strategies. The extent to which private funds grant such requests may further depend on the bargaining power of the institutional investor. Smaller pension plans may encounter difficulties in accessing the necessary information to prevent fiduciary breaches.

Private funds should consider voluntarily increasing transparency to public pension plans to reduce the likelihood of fiduciary breaches by this category of investors. A coordinated market response of this nature could deter regulators from implementing reactionary regulation that would likely be haphazard and excessively restrictive. Lawmakers often react to financial disasters in this manner given the political pressure to quickly develop preventative solutions. The great financial crisis of 2007-2010 provides the perfect example as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) was hastily passed in an effort to prevent future crises of this magnitude. Regulators are still untangling the myriad of financial reforms mandated under this extensive legislation.

With respect to the investment fund industry, the Dodd-Frank Act has arguably extended the intricate patchwork of regulation that applies to these entities, while doing little to alleviate the systemic risk concerns expressed by regulators. This new regulation requires that private fund advisers register under the Advisers Act, which is widely known as the least restrictive amongst the federal securities laws. It also empowers the SEC to collect confidential information from private funds, and to disclose this information to the newly created Financial Stability Oversight Council (“FSOC”). FSOC was created by Congress to monitor and regulate systemic risk. Private funds could fall under FSOC’s jurisdiction due to their abilities to create and transmit systemic risk. However, FSOC has yet to define appropriate measures of systemic risk and the likelihood of a private fund being identified as systemically harmful has significantly declined due to push back from the industry. The Dodd-Frank Act also expanded authority granted to the CFTC by

mandating that certain OTC derivatives be cleared through registered clearinghouses. It then retooled many CFTC exemptions so as to force a larger number of private funds to register with the commission. Yet, many commentators are concerned that systemic risk will instead be concentrated within such clearinghouses. The increased compliance costs associated with dual regulation by the SEC and CFTC could likewise outweigh the benefits of this potentially redundant regulation.

If multiple fiduciary failures occur related to private funds, lawmakers will likely respond in a similar fashion by hastily implementing additional legislation to further restrict public pension plans from accessing alternative investments. With respect to private funds, the SEC has already expressed an interest in implementing prudential regulation over its regulated industries. This could entail setting arbitrary limits on leverage and derivatives trading, and other stringent capital restrictions. In regards to public pension plans, states may respond by implementing caps on alternative asset investments, reducing the existing caps on such allocations, or eliminating access to private funds altogether. Lawmakers could even respond by creating new commissions or self-regulatory organizations that are fully dedicated to regulating alternative investments. A reform of this nature could provide regulators with additional expertise to assist in crafting effective regulations. However, there is a strong likelihood that these kinds of measures could further complicate the web of financial regulation applicable to these entities. Determining the appropriateness of these reforms admittedly depends on the severity of any such market failure. Such drastic measures may indeed be necessary if excessive losses do in fact result from private fund investments. Nevertheless, a coordinated market response via enhanced transparency could prevent these kinds of losses, including the direct and indirect costs of implementing restrictive regulations.

In spite of the legitimate concerns of leaking proprietary information to public pension plans, enhanced transparency can actually benefit the private fund industry. It can provide private funds with a valuable marketing opportunity to distinguish themselves within an industry that has grown increasingly saturated. With the

numerous reports that private funds cannot effectively beat the markets, among other notable criticisms, differentiating from the crowd in this manner can prove quite valuable. Institutional investors have been progressively demanding additional transparency from private funds in response to these critiques. Meeting this demand would likely build the credibility of the industry as private funds could use this opportunity to highlight the many ways in which they benefit the financial markets. Disclosing these strengths could in turn create prevailing market standards that may incentivize “good behavior” for industry participants.

By and large, improved transparency will undoubtedly make it easier for Trustees to fulfill their fiduciary obligations. Even still, pension plans face additional hurdles in optimizing alternative asset investments that will require continuous research by a range of disciplines. These issues largely relate to the lack of standardization in the alternative asset space. Private funds are not obligated to follow standardized procedures in terms of calculating valuations or fees. This lack of standardization can make it exceedingly difficult for Trustees to appropriately evaluate a private fund investment in relation to other comparable funds. Inordinately complex fee structures have recently engendered controversy as institutional investors have withdrawn from private funds due to the complexity and excessiveness of such fees. Moreover, as briefly discussed above, the increasing “publicness” of private funds has not been sufficiently regulated under recent financial reforms. This exposes pension plans to the possibility of allocating assets to systemically harmful funds. These issues are not easily fixed by existing regulatory frameworks and would likely necessitate a wholesale review of the intricate layers of laws that apply to these industries. As markets continue to evolve, lawmakers should consider dedicating significant regulatory resources to the development of proactive regulation that is holistically responsive to the realities of the marketplace. Regulations that sufficiently incorporate the heterogeneous nature of alternative investments are an absolute necessity in this regard.