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

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2016 PRIVATE FUND REPORT:
Public Pension Plans and Private Funds -
Common Goals, Conflicting Interests
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Many observers inexperienced with private funds are often quite surprised when they first learn that the retirement plans of teachers and police officers and sanitation workers serve as the foundation for these financial high fliers. The difference in remuneration is only one of the many, many ways the world of government differs from the world of private funds. What brings these two very different worlds together is central to understanding the key dynamics in the industry and the growth of these funds in recent years.

With public pension funds being asked to achieve higher and higher investment returns in order to deliver retirement benefits to their beneficiaries, these retirement plans are being forced to allocate more of their money to riskier and riskier funds. Unfortunately, the results are not as clear cut as many would like.

Over 30 years ago, the relationship between US public pension money and private equity investment acumen began. In 1981, KKR used money provided by the Oregon Investment Council to acquire the retailer Fred Meyer. Since then, the relationship has deepened and broadened considerably, driving the alternatives industry forward. Conventional wisdom holds that in the US approximately one-half of the money in private equity and venture capital funds comes from tax-exempt investors such as public pension funds.

The most significant group of investors in private equity and hedge funds remain the large US public pension plans, whether on the west coast (California Public Employees Retirement System (CalPERS), California State Teachers Retirement System (CalSTRS), Los Angeles County Employees Retirement Association (LACERA), Los Angeles Fire and Police Pensions (LAFPP), San Diego County Employees Retirement Association (SDCERA), Sacramento County Employees Retirement System (SCERS)), the east coast (Massachusetts Public Employees, New Jersey Division of Pension and Benefits, New York State and Local Retirement System (Common Fund), New York City Retirement Systems (NYCRS), Virginia Retirement System (VRS), Florida Retirement System) or from points in between (Michigan State Office of Retirement Services (ORS), Missouri Public School and Education Employee Retirement System (PSRS/PEERS), Missouri State Retirement Systems (MOSERS), Ohio School Employees Retirement System (SERS), State Teachers’ Retirement System of Ohio (STRS), Texas Teacher Retirement System, Texas County & District Retirement Systems (TCDRS), Employees Retirement System of Texas (ERS), Illinois Teachers’ Retirement System, State Retirement System of Illinois, Illinois Municipal Retirement Fund).

Why invest in private funds at all? Perhaps by better understanding what these investors believe they will gain from entrusting their money with these entrepreneurial firms, it will shed light on the underlying drivers that have led to the relentless growth of private equity and hedge funds during our lifetimes. The simplest answer would, of course, be high investment returns. Dressing this obvious conclusion up a little bit more, the benefits of private equity and hedge funds to investors include attractive risk-adjusted returns, downside protection, low correlation to other asset classes, diversification and access to exceptional investment talent.

As participation in private funds has increased over recent years, investors have gained invaluable experience and knowledge about how these funds operate. Although one by-product of this development could have been a rapid evolution of the structure of these vehicles, this has not occurred. The fundamental structure of private equity and hedge funds has remained largely unchanged, with the principal economic motivation of fund managers continuing to be the opportunity to receive substantial performance-based compensation.

Important, since the beginning of the global financial crisis, more and more attention has been spent by investors on understanding how the funds operate and locating areas of particular risk. For many, the fallout from the crisis has provided them with a very expensive education! Investors contemplating allocations to these asset classes today are increasingly allocating more and more time to understanding the risks each fund possess.

It is worth stressing again this fundamental linkage between highly remunerated financial professionals and large numbers of public employees with generous retirement benefits that must eventually be paid out.
in the processes of securing a prospective investor's participation in a new private equity or hedge fund. During a particular fundraising cycle, it is not uncommon to see a very small number of elite fund managers facing massive over-subscription, while a significant number of others have difficulties obtaining money sufficient to even launch their funds. The practical implications of this tendency for investors to adopt a ‘herd mentality’ around established brand names, influenced in part by subjective factors such as perceived exclusivity, by investors paying sub-optimal fees can have long-term implications on a fund manager's profit and, in extreme cases, viability.

As private funds continue to become more mainstream, the demands of informed investors for clearer and more favorable provisions regarding fees and expenses will increase. Fund managers must take adequate steps to ensure that they provide demanding investors with the information and ongoing support they require to understand the

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arguably grants too many fund managers the higher ground when it comes to negotiating the commercial terms surrounding the actual investment in the fund, including provisions related to fees and expenses.

An on-going debate centers on the relative balance of power between investors and fund managers at any given time. Principally, the focus has been on objective, economic factors, such as the ability of investors to demand lower fees. Increasingly, however, issues of fund governance and on-going oversight of the fund managers arise when discussing relative negotiating leverage.

Due to the difficulty that certain new fund managers face in raising their first fund, it is not uncommon to reward a cornerstone investor, who provides the fund with “proof of concept,” with something to compensate for the value they create by way of their participation. This could include a discount on the management fee, a participation in the performance remuneration, or an equity stake in the fund manager itself. Of course, a fund manager will need to consider relative costs and benefits whether to provide fee discounts or on-going capacity guarantees to early investors in exchange for receiving the assets necessary to launch their initial funds. Any arrangement with regard to fee discounts will need to be examined in light of the fund's overall capacity constraint. Allowing too much of a strategy's ultimate capacity to be taken up

full costs incurred in connection with their investments. The global financial crisis has meant that these investors now have many more questions that need answering in order to justify their investments in private funds to their own constituencies.

The high returns promised by private equity and hedge funds, which are seen by many as the simplest way to cover these deficiencies, come with high price tags. The fees charged by alternative funds are much higher than the rates charged on more traditional investments. In addition, the parties ultimately paying those fees are often former government employees who retain much political clout in and around the halls of power.

As a result, when the hedge funds and private equity funds then end up having a bad quarter, or a bad year, awkward questions can be raised about the about the state employees who naively handed over precious public money to smooth talking Wall Street operators, and paid dearly for the privilege.

As the global financial crisis dragged on, critics of private funds were regularly voicing their informed opinion that these funds needed to be curtailed, that “casino capitalism” had to come to an end. They claimed, “We have a hedge fund problem.” They claimed, “We have a private equity problem.” The issue, in fact, is that we have a public pension plan problem in the United States. Unfortunately, this is not a problem that can be readily discussed and debated in the state legislatures across the country. This is, in fact, a problem that many politicians would prefer to forget.

Notwithstanding this reluctance, there is little sign the public pension plans will be exiting private funds as an asset class in the near future. Although headlines were made when CalPERS decided to liquidate their hedge fund positions, few other plans followed their lead. Therefore, the question of the fees and expenses paid by public pension plans to private funds managers remains a pressing one. In addition to understanding the practical dynamics of these cash flows, it is also useful to consider the broader context of fiduciary duty that governs the relationship of these fund managers to their investors (the plans) and the relationship of these plans to their beneficiaries (the public employees to whom retirement benefits will one day be paid).

The purpose of this Report is to highlight the key issues at work here and lay the groundwork for a more enforced and insightful debate about what the appropriate role of private funds should be in the investment portfolios of our public pension plans.
One nice thing about running a private equity firm is that you get to sit between investors who have money and companies who need it, and send both of them bills. This has made a lot of private equity managers rich

– Matt Levine

The SEC and Private Equity: Lack of Transparency, Misallocation and Fraud

Private equity is among the least transparent financial actors. Prior to implementation of the Dodd Frank Financial Reform Act of 2010, private equity avoided scrutiny by the SEC. Private equity lacks transparency in part because of its complex structure. Private equity firms raise investment funds that are used to acquire portfolio companies in leveraged buyouts. Investors in PE funds (called limited partners -LPs) include pension funds and other financial entities. In Q4 2014, pension funds contributed a third of the equity in PE funds. Overall investors contribute about 98% of the equity in a private equity fund, less than 2% is contributed by the PE funds general partner (GP). All decisions are made by the GP – a PE firm partner or committee of PE firm partners and staff that serves as the fund’s advisor. The GP promises investors that its financial and management expertise will yield outsized returns. In return for these services and the promise of high returns, the LPs pay the GP an annual management fee (typically 2 percent of the capital they have committed to the fund) and 20% of the fund’s profits.

Dodd-Frank achieved some improvements in the regulation of private equity. The reporting requirements for PE fund GP are modest; despite this, SEC regulators have identified widespread abuses. These include inappropriately charging PE firm expenses to investors, failing to share income from portfolio company monitoring/advisory fees with fund LPs, and collecting transaction fees from portfolio companies without registering as broker-dealers.

Misallocating PE Firm Expenses and Portfolio Company Fee Income

The public first learned about the widespread failure of PE fund GPs in April 2014 when the SEC’s top regulator, Mary Jo White, pointedly described these abuses in her testimony to Congress. White’s testimony was followed on May 6 by the “sunshine” speech delivered by Andrew J. Bowden, then the Director of the SEC’s Office of Compliance Inspections and Examinations. Bowden stunned his listeners when he reported that SEC examiners found violations of law or material weaknesses in the handling of fees and expenses in over half the cases they reviewed.

(Continued on next page)
through the financial crisis and recession. Various units of KKR, for example, pulled $117 million in a variety of fees out of First Data, at the time a struggling portfolio company of a KKR fund.

Many current Limited Partnership Agreements require these rebates to be shared with the investors in the PE fund. But vague and confusing wording has meant that too often investors have not received the fee income that is owed them; instead, it has been pocketed by the PE firm. These monitoring fees reduce the ability of a portfolio company to invest in itself and improve its performance – ultimately shrinking its resale value and reducing the return to the PE fund; indirectly, monitoring fees come out of the pockets of the limited partners.

Another way that private equity firms avoid sharing monitoring fees with LPs is to hire consultants to provide services – a practice the SEC has flagged. Traditionally the executives that provide these services were salaried employees of the PE firm. More recently, PE firms have used consultants instead and charged their services to portfolio companies. By treating these executives as consultants rather than employees, the PE firm is able to get around the requirement to share these fees with the LPs. An investigative report by the Wall Street Journal, for example, raised questions about the relationship between KKR and KKR Capstone, which provides advisory services to portfolio companies of KKR’s PE funds. The Wall Street Journal found that KKR Capstone is listed as a KKR subsidiary in its 2011 annual report and as a KKR “affiliate” in regulatory filings by several portfolio companies owned by KKR PE funds. In this case, fees charged by KKR Capstone would have to be shared with LPs; including in its 2006 PE fund, who are entitled to 80 percent of any “consulting fees” collected by any KKR “affiliate.” Capstone’s consulting fees constitute the bulk of the roughly $170 million KKR collected over a 3-year period. KKR says it misspoke and KKR Capstone is owned by Capstone’s management, not KKR, and isn’t an affiliate. As a result, KKR has told LP investors that it doesn’t share Capstone’s fees with them.

The New York Times reports that this is common practice. It notes that PE firm, Silver Lake Partners, reported in a 2014 filing with the SEC “that when it retained ‘senior advisors, advisors, consultants and other similar professionals who are not employees or affiliates of the advisor,’ none of those payments would be reimbursed to fund investors. Silver Lake acknowledges that this creates a conflict of interest.”

When consultants are used, PE investors do not receive any fee income. Instead, the profits of the PE firm are increased because the salaries of the executives providing advice have been shifted to the portfolio company. Adding insult to injury, fees paid by portfolio companies for monitoring services are tax deductible, so the entire scheme is subsidized by taxpayers.

Even when PE firms share fee income with investors, they retain billions. According to the Wall Street Journal, “The four biggest publicly traded buyout firms—Blackstone, Carlyle, Apollo and KKR—collectively reported $2.1 billion in net transaction and monitoring fees (that is, after rebating part of the fees to investors) from their private-equity businesses between 2008 and the end of 2013.”

Money for Doing Nothing

‘Accelerated monitoring fees’ are a particularly egregious practice that PE firms use to enrich themselves at the expense of their portfolio companies and their investors. They are fees for services never rendered. Here, the MSA stipulates that the portfolio company must pay the annual monitoring fee for 10 or more years. If the PE fund sells the company in five years, as is often the case, the company must nonetheless pay all the remaining monitoring fees in one lump sum – for services it will never receive. Even more flagrant is the use of so-called ‘evergreen fees’ – accelerated monitoring fees that automatically renew each year for 10 years. For example, TPG has a contract with Par Pharmaceuticals, one of its portfolio companies, that requires Par to pay TPG annual monitoring fees of at least $4 million for 10 years. The fees must nonetheless pay off all the remaining monitoring fees that automatically renew each year. If Par Pharmaceuticals is sold, it will need to pay a full 10 years of fees to the PE firm for services it won’t receive. Additionally, because the company is no longer owned by the PE fund, accelerated monitoring fees do not have to be shared with the fund’s investors.

Enforcement actions by the SEC led Blackstone – a PE firm that has made extensive use of accelerated fee contracts – to do a U-turn. The SEC found that three private equity fund advisors (i.e., GPs) within the Blackstone Group had “failed to fully inform investors about benefits that the advisors obtained from accelerated monitoring fees and discounts on legal fees.” Blackstone agreed to pay nearly $39 million to settle these charges. It now appears that Blackstone will no longer collect extra advisory fees for services once a portfolio company is sold.

Transaction Fees and Acting as a Broker-Dealer

The transaction fees collected in the course of a leveraged-buyout have the potential to create a conflict of interests. PE general partners may be motivated to carry out transactions without regard to whether they are in the best interest of the fund’s LPs. The fees provide an immediate cash windfall to the GP, regardless of how well or poorly the investment performs. Because transactions of this type create potential conflicts of interest, securities laws require that anyone engaged in the business of effecting transactions in securities for the account of others must register as a broker and be subject to increased oversight by the SEC to ensure fair behavior. PE general partners have generally not registered as broker-dealers with the SEC. A whistleblower case filed in 2013 by a former PE executive identified 200 cases of unregistered broker-dealer activities related to private equity LBOs over the prior decade, including 57 cases worth $3.5 billion in fees.

In April 2013 an SEC commissioner flagged the transaction fees that many PE firms charge
portfolio companies in the course of acquiring them in a leveraged buyout as a potential violation of the Securities Exchange Act of 1934 since the GPs have not registered as broker-dealers. Despite the whistleblower lawsuits and public acknowledgement of potentially illegal broker-dealer activity by PE firms, however, SEC staff has been considering an exemption from registration for PE fund advisors.

SEC Enforcement
Enforcement action has been slow – with only six actions brought between 2014 and 2016. In 2014, the SEC targeted two small PE firms for minor infractions. More serious cases were filed in 2015, when the SEC brought enforcement actions against KKR, three Blackstone Group funds, Fenway Partners, and Cherokee Investment Partners.

The 2015 enforcement action against KKR for misallocating expenses related to failed buyout attempts to the investors in their PE funds was settled by KKR without admitting or denying the charges. KKR agreed to pay nearly $30 million to settle the charges, including a $10 million penalty. KKR’s settlement with the SEC over improper allocation of fees could have resulted in the PE firm being designated an “ineligible issuer” by the SEC and losing its status as an eligible securities issuer. But on the day that KKR settled with the SEC, the PE firm requested a waiver and the Commission granted it, thus allowing KKR to keep its status as an issuer.

In October 2015 the SEC announced that it had reached a settlement with advisors to three Blackstone Group funds for failing to adequately disclose the acceleration of monitoring fees paid by fund-owned portfolio companies. Without admitting or denying the findings, Blackstone agreed to cease and desist from further violations, to distribute $28.8 million to affected fund investors and to pay a $10 million civil penalty.

With only six cases brought by the SEC, results are not reassuring. No matter how egregious the PE firm’s behavior or how inconsequential the firm, the SEC has not insisted on an admission of guilt. Financial penalties have been trifling in relation to the size of the PE firm.

Tax Compliance and Private Equity
“Our assumption is not that everybody is out there cheating in the partnership area. Our problem is, and they know and we know, that we haven’t been auditing them.”
– John Koskinen (2016), Commissioner of the IRS, as quoted by Bloomberg BNA

The failure of the IRS to audit complex partnerships, including private equity partnerships, is well known to these enterprises. Some PE firms have taken advantage of this failure of IRS oversight. Two fairly common practices – management fee waivers and monitoring fee agreements – do not comply with provisions in the tax code.

Management Fee Waivers
In a management fee waiver, the general partner of a private equity fund “waives” all or part of the management fee that the limited partner investors pay for management services. In exchange, the general partner gets a priority claim on fund profits. This sleight of hand, so the private equity funds claim, turns the ordinary income the manager would have received for providing management services into capital gains income, and reduces the tax rate on this income from 39.6 percent to 20 percent. This is the tax equivalent of turning water into wine.

In 1984 Congress reformed the tax code to address this precise situation. It added a provision that disallows the claimed tax benefits from fee waivers if the fund manager does not bear significant entrepreneurial risk. Management fee waivers by private equity firms rarely, if ever, satisfy this condition.

Private equity firms’ use of management fee waivers first became popular in the late 1990s. It is not possible to know precisely how much tax revenue has been lost due to abusive fee waivers. However, during the Romney presidential campaign we learned that his private equity firm, Bain Capital, had waived in excess of $1 billion of management fees over the preceding 10 years and claimed approximately $250 million in tax savings. With management fee waivers used by a majority of private equity firms for the past 15 years, the revenue loss to the IRS is likely to be in the billions of dollars.

In July 2015 the IRS and Treasury clarified the intent of the provisions governing management fee waivers – what the IRS refers to as disguised payment-for-services transactions. And, because the preamble indicated that the proposed regulations are consistent with existing law, the guidance confirms that the IRS can hold PE firms accountable for past misuse of management fee waivers. In fact, recent reports suggest that significant audit activity focused on fee waivers is now under way.
**Disguising Dividends as Monitoring Fees**

The SEC has focused attention on whether PE firms share the monitoring fees they charge their funds’ portfolio companies with the limited partners in its funds. The SEC does not concern itself with the content of the monitoring fee agreements or their tax implications. That task falls to the IRS.

As we saw earlier, when a portfolio company is acquired by a private equity firm, the company typically signs a Management Services Agreement with the firm that obligates it to pay periodic fees to the PE firm. The PE firm typically determines the scope and scale of services it will provide under the MSA. Moreover, these agreements often make it explicit that there is no minimum amount of services that the private equity firm is required to provide.

Under the federal income tax law, compensation paid to service providers is generally deductible by the payer, while dividends are not. This dichotomy creates a well-known incentive for private equity firms to disguise dividends as compensation. To qualify as compensation for services and be deductible, payments must satisfy two conditions: (1) the portfolio company must have compensatory intent — that is, it must intend for these payments to compensate the service provider for services actually provided, and (2) the amount of the payment must be reasonable in relation to the services that are being performed.

Several features of the MSA are highly unusual and indicate that the payments are not for monitoring services but are actually disguised dividends and, accordingly, that these payments lack the requisite compensatory intent. First, the Agreements are not arms-length transactions. The private equity firm is negotiating a contract with a company its PE fund owns and effectively controls. Second, the agreement often provides that it is the PE firm and not the company contracting for the services that will decide whether and when to provide any services as well as the scope of the services to be provided. Indeed, the contract often requires that monitoring fees be paid regardless of whether or not any services are provided. Thus, in the typical monitoring fee context, the compensatory intent requirement cannot be satisfied because there is no requirement that the private equity firm must actually perform any services to receive these payments. In addition, the monitoring agreement can be terminated by the PE firm, and it will still collect the full value of the contract, even though no further services are provided. And finally, when multiple private equity firms take over a company, the monitoring fees are typically allocated among the firms on a pro rata basis in accordance with the shares controlled by each firm.

The facts described in the preceding paragraph suggest that many – probably most – monitoring fee agreements violate the requirement of compensatory intent.

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In a recent case highlighted in the Wall Street Journal we learn about one such case, in which payments conform to the shareholders’ ownership stake. When HCA Holdings Inc., the hospital chain bought in 2006 by Bain Capital LLC, KKR & Co. and Merrill Lynch went public in 2011, it had paid its owners more than $245 million in monitoring fees. Each of three buyout firms got 26.6667%, and the other 20% went to the founding Frist family. According to the WSJ, Patricia F Elcan, who has described herself as a homemaker, was paid for ‘management, consulting and advisory’ services. Her share was set at 4.1948018%, or about $10 million.

In addition to draining federal tax revenues, fees paid by portfolio companies transfer significant amounts of cash from portfolio companies to PE managers. This increases the company’s risk of insolvency and bankruptcy and limits the possibility of growth — to the detriment of the company’s employees and creditors. Given the widespread use of monitoring fees agreements, it is disappointing that the IRS has so far failed to include these fees in examinations, and to crack down when appropriate on the upside gains realized by the PE fund accrue disproportionately to the GP. As a result, the GP can afford to focus on the gains from a risky strategy and ignore the possibility of losses — a classic case of what economists call moral hazard.

Carried interest is a form of profit sharing – or performance-based pay – which GPs receive as a result of their success in managing the PE fund’s investments. Including a profit share as a form of incentive pay in employee compensation is a fairly common practice in the U.S., not just private equity. The United States Steel Corporation provided employees with a share of the company’s profits as early as 1903. Today, its unionized workforce receives a profit share if profits rise above a threshold. Carried interest is the private equity version of a performance fee.

In other industries where employees receive a profit share, this pay is taxed as ordinary income. In sharp contrast, carried interest – the performance fee for PE partners – is taxed at the much lower long-term capital gains rate. There is no economic justification for this anomalous tax treatment of carried
interest. It reduces the tax revenue received by the IRS to the disadvantage of the tax-paying public and it gives a huge boost to the after-tax income of PE firm partners. It’s a loophole that should be closed.

While PE partners would be loath to give up their tax break on carried interest, many admit privately that this tax loophole is indefensible and should be eliminated. Carried interest does not represent a return on capital that GPs have invested because nearly all of the capital in the PE fund is put up by the fund’s limited partners. This disparity between GPs’ investments and returns led Private Equity Manager to conclude that GPs’ disproportionate share of a PE fund’s gains is “more akin to a performance bonus than a capital gain” and to agree with the view “that a GP’s share of profits made on investor capital should be taxed as income, not capital gains.”

In January 2016 the editorial board of the Financial Times labelled the carried interest loophole “a tax break that Wall Street cannot defend.”

Having misleadingly characterized carried interest as a return on capital rather than a performance fee, many PE firms have felt no obligation to tell investors how much they are paying. Many PE investors – including public pension funds – have failed to insist on receiving this information. Instead PE firms have reported returns net of management fees and carried interest. The industry argues that if the PE firm partners are doing well, investors in their funds must also be doing well – so why be concerned about how much they are paying?

That argument is not holding up so well these days. The flagging performance of PE funds relative to the stock market over the past decade has led to questions about whether the high fees that investors pay are warranted. Good estimates of the total carried interest the industry collects are not available. The industry maintains that carried interest is small and the tax revenue gained from treating it as ordinary income is too little to be worth the added effort of the industry to track and report it. The Congressional Joint Committee on Taxation (JCT) estimates that taxing carried interest as ordinary income would raise about $1.4 billion in fiscal 2016 and about $15.6 billion over the next 10 years. While these are not trivial amounts of money, they are small in relation to total taxes collected. However, this estimate is disputed by tax experts. Professor Victor Fleischer estimates that the amounts the IRS would collect is 10 times as much - $180 billion over 10 years. This suggests that there really is a lot of revenue at stake, and apart from the issue of tax fairness, the country would benefit from taxing carried interest appropriately.

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That argument is not holding up so well these days. The flagging performance of PE funds relative to the stock market over the past decade has led to questions about whether the high fees that investors pay are warranted. Public pension funds had to admit that they had no idea how much they paid. The two sector workers, CalPERS announced it had paid $3.4 billion in these fees in the 25 years from 1990 to 2015.

In contrast, CalSTRS has redoubled its efforts to justify its position that carried interest is not a fee and does not need to be reported. Like CalPERS, CalSTRS has admitted that it does not track the carried interest it pays. The pension fund doesn’t think it is appropriate to do so because carried interest, in its view, is not a payment but a profit split. CalSTRS position is that a fee is not a fee if it takes the form of profit sharing. But this argument does not hold up – a profit share paid based on performance is clearly a performance fee. California State Treasurer and CalSTRS board member John Chiang has continued to press for information, and CalSTRS is considering whether to ask for and track the carried interest it pays PE firms.

Good estimates of the total carried interest the industry collects are not available. The industry maintains that carried interest is small and the tax revenue gained from treating it as ordinary income is too little to be worth the added effort of the industry to track and report it. The Congressional Joint Committee on Taxation (JCT) estimates that taxing carried interest as ordinary income would raise about $1.4 billion in fiscal 2016 and about $15.6 billion over the next 10 years. While these are not trivial amounts of money, they are small in relation to total taxes collected. However, this estimate is disputed by tax experts. Professor Victor Fleischer estimates that the amounts the IRS would collect is 10 times as much - $180 billion over 10 years. This suggests that there really is a lot of revenue at stake, and apart from the issue of tax fairness, the country would benefit from taxing carried interest appropriately.

*A longer version of this paper with references is available from the authors.
In the past year, there has been intense scrutiny on private equity fees at public plans, and the headlines about “hidden fees” border on salacious. However, the real reasons for a lack of transparency in investment costs, particularly for private fund investments, are far more mundane, and the solution will require collaboration, time and resources, as well as persistence. I am sharing my own personal experience to draw attention to the roadblocks pensions currently face, the reasons we must embrace standardization on the limited partner (LP) and general partner (GP) side and how pensions can affect industry reporting for the better while being certain that expectations are well-managed in the interim.

**Background**

My story starts at a public pension of nearly $30 billion assets under management (AUM) where I was hired specifically to build a controlled process to collect the total “investment expense” of the portfolio and to disclose it in the annual report on a fiscal year-end of June 30th according to state statute. The ultimate success of our annual fee reporting project was featured in a white paper last year by CEM Benchmarking (CEM) titled “The Time has Come for Standardized Total Cost Disclosure for Private Equity.”1 But at the start, I quickly found it was going to be a far more complex project than anticipated. The pension portfolio had a sophisticated allocation including hedge funds and numerous private markets investments. Nearly 100 investments were in a commitment-based limited partnership structure with a waterfall provision. Looking at the four fiscal quarterly Net Asset Value (NAV) statements - or quarterly investor capital account statements - for each investment, I realized that we could not automate them because they were PDF documents nor could we simply key the line items into a spreadsheet or database because the line item detail varied far too much from one investment to the next. For example, fund expense categories were not consistent and most of the private equity statements did not clearly identify the accrued versus paid carry for the reporting period.

I decided that the best way to ensure we collected the same data for each investment was to develop a simple, custom reporting template and require each investment manager to complete it, each fiscal quarter. We laid out our template in a NAV statement format with specific line items that would provide details for the quarterly management fees, carried interest (or performance fees for non-private market funds) and other pass-through investment expenses. While using the NAV format was a big improvement to the process because it has some inherent mathematical controls, there were still too many ways that a typo or miscalculation on the form could occur. The reason for this is that completing the custom template was a manual reporting task for all of our investment managers; their reporting systems were not setup to provide this kind of detailed data. I found that some GPs would list only the paid carry for the period while others disclosed the net changes in accrued carry that related to the unrealized gain/loss for the quarter – these are two very different data points.

The traditional investments were of course much easier to validate but when it came to the investments where carry was involved, the only way to be certain that the amount that was entered on the template by the GP was accurate and to ensure that it reflected only the time period requested (one fiscal quarter) was for our team to recalculate the waterfall. This meant that we had to create and maintain a fee model for each one of these investments and then, each quarter we updated the models using the cash flows and valuations all to test the manager-reported fee data for reasonableness.

CEMs report on private equity fee reporting along with a convergence of many factors led to a groundswell of support for standardization in early 2015 and many of these interested parties, myself included, joined the Institutional Limited Partners Association (ILPA) transparency initiative that launched last summer. I continued to contribute to this effort even after I moved to a plan sponsor consulting role for a public plan, I do not advise them to take the same path. Developing another template, building a fee validation team and creating an internal validation process all take time and the work is extremely manual so it requires substantial resources which can be very limited at a public pension. More importantly, one more limited partner with yet another unique fee template actually moves us that much further away from the goal. Instead, we must focus our efforts on a single industry-wide solution.

**The Solution: The ILPA Template**

In addition to my plan sponsor role in product development, I have continued my efforts advocating for public pensions seeking fee transparency and standardization in investment fee reporting. I have been able to stay close to the core of this initiative by
Managers will be initially reluctant, but we must be undaunted and remember that we are the investors, the clients, and together we can create sufficient demand.

Public pension plans are uniquely positioned to lead the way for greater transparency.

because there is a major efficiency angle for GPs as much as LPs. However, if every LP adopts a slightly modified version, then something has gone awry. GPs will, and rightly so, reject the template if there is not sufficient demand for it, and if it is not uniform because implementation will take time and resources to incorporate into their existing operations and reporting. And, because the template will require such an investment from GPs, limited partners must focus on adoption prospectively; existing and older vintages simply do not have this historical data at the ready.

Public Pension Plans
Public pension plans are uniquely positioned to lead the way for greater transparency. They have more sensitivity to a lack of transparency than many other investors not only due to their size and the sheer number of beneficiaries who they ultimately serve, but because they also frequently answer to elected officials, policymakers and taxpayers. These competing pressures create the very reasons that public pension plans can have the most impact - their visibility and influence. And these intricate layers upon a public pension plan only accentuate the need to communicate clearly, but the complexity of private equity fee terms is juxtaposed with their desire for transparency.

The reasons for supporting the transparency movement go beyond managing the headline risk that surrounds an inability to identify investment costs from existing GP reporting and instead speak to our desire to accurately measure, compare and manage investment costs. Further, new requirements for public plan fee reporting are lurking just around the corner and recent proposed legislation in some states only reinforces this strong possibility.

We have a long road ahead. It could take up to two or three years to fully implement the ILPA template so it will require patience and effective communication internally as much as externally about the realistic timeline. However, I have witnessed on a small scale what we can achieve in transparency into investment costs through persistence and standardizing reporting. The time has come to apply these concepts on a much larger scale and collectively, we can improve reporting for the industry. The ILPA Template’s release is just the first step. I am encouraging public pension plans to embrace the ILPA Template through official endorsement and to begin requesting it in their private equity negotiations with their legal counsel’s advisement. Some investors have already had success incorporating it into their side letter agreements which is very encouraging and ultimately the hope is that the ILPA Template will become part of the fundamental core documents, such as the limited partnership agreement (LPA).

Looking Ahead
All limited partners should embrace the ILPA Template as the standard best practice. Public pensions represent one of the single, largest investor groups and their unique pressures and responsibilities happen to give them abundant influence and visibility. It will be important to adopt the ILPA Template uniformly, meaning “as is,” to gain the inherent efficiencies, not to mention our GPs’ attention. Managers will be initially reluctant, but we must be undaunted and remember that we are the investors, the clients, and together we can create sufficient demand. As such, we must focus this effort on a go-forward basis and not be mired in righting old reporting.

I cannot emphasize enough that we should remain resilient and carefully manage expectations – expectations of both our own and those of our stakeholders. Real progress, worthwhile progress, takes time. And there is only one solution. Standardized investment fee reporting is essential for public pensions. I am confident that together we will shape investment cost reporting for the industry.

2 The AltExchange XML file can be downloaded from the ILPA website at www.ilpa.org.
Much like investors no longer buy into unknown risk in the aftermath of the financial crisis, investors won’t buy into unknown cost in the aftermath of the zero-interest environment. The future will allow asset owners, such as US public pension plans, to take investment decisions based on a proper risk-return-cost relationship matrix, and ultimately we will see real declining margins in the financial services industry. Much needs to happen until that day, but change cannot be prevented, not even in the almighty world of financial services.

The financial services industry is opaque. Best practice is not a standardised term across asset classes, or across markets. Embedded charges are perceived as being best practice by some managers, but not by others. For example, consider payment for research through brokerage. While brokerage is clearly a transaction cost, research is clearly a management fee component. In a proper cost dissection exercise, the research component must thus be added to management fee charges and not remain part of transaction cost, the mere analysis of which is cumbersome though. Another example is the use of time stamps for transactions. It seems obvious to a sophisticated investor that without time stamps, one will not be able to analyse trading efficiency. Regardless, we see many asset managers that claim to not be able to deliver time stamps, limiting analysis to daily high/low only instead of a preferred choice of intraday trade data.

When it comes to reporting, certain standards are established in some places (e.g., institutional investors participating in private funds). What is called “trailer fees” in one place is called “retrocession” somewhere else, what is called “soft dollars” is called “bundled brokerage” in other places, and so on. The CFA Institute, for example, is working on cost standards, trying to define for cost what GIPS does for performance reporting. I support this initiative to bring clarity where the same

| TER-OAK % = | ((Total Operating Cost) / (NAV)) * 100 |

Where there may be some justification for these differences in transaction and holding charges due to different regulatory requirements in different places, this practice is often something that has developed simply due to historical reasons.

Best practice is not a standardised term across asset classes, or across markets.

The interesting bit here is what has to be included in the Total Operating Cost, as this includes management fees, carried interest, administrative charges and operating expenses.
Importantly, this measure includes costs on not just the initial level, but on all levels of underlying investments. The TER-OAK is calculated once per fiscal year of the fund. This guideline is much stricter than the ones for investing into non-alternative assets, where the running cost of underlying companies would not be reported as cost. Notably, this has led to a peak in reported costs for private equity investments, and an outcry about the private equity investors due to a perception change.

How much of the alpha is being kept by the manager is after all the key figure when it comes to cost.

In all fairness, one needs to acknowledge that the cost for running an investment management firm has increased steadily over the years. Only better processes, software and automation will allow asset managers to make up for some of that cost. We would not be surprised to see asset managers eventually starting to offer their services on an open-book concept, reporting transparently on cost of production and agreeing to a margin on top as pressure increases on all fronts.

Thanks to unlimited computing power in the cloud and data becoming apparent to everyone, we will at some point see a fundamental shift in the relationship between consumers and providers in the asset management space. Technology will give consumers the power and transparency to understand and access unbundled building blocks and buy only what they need to assemble what they want. Consumers will have the ability to share findings, research and advice between each other and will be able to buy anything, anytime, anywhere, from anyone. Quantitative investment intelligence and cloud computing capacity becoming available to everyone will mark the dawn of information asymmetry in the financial services industry and put an end to decades of excessive profit extraction.

Asset owners, such as public pension plans, will no longer have to invest based on incomplete cost information and will be able to make decisions based on return-risk-cost relationships. Cost will gain popularity since it is the element best predicted, and will gain importance as the appreciation of its long-term compounding effect will continue to rise, not just in low return environments.

Better reporting on cost will help to create a new perspective on investments and their performance. Return, risk and cost are all important elements to judge upon such

People that are more interested in change than money are starting to come to power, much the opposite of what Wall Street traditionally represented. Tesla has demonstrated that building a car is a software problem. Politicians who once wanted to be photographed with bankers are now avoiding them. The signs of a paradigm shift are everywhere.

Like in nature, where every element is constantly seeking for balance, the very much unbalanced financial system of today’s world is slowly moving towards a balanced situation. The only ones left claiming this is not happening are asset managers trying to make sure their next years’ bonuses pay out, knowing that by the time things go south they will be retired at the age of 45.
In a continuing low-interest rate environment that stifles fixed income returns, pension funds are under increasing pressure to produce strong returns from other asset classes, including alternative assets like interests in hedge funds, private equity funds, and venture capital funds. As private funds themselves struggle for returns in a hyper-competitive market, pension funds have realized that “the most sure-fire way to enhance returns is to reduce fees.” As a result, public pension funds have begun to press private funds to provide more transparency of their fees. For example, legislation under consideration in California would require private equity fund managers, partnerships, portfolio companies, and affiliates to make the following disclosures, on a form prescribed by the public pension or retirement system, with respect to each limited partner agreement between the private equity fund and the public pension fund:

1. The fees and expenses that the retirement system pays directly to the private equity fund managers and partnerships subject to the agreement.

2. The fees and expenses not included in paragraph (1) that are paid from the private equity fund, including carried interest, to the private equity fund general partners and affiliates.

3. The fees and expenses paid by the private equity portfolio companies to the private equity fund general partners and affiliates.

What may be most surprising to observers of this heightened focus on fees is that such a request had to be made at all. Shouldn’t pension funds already know how much they are paying in fees to private funds? In fairness to pension funds, private funds have numerous ways of concealing fees.

For example, a private equity fund might hide fees through related-party transactions. As Yves Smith notes, “professionals have been presented as part of the private equity ‘team’ for marketing purposes, then being billed to the funds as independent consultants. That makes these consultants expenses to the investors, when the investors assumed those individuals were employees, and hence on the general partner’s dime.”

It is tempting to see high and hidden private fund fees as simply a deception by private funds on unsuspecting pension funds. While not attempting to justify private funds’ actions, this article offers a different perspective: high private fund fees are, in part, a result of poor governance by state legislators and pension funds themselves.

Underfunding Leads to Riskier Alpha Chasing
Greater use of alternative investments is correlated with higher unfunded liabilities. This connection should not be surprising—as pension funds are faced with millions or even billions in unfunded liabilities, they often look to higher-yielding (and, relatedly, higher-risk) assets to help make up the difference. Pension funds have pushed billions of dollars into alternative assets classes in recent years.

How pension funds came to be underfunded is a complicated analysis, involving changes in demographics, market fluctuations, and benefits changes. Most significantly, however, pension funds often faced large unfunded liabilities because of legislative malfeasance. One of the most egregious examples is Illinois, which was sued by the U.S. Securities & Exchange Commission for making material misrepresentations and omissions about its pension liabilities in its bond offerings. Among other things, the State of Illinois enacted a Statutory Funding Plan in 1994—designed to reduce a 90% funding ratio for each state pension system by 2045—that actually increased the unfunded liability of the state’s pension plans. Illinois used accounting methods that decreased the amounts required to be paid by the State, and failed to satisfy the already inadequate funding requirements of the Statutory Funding Plan. Notoriously, the State enacted pension holidays in 2006 and 2007, which lowered contributions by 56 and 45 percent, respectively.

While Illinois is an outlier in terms of both the inadequacy of its pension funding and...
the blatantly opportunistic way that the state's politicians pushed such heavy obligations onto future, rather than current, generations of voters, many other state and local plans have engaged in politically expedient accounting contortions over the years to kick the can down the road. Politics help explain the use of alternatives in that over the years politicians reduced burdens on current voters and reduced contributions in good times (with strong market performance) because it looked as if there would be no trouble meeting liabilities. In some cases politicians increased benefits as well. In bad times (like the Financial Crisis) states did not initially increase contributions. As a result, funds have to seek alpha to make up the difference, and have had to turn to private funds to make up the difference. This creates a sellers' market for private fund managers, in which they are able to charge higher fees to desperate pensions. Instead of having the ability to carefully scrutinize private fund investments, states are often in the position of having to take whatever they can get, especially since the debt markets are providing low returns as the Federal Reserve has kept interest rates artificially low.

Lack of Meaningful Oversight Through Litigation

Private pension plans, such as those sponsored by a corporation for its employees, are subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA provides participants, beneficiaries, fiduciaries, or the Department of Labor with causes of action for breach of fiduciary duty by plan officials. Enforcement within the Department of Labor, including enforcement of fiduciary duties, is managed by the Employment Benefit Security Administration (EBSA). Overall, the EBSA closed nearly 4,000 investigations of various types in 2014, and filed over 100 civil cases. Benefits advisors also refer matters to the EBSA for enforcement, with nearly 700 investigations opened as a result of referrals from advisors. Private ERISA litigation is also robust, as the cases are often certified as class actions and thus more attractive to plaintiffs' firms. In 2014, for example, numerous ERISA class actions produced multi-million dollar awards, including actions alleging that fiduciaries breached their duties by awarding themselves excessive fees and receiving improper benefits, failing to prudently and loyally manage assets, and, most popularly, continuing to invest in the company's own common stock when such an investment was not prudent.

By contrast, suits against state public fund officials are rare and even more rarely successful. Unlike private pension funds operating under ERISA, state pension laws do not provide for private causes of action, particularly for generalizable claims. Provided that they are well-calibrated, private rights of action provide an important check on fiduciary misbehavior. If state legislators believed that private causes of action would be valuable, they could provide for them in at least three different ways. First, states have the ability to waive sovereign immunity for public officials, thus opening the actions of the fiduciaries to scrutiny in state and, potentially, federal courts. Second, state legislatures could include in their pension fund legislation provisions providing for a cause of action for breach of fiduciary duties. Finally, a state may create a politically independent pension fund entity that would not clearly not be characterized as an “arm of the state” under sovereign immunity jurisprudence. Aside from the potential benefits that the threat of liability may have on trustee behavior, a politically independent governance structure would be less susceptible to political interference, politically-motivated investments, and pay-to-play schemes.

Even where a cause of action is available, a plan participant may have difficulty showing that a particular investment caused an injury to the participant. For example, in 2010 a Texas teacher sued the trustees of the Teachers Retirement system on behalf of all current and retired teachers, alleging imprudent investment in derivatives. The court found that the plaintiff lacked standing because she failed to allege a concrete, particularized injury as a result of the trustees’ conduct, although the fund may have decreased in value as a result of the trustees’ investment decisions, that decline had not yet resulted in decreased benefits to the plaintiff.

Suits against state plan officials are also rare because, as public officials, they are generally protected by sovereign immunity. In Ernst v. Rising, for example, a group of Michigan state court judges sued the officials of the government retirement system (including the State Treasurer and the members of the Michigan Judges Retirement Board), alleging that Detroit-area judges receive more favorable retirement benefits than other judges in the state. The central issue before the 6th Circuit panel was whether the retirement system was an “arm of the state,” and thus entitled to sovereign immunity under the Eleventh Amendment. The court noted that the members of the retirement systems board included elected public officials and members appointed by the governor with the advice and consent of the state senate. The board is compensated by the Michigan legislature, and takes an oath of office which is filed with Michigan Secretary of State. The boards activities are subject to the Michigan Administrative Procedures Act, and the state Department of Management and Budget is responsible for the budgeting, procurement, and related management functions of the retirement system. The retirement system funds are invested according to the state Public Employee Retirement System Investment Act, and the funds are subject to annual state reporting and auditing requirements. Perhaps most importantly, the court that the retirement system is funded, in part, by annual legislative appropriations and other public funds. The retirement thus functioned as an arm of the state, and was entitled to sovereign immunity.

The consequence of the few rulings on fiduciary duties is that, assuming that payment of high private fund fees results from a breach of either the duty of care—simply not knowing how much in fees a pension fund is paying to private funds—or the duty of loyalty—the awarding of investment mandates or payment of fees resulting from a conflicted transaction, there is no practical way for pension fund beneficiaries to remedy the breach of those duties. State legislators should consider enacting fiduciary

Most significantly, however, pension funds often faced large unfunded liabilities because of legislative malfeasance.
statutes that enable beneficiaries to bring meritorious claims for breaches of fiduciary duties, particularly for breaches of the duty of loyalty that may arise in how private fund mandates are awarded and compensated.

**Less Transparent Mandate Processes and Fees Provide a Mechanism for Rent-Seeking**

Corruption in public pension funds is not new or confined to transactions with private funds. However, the relative lack of transparency with the process by which private funds are awarded investment mandates, as well as how their generally high fees are calculated and paid, increases the risk that the fees could be used as a rent-collection mechanism.

The corruption with public funds may start with private fund rent-seeking, but as Fred S. McChesney noted, “[m]uch of what is popularly perceived as rent seeking by private interests is actually rent extraction by politicians.” The rents can flow both ways, and the common feature is that beneficiaries and taxpayers ultimately pay the costs of both.

Undertaken by hurdle rates, however, private fund managers may collect performance fees for relatively poor performance.

While the most egregious forms of corruption and rent-seeking appear through pay-for-play schemes, public fund officials and those to whom they are accountable should guard against more subtle forms of corruption that may influence private fund mandate decisions. Even if the decision to award a mandate is made by professional staff instead of a politician (as in a traditional pay-to-play scenario), in which the politician demands a campaign contribution in exchange for a mandate), the decision may still be improperly influenced by soft corruption like gratuitous training sessions in exotic locations, expensive dinners, golf outings and the like. Pension funds must put in place governance mechanisms to detect and help prevent all forms of corruption, and mandates and fees should be awarded in the best interests of the fund beneficiaries and the ultimate residual risk-bearers: the taxpayers.

**The Obscurity of Private Fund Fees and Asset Values Masks Return on Performance**

Private funds, as with all investment vehicles (including ordinary corporations), are subject to agency costs as the investors-principals have limited ability to monitor—or, in some cases, even understand—the investment processes of their private fund manager-agents. The very structure of private fund fees, in which a large part of the managers’ returns are derived from performance of the fund assets, thus giving the managers some “skin in the game,” is thought to provide an adequate check on these agency costs. Unless accompanied by hurdle rates, however, private fund managers may collect performance fees for relatively poor performance. As strong returns have become harder to achieve, some pension funds find themselves in the difficult position of having to expose their lack of diligence in negotiating for more appropriate fee arrangements.

Additionally, pension fund officials—as agents of beneficiaries and their sponsoring government and its taxpayers—may themselves have an incentive to provide limited information on asset values and performance to their beneficiaries as a means of avoiding criticism for poor performance. Coupled with the fact that many alternative investments do not have readily-ascertainable asset values, pension fund managers may devolve to a “Don’t ask, Don’t tell” policy for asset performance and for the fees charged for the performance.

**The Lack of Professionalization at Public Pension Funds is Penny Wise and Pound Foolish**

Finally, the very fact that state and local funds are political entities, and that their managers are state and local employees, contributes to higher fees. Politicians and pension funds (and, in many cases, the employee trustees who hire the managers and set the terms of management compensation) may balk at paying pension fund managers more than the normal state schedule provides, most skilled managers, however, will not accept salaries deeply below the market rates they could obtain in the private sector. Public funds are thus unable to professionalize and disintermediate many of their investment strategies. As a result, instead of paying in the hundreds of thousands for qualified market professionals, pension funds may pay many millions for external managers to access investments that could reasonably be made in house.

Creating and maintaining a capable in-house team is a deliberate, long-term process. Certainly, not every fund is capable of engaging in complicated strategies and in asset classes that require difficult-to-acquire specialist knowledge. However, many funds are paying high fees for even relatively simple strategies. Many funds are also too small to employ specialized asset managers. Notwithstanding these barriers, many funds are discovering that they can find, and have found, the talent to bring many strategies in-house, provided that they are willing to pay at levels that would entice a skilled manager. Often, the pay is significantly reduced from normal market rates, but also provides benefits that the private asset manager employment market cannot, such as living in a lower-cost community with a more advantageous work-life balance. Also, many pension funds are joining forces with other funds to save costs, and some pension funds in other countries, including the Ontario Municipal Employees Retirement System, has served as a “general partner” in investment vehicles in which other “limited partner” pension funds have invested.

**Conclusion**

Although private funds have been justifiably criticized for the “two-and-twenty” fee structure, public pension funds also deserve some blame. Poor pension fund governance contributes to high private fund fees in several ways. While efforts to encourage private fund fee transparency should continue, public pension funds can create more robust governance structures that will help limit inappropriately high private fund fees.


2 Ernst v. Rising, 427 F.3d 351 (6th Cir. 2005).
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.

Studies have estimated that public pension plans account for close to 30% of the aggregate capital invested in alternative assets.

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 plans investment. Valuing
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.
Recent scandals involving fraud, bribery, and corruption of public pension officials and other third parties have drawn the public eye towards the management of retirement assets. Individual and entity custodians, including pension boards of trustees, are charged with making investment and other decisions relating to pension funds. These funds hold more than three trillion dollars in assets. Until now, the guardians of these moneys have operated almost invisibly in the background of the public pension crisis.

In certain states like California, citizens entrusted the pension board with additional authority over fund management. Californians thought that increasing the responsibilities of these caretakers vis-à-vis the political branches was best to ensure the safety of their retirement assets. News headlines have confirmed, however, that the primary protectors of public pensions have been sleeping sentinels and worse.

The California Public Employees’ Retirement System (CalPERS), the largest pension plan in the country, recently disclosed that it could not track the fees that it pays to private equity firms. Governments should...reform existing law by removing any scienter requirement for fiduciary and third party liability as well as prohibiting dual roles of fiduciaries, if feasible, that may influence opportunism.

Yet, there appears to be no statewide comprehensive study and comparison of such duties. The laws are written in general terms, and those terms, even when imposing common duties, can differ state to state. Given the broad language and other variances in the expression of fiduciary obligations, the specific substantive standards and available remedies are not readily apparent. To date, the call for uniform standards of fiduciary responsibility in the management of public retirement systems across states has been unsuccessful. Generally, though, the legal structure derived from the fiduciary relation protects against carelessness, as well as tortious and criminal acts.

This note attempts to understand the role and responsibilities of public pension managers in light of the fiduciary principle that developed in the private law of equity. It argues that looking to the past can help inform present and future issues involving fiduciaries obligations in the public pension setting. The note uses the historic context to draw out a number of ideas and impressions to discuss more generally the fiduciary obligations of pension boards and other third-party trustees in managing public pension systems. Along these lines, it shows how private law principles relating to fiduciaries and the trust can be applied in a public law setting.

The inquiry should assist policy-makers and courts in creating, interpreting, and applying fiduciary standards and pension managers and financial intermediaries in complying with them. While the focus is on framing (rather than resolving) the problems faced by public pension plans, the analysis should inform the form and content of the duties themselves and help identify when they are breached. As an overview, the types of behaviors that may give rise to liability involve inadequate funding and disclosures as well as incurring unreasonable investment costs. Governments should also reform existing law by removing any scienter requirement for fiduciary and third party liability as well as prohibiting dual roles of fiduciaries, if feasible, that may influence opportunism.

**Understanding Fiduciary Law**

The obligations owed by the overseers of retirement assets to plan members and their beneficiaries are fixed, and function within the boundaries of a fiduciary relationship. When owners of property place it under the exclusive direction and control of others to manage for the owner’s benefit, the legal arrangement is typically called a trust. Thus, like all fiduciary relationships, the structure of the relation itself affords a special opportunity for the property manager (trustee) to exercise power and control over the property to the detriment of the owner’s funds (beneficiaries).

To prevent such dangers, the law imposes duties of undivided loyalty and reasonable care along with severe penalties for breach, including the disgorgement of unjust gains. More precisely, a trustee must act with}

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**Governments should...reform existing law by removing any scienter requirement for fiduciary and third party liability as well as prohibiting dual roles of fiduciaries, if feasible, that may influence opportunism.**
by trustees and other fiduciaries to their beneficiaries. One area that has absorbed and adapted ancient fiduciary law is the management of public pensions. But there has been few attempts to track the transformation of fiduciary principles, a major branch of private law, into the public realm.

As mentioned above, governments clothe pension managers, especially boards and others undertaking a managerial role with respect to pension assets, with fiduciary status. The obligations imposed on the board and third party managers include duties of undivided loyalty and reasonable care at the core of fiduciary law. The fiduciary framework is critical to ensuring that pension plans sponsored by government employers contain sufficient monies to provide expected and needed benefits. The next section describes the foundation of the fiduciary principle in equity as a way of analyzing the scope and content of fiduciary duties, as well as the import of fiduciary relations, in the public pension field.

Analyzing Fiduciary Obligations In Equity
The study of the traditional equitable environment where fiduciary relations have arisen is a way of looking at the problem in public pension systems. The evaluation should help comprehend challenges involving the obligations of pension boards and other fiduciaries to their fund beneficiaries.

The fiduciary principle is a product of equity. To be sure, fiduciary law is considered the “heart of equity.” And the trust, especially, is acknowledged as one of equity’s most celebrated creations. Given its antecedents in equity jurisprudence, state courts have found the judge-made law of equity germane to understanding the role and responsibilities of public pension trustees. Equitable ideas affect how judges interpret positive law as well as in how they understand legislative silence.

There are, of course, other contexts for comparison. Additional perspectives would provide a multidimensional view of the fiduciary issue for public pensions. For example, the regulation of private pensions and the duties of fiduciaries under the Employee Retirement Income Security Act (ERISA) would be an obvious choice for analysis. Yet even ERISA is supposed to be based on the equitable law of trusts. Thus, while this note looks through only one lens, it is an important one. The idea is to advance a theoretical framework for thinking about the role of equity in the fiduciary law of government retirement funds. An equitable model of decision-making, along with its development of ethically-based substantive standards should inform the way that fiduciary principles and doctrines are created and interpreted in safeguarding public retirement systems.

The merger of law and equity, however, has obscured the evolution of equity. The removal of equity as a standard course in the law school curriculum has aggravated the problem. Scholarship on equity waned in the wake of these phenomena. So courts have lost sight of certain equitable doctrines along with the reasons for their existence. In this regard, Roscoe Pound’s prediction at the turn of the twentieth century has come true. He feared what would become of equity without a holistic and trans-substance approach to its study. Courts have carried equitable principles forward in their cases. Yet many have ceased understanding them. Even trust law has been a victim of historical incomprehension and molded by mistakes concerning the classification of equitable precepts.

Analyzing the common criteria found in fiduciary relationships from an equitable perspective helps us to appreciate that relation in the public pension context. It will correspondingly inform the setting of substantive standards for trustee fiduciaries. There are three criteria comprising the fiduciary relation in private law: disproportionate hardship, hidden action, and vulnerability. These conditions separately concerned the early Court of Chancery. The considerations collate in the fiduciary relationship. These collective concerns explain why the relationship is an enhanced form of equity.

If fiduciary law is a “beefed up” version of equity, then the public pension trust is the Big Mac. As described below, the circumstances are more pronounced in the public pension scenario.

First, the demise of public pension systems will cause severe hardship. Failing to provide the promised retirement benefits when due results in financial devastation to pension plan participants and their families or the very real possibility of such destitution. Government workers depend on pension assets to secure their retirement. Many workers and retirees do not have access to Social Security should their retirement plans fail. In fact, certain groups of employees in the worst funded pensions lack this federal safety net. Moreover, unlike pensions offered by private companies, government plans do not have either oversight

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by the federal government or an insurance program to provide benefits if the plan fails. Plan participants, presumably like most Americans, also lack other savings to survive through old age.

Second, in terms of hidden action, public pension plans are shrouded in secrecy. For more than a decade now, academics and activists have been calling for increased transparency to plan participants and the public. Part of the problem is the absence of uniform standards to compare the financial status of pension plans between various public systems. Another issue involves overly optimistic actuarial assumptions that minimize the pension funding deficit. Without an effective way to evaluate their plans, participants do not know the security of their employer’s retirement promises.

Third, public pension plan participants are extremely vulnerable. In comparison to other fiduciary relationships such as those found in corporate law, beneficiaries are not necessarily financially literate. Even if they were, participants are unable to estimate the risk to their expected retirement savings given
the absence of transparency already discussed. Besides, few will be able to do much about it. Assuming it is even possible for employees to uproot and transplant themselves in another state with equivalent job prospects and a retirement system that is not in jeopardy, it is not practical. Many pension plans have built in deterrents to prevent employees from leaving their employment. Employees may lose employer contributions if they have not satisfied the terms of service. As a result, the mobility risk makes public pension participants more exposed than workers in the private sector.

Also, in addition to the three criteria identified above regarding private fiduciary status, there are another concern at the historic core of equity that is relevant to the fiduciary principle in the public pension setting. This matter is not necessarily present in private trusts or other fiduciary relations like those found in corporate law. Yet this consideration is paramount to understanding the way that fiduciary law can be reimagined and transformed in a public law location. More specifically, the tradition of equity is sensitive to the public interest. Justice Joseph Story expounded on equity's association with public policy. He explained how equity intervened when there was “tendency to violate the public confidence or injure the public interest.” The purpose of equity's interference in the public interest was to shut off the inducement to perpetrate a wrong in the first place. It was not simply to remedy the wrong after it had been done.

State courts rely on public policy in the application and modification of equitable principles. The Supreme Court of the United States has also imbued modern equity law with the public interest. The public interest doctrine allows judges to expand or contract equitable doctrines in interpreting statutes, including those aimed at preventing the unconscientious abuse of rights at the foundation of fiduciary law.

Public policy should be equally important in defining the fiduciary relation between those managing public pension plans and their beneficiaries. Government retirement systems operate in a political environment where pressure is exerted on and by plan fiduciaries. By the same token, what becomes of the pension plans has micro and macro-economic effects. The demise of public retirement systems will extend beyond the financial deprivation of the individual pension plan participants and their families. Failed (and failing) pensions will adversely impact all state citizens. Taxpayers will share the burden of plan insolvency when states raise taxes to cover pensions. Given the pervasiveness of the public pension problem across the country, individuals seeking to move to another state to avoid additional tax liabilities will likely encounter similar issues when they arrive.

For state governments, the unsustainability of government pensions will cause higher funding costs for public employers sponsoring the plans, higher general borrowing costs for states and municipalities with insufficiency funded plans, and ultimately higher borrowing costs for states regardless of how adequately their benefit plans are funded. State services, such as money for schools, will also suffer repercussions where paying down the pension debt will curtail them. The dire financial situation in several states, particularly California, led one analyst to conclude that “bankruptcy or the complete cessation of all state functions save paying benefits to retirees is not unthinkble."

The pension deficit is detrimental to the shared concerns of state citizens in another manner as well. Government workers counting on their pensions play an important social and economic role in the welfare of the respective states. They have careers in education and public safety and include teachers, police, firefighters, and first-responders. Thus, pension cuts will likely result in a lower quality of applicants for some of the nation's most important jobs.

The federal government will not be immune from the looming financial disaster either. It certainly recognizes that retirement savings plans are a driver of the national economy. Even without a federal bailout, the nation as a whole will be adversely impacted as government workers with little personal savings are forced into the welfare system. Consequently, alarming actuarial deficits adversely impact the economic welfare of the entire country and everyone within it.

In summary, equity's attention to the public interest dramatizes fiduciary responsibilities in the public pension field. The underlying indica of fiduciary status, understood against the background law of equity, helps to explain the content of fiduciary duties and their seemingly stringent remedies. In fact, a fuller appreciation of the fiduciary relation and its application in government retirement systems can be realized by tracing it to the origins of equity jurisdiction.

Sir Thomas More, the first Lord Chancellor drawn from the ranks of the common lawyer, is said to have grounded the authority of the Chancery in fraud, accident, and things of confidence. These are the three general circumstances that moved the conscience of the Chancellor. Confidence is often connected directly to the fiduciary relationship and particularly the trust. The idea of accident includes relief from forfeiture which motivates the fiduciary relation. Equitable fraud, furthermore, is more expansive than common law fraud. The object was to deter the commission of the wrong and safeguard the public interest. Therefore, equity extended the ancient maxim that one should not profit from their own wrong to include situations where it is hard to tell if one was profiting from their own wrong. Activities regarded as fraudulent in equity were done without any intention to deceive or cheat. The state of mind was simply irrelevant. In certain situations, equity acted on simple negligence. In this manner, equitable doctrines operated as a means of preventative justice and corrective justice. These underlying notions of ancient equity align with the development of fiduciary doctrine and the trust. Such situations included a fiduciary pursuing their own interest. Similar to other fiduciary relations, it is the structure of the relationship and especially the discretion afforded to the trustee, which gives the trustee a unique ability to harm the beneficiary. Hence, the primary duties of care and undivided loyalty that arise...
out of this discretionary relationship of great dependence are quite broad.

To be sure, traditional trust law discourages self-interested fiduciaries. An undisclosed conflict of interest – regardless of harm – often lead to a presumption against the fiduciary and per se liability and disgorgement. Equity was overinclusive and strikes down all disloyal acts of the structure of the relationship and the interests at stake. Again, equitable doctrines were derived in the service of safeguarding against strategic behavior. Fiduciary law is even broader than general equity because of the sustained problem of opportunism. But the law is also limited due to the fact that personal liability only attaches to those who choose to become a fiduciary. Third party claims are also restricted to those with knowledge. As such, states should not elevate the criteria against actuaries, accountants, pension advisors, or anyone else, who aids and abets fiduciary breaches by pension boards to require specific intent. In fact, states should consider expanding by legislation or adjudication who may become a fiduciary of public pensions beyond retirement boards or other designated entities.

Reforming Fiduciary Law
An equitable outlook is admittedly incomplete. Because the fiduciary relation is an outgrowth of equitable tradition, however, the cleansing power of equity should be a criterion of comparison. There are myriad possible ways that pension plan actors can violate their obligations by acting wrongfully with respect to the corpus of the trust. This section makes no attempt at completeness in evaluating individual responsibility and its limits in the public pension situation. The subject is so large that only a few instances of fiduciary responsibility in the public pension scenario will be examined.

Based on traditional equitable principles, government retirement systems should remove the requirement of intent to trigger fiduciary liability. In Wyoming, for example, the legislature amended the statute to “make clear” that board members are not personally liable for acting within the scope of their responsibilities unless their conduct rises to the level of “willful misconduct, intentional torts or illegal acts.” While fiduciary law may seem far-reaching, it is necessary in light

of its history. The reasons behind the rules should serve as guide. What is more, if states are going to regulate the fiduciary framework in a way that alters its equitable tradition, they should consider adding more, rather than less, protection from malfeasance in the management of government retirement funds.

The next section turns to how the fiduciary relationship should be structured in the setting of government retirement systems.

Fiduciary law should be understood in its present form by the concerns that provoked it in preventing opportunism.

rather than trying to distinguish the harmful from the unharful by permitting a trustee to justify the representation of the two competing interests.

In this vein, fiduciaries are also liable without bad faith or fraud. Even good faith is not a defense. A recognized authority on traditional equity, former Australian High Court Justice William Gummow, advises that “[t]hose who believe it unfair or too stringent to hold a fiduciary liability for unauthorized profits without an intent to deceive or sharp practice misunderstands the Chancellors’ approach in these matters.” Equity took an extreme attitude to the problem strategic behavior.

Accordingly, the derivation of the fiduciary principle and its connection to the grounds for equitable intervention serves as a warning to those who would restrict the application of fiduciary law. Fiduciary law should be understood in its present form by the concerns that provoked it in preventing opportunism. Moreover, equity’s association with the public interest, along with its assistance of the vulnerable and its regard for relieving against forfeiture found in the fiduciary relation, should caution against diluting the traditional duties of trustees and other fiduciaries in managing critical retirement assets, or in circumscribing the remedies available to beneficiaries in the event of breach. It bears repeating that the potential for political interference is another reason to keep the fiduciary duties of the pension trustees strong. Again, the potential damage from public pension mismanagement or self-dealing are particularly egregious due to extreme hardship, vulnerability, and hidden action.

Consider equity’s approach to the duty of loyalty, state governments should consider banning dual roles of fiduciaries that may affect their judgment and promote opportunism. At minimum, there should be a process in place where prospective and existing fiduciaries are vetted to ensure that no conflicts of interest exist (or those that exist are acceptable). History teaches that whenever a fiduciary can benefit at the expense of plan participants and beneficiaries, there will be an incentive for opportunistic behavior. Recall that the purposes of the “no profit” and “no conflict” rules of fiduciary law is to preclude the fiduciary from being influenced by considerations of personal interest and from misusing the position for personal advantage. State governments should additionally disallow fiduciaries from waiving or otherwise limiting their obligations as is often found in corporate law.

A related issue involving the duty to act in the sole interest of the plan beneficiaries is when the retirement board, by various means, wrongfully reduces the employer’s contribution. In California, at least one lower court has granted retirement boards and associations statutory immunity from such claims seeking damages to the fund. The interplay between the law of pension governance and government immunity should be reconsidered or the waiver of immunity for fiduciary claims made clear.

2016 PRIVATE FUND REPORT: Public Pension Plans and Private Funds - Common Goals, Conflicting Interests
Fiduciary breaches often occur in the absence of fraud and corruption. Examples abound of neglect, inadvertence, or incompetence. As an initial matter, the standard of review of a board’s discretionary decisions are an open question in some states. Courts (or legislatures) should refrain from adopting the deferential business judgment rule found in the law of corporate governance.

With respect to specific fiduciary violations, state pension funds nationwide are beginning to examine more closely how much they are paying Wall Street to manage their investments. These fees can exceed more than a billion dollars and result in a substantial weight on returns. CalPERS’ failure to account for some of its investment fees is an especially clear violation of fiduciary obligations. By analogy, a private fiduciary’s failure to monitor and evaluate investment costs has recently been held to be a breach under ERISA. Moreover, it makes sense that a reasonably prudent fiduciary would not only ascertain the fees by Wall Street, but also to check them against actual fees incurred. Further, to keep investment expenses reasonable, the fiduciary obligation should require trustees to consolidate fund management to create economies of scale.

Perhaps a more contentious issue on the horizon, but one that should also result in fiduciary liability, is the failure to accurately evaluate liabilities leading to inadequate funding and disclosure. The undervaluation of the pension deficit is due in part to an unsuitable discount rate. There is a growing consensus among economists and other scholars that private sector actuarial standards should be used to provide an accurate representation of the default risk. This would mean valuing pension liabilities according to the likelihood of payment, rather than the return expected on pension assets. Overstating pension health lowers necessary contributions to the plan. In a defined benefit plan paradigm, government employers promise to contribute to the plan at whatever levels are necessary to fund the plan. Funding levels affect both benefit security and the ability to receive enhanced benefits. There are no legally mandated minimum funding levels like that for private sector pensions so the criteria for determining funding are even more important for public sector pensions. No doubt pension actuaries, in response, will rely on the fact that the discount rate is an industry standard. Yet Cardozo captured the elevated ethical standards of equity and fiduciary law when he announced that fiduciaries are “kept at a level higher than that trodden by the crowd.” Fiduciary integrity in assigning the correct rate of return on plan assets will lead to the financial integrity of government pensions.

Finally, equitable defenses may limit the liability of fiduciaries. This could possibly occur if an alleged breach of duty results from a decision of the board with pension plan participants serving on it. A majority of boards are comprised of some active and retired participants of the retirement system who are elected by their fellow participants. The agreement by participant board members may be attributed to all pension plan participants and raises issues of acquiescence and estoppel. In the application of equitable defenses, however, judges have residual discretion to refuse such defenses under the circumstances of the case and the policies at stake.

Based on the foregoing, an equitable perspective suggests that, if anything, the law should aspire to a stronger legal bond between public pension trustees and beneficiaries than exists under extant law. To the extent that high obligations effect fiduciary behavior, such as turning over the in-house management of assets to outside investment managers or deterring board membership by those less financially astute, such changes can only benefit public pension systems.

In conclusion, legions of Americans working in the public sector are at risk of losing their pensions. Government plans have failed to build and maintain sufficient asset reserves to meet their benefit commitments. In California and other states, some blame will attach to those who manage and maintain these funds. Holding fiduciaries charged with protecting plan assets to high standards and individual accountability is an important means of maintaining these important streams of retirement income.

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