**Public Pension Management and Asset Investment Review Commission (PPMAIRC)**

**Data Request: SERS-004**

**Date submitted: July 12, 2018**

**Date for response: July 2, 2018**

**Fee transparency**

3. Please describe the system’s current practices on reporting fees to the Board and the public.

For all investment managers/opportunities, the Board is asked to consider, the fee structure of the manager/opportunity is included in the material provided to each Board member before the manager is interviewed. Total monthly fees paid to investment managers are reported to the Board in the Statement of Changes in Fiduciary Net Position. The annual fees and expenses paid to each manager/fund in which SERS is invested are reported in SERS’ annual budget book, and in the aggregate in SERS’ Comprehensive Annual Financial Report (“CAFR”), which are available to the public on SERS’ website, www. SERS.pa.gov.

The term “fee” in this inquiry is not defined. Unlike index strategies, where fees are clearly defined, static and charged on a quarterly basis, “fees” for private equity/real estate partnerships are more complex, especially considering the multi-phase temporal structure of payments to the General Partner and how those payments are ultimately refunded to SERS as a limited partner. During the investment stage of the partnership, each limited partner is charged its pro rata share of (i) the investment costs of the Fund’s underlying portfolio investments, (ii) a management fee paid quarterly to the general partner, and (iii) partnership expenses to run the Fund, all of which comes out of their capital commitments. In most cases, once income is realized by the Fund, that income is distributed 100% to the limited partners until both of the following conditions are satisfied: (A) a complete return of all capital contributions, including all costs, fees and expenses; and (B) a preferred return on capital commitments, typically 8%-10% compounded annually. Only after these conditions have been completely satisfied are any additional profits shared between the limited partners and the general partner (typically split by 4 out of 5 excess dollars going to the limited partners, and 1 out of 5 excess dollars going to the general partner). As a large majority of SERS’ partnership investments have not only completely returned all capital contributions, but also realized excess profits over the life of the Funds, 100% of management fees initially paid to the general partners of such Funds were fully reimbursed.

Therefore, complete and accurate reporting and analysis can only be done in the context of returns net of fees, which can only be calculated at the end of the life of an investment, rather than pointing to an arbitrary point on the J curve for a cost analysis. While “fees” are reported on the templates provided in the response to the inquiry in #6 below in all cases, and while “fees” are generally reported in SERS’ budget materials and CAFR, the ultimate “fees” that SERS actually pays as a limited partner in a partnership are not, and cannot be, accurately known until the completion of the Partnership, and in most cases, are $0.

In SERS’ non-partnership passive investment strategies, as well as some comingled active strategies, the fees are based on a percentage of portfolio assets under management.  Often, the rate of the fees is reduced in a tiered structure (i.e., each higher tier of funds under management carries a lower fee percentage that is paid to the manager).  This fee structure is usually set-up as follows: “The first $X under management is charged a fee of AA%; the next $XX-$XXX under management is charged a fee of BB%; etc.”  As this fee structure is based solely on assets under management, and is not performance-based, fees are paid regardless of performance of the manager.

Other comingled active strategies have a fee structure similar to what is described above, but with a reduced base fee coupled with a performance incentive fee.  This structure rewards the active manager for surpassing established benchmarks for the portfolio it is managing.  This additional performance-based component of the management fee is typically expressed as “reference benchmark plus XXX basis points [of over performance beyond the benchmark] earns an additional Y%”.  If the manager does not exceed the benchmark by the amount stated, no incentive fee is earned, even if the manager is able to earn a return.  These fee structures often have an upper level asset floor set every evaluation period where applicable, so that any losses in an investment strategy must be recouped before an incentive fee is eligible to be earned.

5. Please provide a copy of the applicable offering document(s)/side letter(s)/investment management agreement(s) outlining the terms of the investment arrangement for each investment made within the past five years.

With regard to the request to provide applicable offering documents, there are restrictions by the Securities and Exchange Commission on who is allowed to view the offer of unregistered securities. See the Securities Act of 1933, as well as Rule 506 of Regulation D, definition of Accredited Investor (https://www.sec.gov/fast-answers/answers-rule506htm.html). Federal law requires the general partners to keep their offering materials and constituent documents confidential, or they risk losing certain registration exemptions that are vital to their business model (including avoiding federal restrictions on the amount of capital they can raise). Because SERS expects that the general partners will not want to risk being required to register securities under the regulations, it is anticipated that disclosure could result in SERS being (i) ejected from the existing investment, or (ii) sued for breach of contract. As such, this information is not permitted to be released to unauthorized individuals.

As to the request for side letters, the contract documents for each of SERS’ limited partnership investments, including the side letters themselves, expressly require the Board to hold sensitive investment or financial information in strict confidence (including the Limited Partnership Agreements and the side letters that modify them), absent receipt of the prior consent from a general partner to disclose. Such documents further require that the Board utilize the exemptions set forth in the Pennsylvania Right-to-Know Law, 65 P.S. §§67.101-67-67.3104, and the Retirement Code, 71 Pa. C.S. §5902(e), as well as to notify the general partners of any potential disclosure in breach of such agreements in advance so that they may seek injunctive relief in the form of a court order blocking the potential disclosure. Given this, SERS and its general partners have agreed that only certain partnership terms and information may be released to the public (i.e., redacted Subscription Agreements[[1]](#footnote-2), which are uploaded onto the PA Treasury Department’s website; information contained in the CAFR). Please see attached copies of redacted Subscription Agreements for each investment during the applicable period (file names beginning with 004-5).

Please see attached copies of redacted Investment Management Agreements for each investment during the applicable period (file names beginning with 004-5).

The following items are redacted in Subscription Agreements prior to their public posting on the Treasury Department’s website: (i) SERS Banking/Wiring/Delivery instructions; (ii) SERS Correspondence Charts; and (iii) SERS Federal ID Number (TIN), as such information is exempt from disclosure under Section 708 of the Right-to-Know Law, 65 P.S. §§67.101-67.3104.

6. Please provide a copy of the most recent invoice showing the fee calculation (for private equity/real estate/infrastructure/etc., please additionally provide a copy of the capital statement showing the carry calculation and a copy of the ILPA report) for each investment made within the past five years. Please see the attached templates marked 6A, 6B and 6C (file names beginning with 004-6). 6A and 6B were the templates being used by SERS, as requested in each of its side letters, before SERS adopted the ILPA standard. Template 6C is the ILPA standard template now being requested by SERS in its side letters. While SERS may not receive the information in the form of the template requested, SERS receives the information contained within the template in varying formats on a partnership-to-partnership basis. Actual reports issued by individual partnerships and managers are confidential as described more completely in the response to the inquiry in #5 above.

**Financial Consultants / Advisors**

1. Please identify all consultants and advisors used by the system, the services they provide, the managers they oversee, the date of and a copy of their last presentation to the system, and their costs.

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| Consultant Name | Description of Services | 2017 Fee |
| RVK, Inc. | General Investment consultant which advises the Board and SERS’ investment staff on investment related matters including but not limited to the biennial strategic plan, asset allocation matters, assists in performing due diligence on public market managers, calculates, prepares and presents quarterly performance reports. Please see the attached presentation dated March 31, 2018. | $707,000 |
| StepStone Group LLC | Private Equity consultant which advises the Board and SERS’ investment staff on investment related matters relating to private equity investments including but not limited to performing continuous due diligence on prospective private equity funds, recommend top-tier private equity funds, provide on at least a semi-annual basis a performance review of SERS’ private equity portfolio. StepStone also provides back-office support for SERS’ private market managers. Please see the attached presentation dated June 30 2017.2 | $1,975,000 |
| NEPC, LLC | Real Estate consultant which advises the Board and SERS’ investment staff on investment related matters relating to real estate investments such as but not limited to performing continuous due diligence on prospective real estate related opportunities, recommend top-tier real estate and real estate related investments, provide on at least a semi-annual basis a performance review of SERS’ real estate portfolio. Please see the attached presentation dated January 31, 2018.3 | $291,000 |
| GCM Customized Fund Investment Group | Assist in the monitoring of some of SERS’ non-core private equity funds/investments.4 | $210,000 |
| Abel Noser Corporation | Provides post trade cost analysis on SERS’ public market separate account managers to ensure execution prices received by managers and brokers, as well as all commissions paid are in line with industry and peer standards. Please see the attached 4 Trade Cost Analysis reports dated Q1 2018. | $53,000 |
| Institutional Shareholder Services Inc. | Proxy voting agent which votes SERS’ shares consistent with SERS’ U.S. and Non-U.S. proxy voting policies. Please see the attached Q1 2018 report. | $93,000 |
| Korn Ferry Hay Group, Inc. | Provides on-going pension actuarial services to SERS that includes but is not limited to annual valuations of the liabilities and recommended contributions, periodic analysis of experience for use in revising valuation assumptions, annual benefit cash flow projections and on-going advice and analysis on proposed legislation. Please see the two attached 2017 actuarial reports. | $443,000 |

2 The third page of the introduction section, and pages 2-8, 11-13, and 43-49 were either partially or fully redacted because they contain confidential proprietary information and trade secrets.  65 P.S. §67.708(b)(11). Page 16 was redacted because the records reflect internal, predecisional deliberations of SERS’ employees, which are exempt from access under the RTKL.  See 65 P.S. § 67.708 (b)(10)(i)(A).  Pages 2 and 10-12 are partially redacted for the additional reason that disclosure of that record would have a substantial detrimental impact on the value of the investment or would otherwise cause substantial competitive harm to the party who provided it to SERS, or would be a breach of the fiduciary duty set forth in the Retirement Code.  71 Pa. C.S. § 5902(e)(2)(i)-(iii).

Page 9 and pages 20-31 and 33-42 were redacted because the records are exempt from disclosure by Section 5902(e) of the State Employees’ Retirement Code, 71 Pa. C.S. §§ 5101-5957 (“Retirement Code”).  SERS was able to obtain such information only upon agreeing to maintain its confidentiality; and disclosure of such information would cause substantial competitive harm to the party who provided it to SERS and would have a substantial detrimental impact on the value of the related investment.  71 Pa. C.S. § 5902(e)(2)(i)–(iii).  Consequently, disclosure of those records would be a breach of the fiduciary duty set forth in the Retirement Code.  71 Pa. C.S. § 5902(e)(2)(iii).  Therefore, the records are excluded from the RTKL’s definition of “public record.”  See 65 P.S. § 67.102 (definition of “public record”); see also Bains v. State Employees’ Retirement System, Pennsylvania Office of Open Records Docket No. AP 2015-2667.  These records are denied for the additional reason that they contain confidential proprietary information and trade secrets.  65 P.S. §67.708(b)(11).  The value of that confidential information is that it is not generally known or readily ascertainable by proper means; and its disclosure would cause substantial competitive harm to the parties from whom SERS obtained it.  Therefore, all reasonable efforts are taken to maintain its secrecy.  Id.

3 The records on pages 8, 15, and 17 of the NEPC Real Estate Semi-Annual Performance Review as of 06-30-17 were redacted because they contain confidential proprietary information and trade secrets.  65 P.S. §67.708(b)(11). Page 16 was redacted because the records reflect internal, predecisional deliberations of SERS’ employees, which are exempt from access under the RTKL.  See 65 P.S. § 67.708 (b)(10)(i)(A). The records on pages 20-22 were redacted because the records are exempt from disclosure by Section 5902(e) of the Retirement Code, 71 Pa. C.S. §§ 5101-5957.  SERS was able to obtain such information only upon agreeing to maintain its confidentiality; and disclosure of such information would cause substantial competitive harm to the party who provided it to SERS and would have a substantial detrimental impact on the value of the related investment.  71 Pa. C.S. § 5902(e)(2)(i)–(iii).  Consequently, disclosure of those records would be a breach of the fiduciary duty set forth in the Retirement Code.  71 Pa. C.S. § 5902(e)(2)(iii).  Therefore, the records are excluded from the RTKL’s definition of “public record.”  See 65 P.S. § 67.102 (definition of “public record”); see also Bains v. State Employees’ Retirement System, Pennsylvania Office of Open Records Docket No. AP 2015-2667.  These records are denied for the additional reason that they contain confidential proprietary information and trade secrets.  65 P.S. §67.708(b)(11).  The value of that confidential information is that it is not generally known or readily ascertainable by proper means; and its disclosure would cause substantial competitive harm to the parties from whom SERS obtained it.  Therefore, all reasonable efforts are taken to maintain its secrecy.  Id.

4 GCM’s report cannot be disclosed, as it contains confidential proprietary information and trade secrets.  See RTKL (65 P.S. §67.708(b)(11)).

1. For each investment manager, please provide the quartile comparison of performance for a manager that was presented to the Board at the time of hiring, and the current equivalent quartile comparison. An investment recommendation memo is provided to the SERS Board by the Investment Office and the applicable consultant whenever the Board is requested to consider making an investment in a private market manager fund. Included in the investment recommendation memo is the performance quartile ranking of the private market managers’ previous funds. However, due to the confidential/trade secret nature of the written materials presented to the Board, SERS is contractually prohibited from disclosing them (or the proprietary methodology utilized by SERS’ consultants to produce such performance rankings) to the public. Further, confidential and proprietary information is otherwise exempt from disclosure under the Right-to-Know Law (see 65 P.S. §67.708(b)(11)), as disclosure of such information would cause substantial competitive harm to the party who provided it to SERS, and would have a substantial detrimental impact on the value of the related investment and/or investment relationship. See 71 Pa. C.S. § 5902(e)(2)(i)–(iii). Consequently, disclosure of the materials presented to the Board would be a breach of the fiduciary duty set forth in the Retirement Code. See 71 Pa. C.S. § 5902(e)(2)(iii).

1. [↑](#footnote-ref-2)