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The Rise and Rise of Public Pensions in Private Equity

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By Chris Montgomery
Special Counsel | Fund Finance

Two recent news items got me thinking about public pensions, their continued rise in private equity and their sovereign status. The first news item, already widely covered in the media, is the announcement by the Securities and Exchange Commission (SEC) of new rules requiring (among other things) enhanced periodic disclosure for fees, expenses and performance (including, possibly, reporting performance with and without the use of fund financing) (*see, e.g.,* "**The SEC's Private Market Takeover**" in *The Wall Street Journal*). *The Wall Street Journal*, in its unfavorable write-up, described the SEC as dancing "to the public pension tune," and *The Washington Post*, taking a more favorable view, noted that part of the motivation for the SEC is that "many retirees depend on the pensions that are invested in" private markets. (For *The Washington Post's* write-up, *see* "**SEC proposes basic rules for private equity, hedge funds**"). What's notable is both the media supporters and the media detractors have focused on public pensions. The media coverage therefore seems to imply that public pensions are partly driving this regulatory change.

I am not so sure, since that would be in conflict with the second news item, which is the increasing deployment of public pension money in private equity as a long-term secular trend. According to Prequin, the average public pension allocation has increased from just above 6% in 2010 to close to 9% in 2021. In percentage terms, that's a huge increase and a vote of confidence in private markets. (*See* "**Retirement Funds Bet Bigger on Private Equity**" in *The Wall Street Journal*). It's also worth remembering that these percentages are of massive holdings. Some of the biggest players have allocated an even larger exposure: the California Public Employees' Retirement System voted to increase its private equity allocation to 13% over the next four years, which equals roughly $25 billion dollars of additional demand from a single investor. With the increased demand from public pensions for private equity products, we have seen a greater internal focus on questions of sovereign immunity and its associated waivers at banks and sponsors. (I would also forecast an ever-increasing number of SMA facilities with public pensions, especially in the latter half of this year.)

What we can say for certain is that public pension money has confidence in private equity returns (now more than ever), but at least some voices in the media think that the current push for greater regulation and disclosure comes from those same investors. It's possible both of these statements are true, but it seems more likely that we need to be skeptical of the claim that public pensions are the source of the SEC's recently proposed rules. It is just as probable that the SEC was going to focus on private markets anyway, regardless of the actions or concerns of public pensions. Nonetheless, the greater exposure to sovereign-status public pensions and the greater focus on private market regulation are at least correlated. Both of these trends have been major stories of the past year, and each trend features sovereign-status public pensions as key actors.

In any case, there is some concern that increased public pension money may expose sponsors and funds to greater sovereign immunity risk and also that increased public pension participation in these markets may lead to greater regulation. The first concern, sovereign immunity, can be addressed succinctly: the exceptions and waivers to sovereign immunity which we see from many states and their agencies (*i.e.*, their public pensions) remain robust. The second concern, which is that the increased participation of public pensions in private equity is causing greater regulation, is likely unfounded based on the facts we can observe.

Two Sides of the Sovereign Coin

The current British sovereign gold coin features the face of Elizabeth II on the obverse (front) and St. George slaying his dragon on the reverse. It's the perfect embodiment of these two ideas: Elizabeth as sovereign looks serenely into the distance, but there is also the myth on the back: real or imagined dragons need slaying. (Certainly the proposed SEC rules are the sword, but I will let the reader decide who is St. George and who is the dragon.)

Side One: The Queen Can Do No Wrong

Fund Finance Friday has covered sovereign immunity before in detail. (*See* "**Immunity Unlikely**" by Wes Misson, which offers an excellent overview of the issue and the sponsor/lender protections available via various waivers.) The short version is that public pensions enjoy sovereign status under the Eleventh Amendment of the United States Constitution (though they are only one category of investors that may enjoy sovereign status, as foreign governments (or their agencies), supra-national organizations and Native American tribes may have sovereign rights in federal or state courts as well). However, the sovereign immunity of state public pensions is often waived when the state agency is entering into a commercial contract. This waiver may take the form of statutory or constitutional waivers (37 such states as of 2021) or common law waivers (12 such states as of 2021). In addition, we often see a public pension investor reserve its Eleventh Amendment status in a side letter, but will also have what lawyers call "mitigating language," which essentially states that the reservation of sovereign immunity does not in any way limit the investor's obligations to fund capital calls. Sovereign immunity is therefore often mitigated, and counsel perform careful due diligence to identify the risk and assess the mitigations available given the jurisdiction in question and the language in the side letter and limited partnership agreement. When such mitigants exist, the sovereign has a serene gaze indeed.

Side Two: St. George vs. the Dragon

Then there's the dragon, real or imagined. This is the media narrative that increased regulation of private markets is coming and that it's in part driven by public pension investors. It's easy for some in the media to make that connection − according to *The Wall Street Journal* article, public pensions count for 35% of all private equity capital, so it is tempting to connect the correlation of increased public pension money with increased regulation and to infer a causation. I would be skeptical of that claim. Pension funds have been and continue to be extraordinary partners with their private equity sponsors. The largest pension funds are not just investors, but co-investors, joint-venturers and some are even exploring the option of becoming liquidity providers to select sponsors.

Conclusion

We have often heard or read that "private markets are the new public markets." A cynic could now say "private regulations are the new public regulations." While the current composition of the SEC certainly suggests a greater role for regulation in private markets, it is not at all clear that these actions are a result of greater public pension participation. We should not blame public pensions for the political decisions of a select few in Washington. In fact, the increased allocations toward private equity suggest that the partnership between public pension investors and private equity sponsors is stronger than ever (for my part, my father's public pension is tied up in many of the deals I work on, even though I typically represent the lenders). In addition, while many bankers/sponsors may receive increased internal scrutiny on sovereign immunity exposure to such investors, reputational risk and legal waivers mitigate this exposure into a manageable commercial risk (with some exceptions for certain problematic jurisdictions). Despite the proposed regulations, it's not an exaggeration to say that the relationship between public money and private equity is now a cornerstone of the American economy. It's a bit like a certain motto written on another English coin: *honi soit qui mal y pense*, or "shamed be whoever thinks ill of it."