VRS COMMENTS ON DRAFT VPA TRADE SECRETS STATUTE

July 21, 2015

The following information is presented to the FOIA Council in relation to the recently proposed trade secrets statute (generic proposal). In concept, VRS is not opposed to a generic statute, but has a fiduciary duty to its members and beneficiaries to pursue changes that will protect the investment of retirement trust funds. Art. X, § 11 of the Constitution of Virginia provides that "[t]he funds of the retirement system . . . shall be invested and administered solely in the interests of the members and beneficiaries thereof." When the Subcommittee on Records reviewed the existing VRS exemptions in 2014, they were determined to be appropriate and no action was deemed necessary to remove or narrow them. As VRS noted during the 2014 review of its existing exemptions, to meet our fiduciary duty set forth in the Constitution, statutes and regulations, it is critical that we retain our current exemptions. As the generic proposal addresses § 2.2-3705.6, we anticipate the concurrence by the working group in retaining the protections for our trust in § 2.2-3705.7.

In order for the generic statute to apply to the VRS trust fund, in addition to its existing specific exemptions, there are a few primary issues that VRS would like to highlight in the proposed draft:

1. VRS' internal investment research and internally developed algorithms and software are not covered under the "Trade Secrets Created by a Public Body" section because that section is limited to academic, medical or scientific research and thus could not be withheld to protect its proprietary value.
2. Trade secrets submitted by VRS' external managers are not covered under the "Trade Secrets Submitted to a Public Body" section as currently drafted because they do not meet requirement (iii), which requires that a trade secret must be submitted in compliance with a statute, law or regulation of the Commonwealth or the U.S., or as a requirement of a public procurement, public financing or economic development transaction, none of which apply to the trade secrets submitted to VRS by its external investment managers.
3. Proprietary and confidential analysis is key to investment managers' success. If this information cannot be protected from competitors, managers will lose the economic value of their internal analysis and expertise. The protection of proprietary and confidential internal information is of paramount importance to these managers.
4. Managers will simply not allow VRS to place investments with them if they must be named as a defendant in FOIA enforcement actions and are statutorily liable for unlimited attorneys' fees in the event of a judicial finding that the records submitted were not property trade secrets. This is particularly true of the top quartile managers, with which VRS partners and seeks to partner.
5. There is strong and active competition among investors for access to top investment managers. If a potential investor (i.e., VRS) is required to impose onerous, costly and burdensome conditions on the manager, the manager is easily able to refuse to allow the entity to invest with the manager.

Background

- VRS manages approximately $68 billion on behalf of more than 650,000 members, retirees and beneficiaries
- As of March 31, 2015, VRS had approximately $5 billion invested in its private equity portfolio, equal to about 7.4% of total assets
- Private equity has historically been VRS' most profitable asset class
    - As of March 31, 2015, the 10-year private equity returns were 13.2% (net of fees)
- Protecting confidential proprietary information and trade secrets is required in order to be allowed to invest with premier private managers (i.e. top-quartile managers)
    - Funds avoid or disallow investors that are unable to guarantee protection of confidential information
    - VRS is now able to invest with such funds due to existing exemptions
- Public managers will also provide more in depth information to entities that are able to protect confidential and proprietary background and analysis
- Prior to the passage of VRS' existing FOIA exemptions, VRS' inability to protect confidential proprietary information led VRS' top-performing private equity manager to drop VRS as an investor
    - The manager, whose internal rate of return exceeded 90% as of March 3, 2014, cited potential risks due to Virginia's FOIA laws and the lack of protection for its proprietary and economically valuable trade secrets
    - This prompted VRS to pursue and obtain its existing exemptions
- Historically, most requests for private equity information have come from data aggregators, who collect information, bundle it, and sell it to subscribers, including other managers
    - This harms VRS as it allows other investors to "front run" VRS' investment strategies, as well as the internal strategies of VRS' external managers
- The VRS Board of Trustees recognizes the value of private investments and has increased the trust fund's allowable exposure to private equity and other private investments, including real assets
    - However, VRS has not been able to increase its allocation to private investments as quickly as hoped due to competition for the best investment opportunities
- Without protection from forced disclosure, VRS will likely face further difficulties in investing and the trust fund will lose the opportunity to benefit from potentially higher returns

Trade Secrets Created by a Public Body

VRS' internal investment research is not protected by the generic proposal. In order to protect a trade secret created by a public body, the proposal requires that a record be "in connection with or for the purpose of conducting *academic, medical or scientific research* or commercially exploiting such research for the financial benefit of the public body." VRS cannot satisfy these elements because, in a strict sense, internal investment research is not academic, medical, or scientific in nature. Instead, VRS' internal research is mathematical and financial in nature. Under the proposal, therefore, VRS would lose protection of its internal investment research. To address this nuance, we suggest the following:

Recommendation – On line 11, after "medical" insert ", investment"

Trade Secrets Submitted to a Public Body

Trade secrets submitted to VRS by its external managers will not be protected by the generic proposal. The generic proposal requires that, in order to be protected, a record must be submitted "(a) in compliance with a statute, regulation, or other law of [the] Commonwealth or the United States or (b) as a required component of a submission made in connection with a public procurement, public financing or economic development transaction."

VRS and its external managers cannot satisfy these elements. First, most of the trade secrets submitted to VRS are received as part of a contractual relationship rather than a law or regulation. Some information is even obtained absent a contractual obligation, but nonetheless requires protection from disclosure or else external managers would cease sharing it with VRS. Second, the trade secrets submitted to VRS are not related to a public procurement, public financing, or an economic development transaction. VRS does not deal in public financing or economic development transactions, and VRS' private equity managers, in a strict sense, are not retained through a public procurement. Therefore, the trade secrets submitted to VRS by its managers would not be protected under the proposal. To address VRS' unique circumstances, we recommend the following change:

Recommendation – At the end of line 25, insert "contract,"
– On line 25 after "with" insert "or in relation to"
– On line 27 after "public financing" insert ", investment"

New Process for Resolving Disputes Concerning Trade Secret Designations

Top-quartile funds are not likely to be willing to submit to the proposal's requirements for the resolution of disputes concerning the classification of material as trade secrets. In the private equity industry, there is more capital available to top-quartile managers than they can invest. Therefore, top-quartile managers can afford to be selective in choosing investors. Although VRS is a public body of the Commonwealth, it is measured against private pools of capital that are not subject to public disclosure laws. In this respect, VRS is already at a disadvantage. However, the existing FOIA exemptions typically alleviate most managers' concerns.

The proposed resolution process, however, would increase VRS' disadvantage in this space. Having investment partners be named as defendants in FOIA litigation is yet another reason for top-quartile managers to exclude VRS from future investments. In addition, the proposal would subject VRS' external managers to unlimited litigation costs as a matter of law to the extent the requesting party is awarded attorneys' fees.

Recommendation – Exempt VRS from the provisions related to naming the submitting party as a defendant in litigation related to withholding trade secrets and the provisions related to paying legal fees for a prevailing requesting party.