ROPES & GRAY

ALERT

Asset Management

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California's New Fee Disclosure Law For Public Pension Plans Investing In Alternative Investment Vehicles

On September 14, 2016, California Governor Jerry Brown signed into law a bill intended to provide transparency with respect to fees and expenses paid by California public pension or retirement systems ("PPPs") to private equity funds, venture funds, hedge funds and absolute return funds (each, a "Fund") in which they invest. This alert seeks to answer some of the key questions regarding the new law (the "Fee Disclosure Law") that we believe will be of particular interest to our clients.

EFFECTIVE DATE

- ***When does the Fee Disclosure Law go into effect?*** January 1, 2017. Specifically, the Fee Disclosure Law applies to all new contracts, including subscription agreements, between a PPP and a Fund entered into on or after January 1, 2017, and to all existing contracts pursuant to which a PPP makes a new capital commitment on or after January 1, 2017. A PPP will also be required to "undertake reasonable efforts" to obtain the information required by the Fee Disclosure Law for any existing contract with a Fund for which the PPP has not made a new capital commitment on or after January 1, 2017.

DISCLOSURE REQUIREMENTS

- ***What information will be disclosed?*** A Fund must provide its PPP investors the following information regarding fees: (i) the fees that the PPP pays directly to the Fund, the fund manager or related parties; (ii) the PPP's pro rata share of the fees that are paid from the Fund to the fund manager or related parties; (iii) the PPP's pro rata share of the carried interest paid to the fund manager or related parties; (iv) the PPP's pro rata share of the aggregate fees and expenses paid by all of the portfolio companies held by the Fund to the fund manager or related parties; and (v) the information already required to be disclosed under California Public Records Act ("CPRA"). A PPP will also be required to disclose the gross and net rate of return of each Fund, since inception, in which the PPP participates.
    - ***What are "related parties"?*** In defining "related parties," drafters closely tracked the expansive language in ILPA's Fee Reporting Template, which attempts to capture all fees that are directly or indirectly borne by PPPs and, ultimately, paid to the manager, its staff or owners or certain service providers thereof. For example, of note to private equity fund managers, the definition picks up consulting, legal and other service providers regularly engaged by Fund portfolio companies that also provide advice or services to the manager or its affiliates. Also of importance to clients, given ongoing SEC scrutiny of this issue, is the inclusion of "operational persons" in the definition. This includes any operational partner, senior advisor or other consultant or employee whose primary activity for a manager, its affiliates and certain other entities managed by current or former related persons is to provide operational or back office support to any portfolio company of any Fund or account managed by a related person. "Related person" means any current or former employee, manager or partner of any related entity (a term that is not defined, and appears to have been transcribed incorrectly from the ILPA definition) that is involved in the investment activities or accounting and valuation functions of the manager, its affiliates, certain other entities managed by current or former related persons or any of their respective family members. The Fee Disclosure Law

does not set forth a *de minimis* threshold triggering the obligation to disclose fees with respect to related parties, a fact that further increases the burden of the new law.

- ***Raw dollars, not percentages:*** The Fee Disclosure Law calls for the disclosure of raw dollars, not percentage figures related to fees and expenses in connection with a PPP's investment. This conforms with the approach under CPRA, which calls for dollar amounts of items such as the PPP's commitment, contributions, distributions received and remaining value of the Fund's assets attributable to the PPP. Although it may be possible to piece together information disclosed under the Fee Disclosure Law and other information in the public domain to get a rough estimate of the percentage interest of a particular PPP, given the varying fee structures that a manager may apply to different investors and the proliferation of parallel funds, it would be difficult to deduce aggregate fees and carried interest received by a manager.

- ***Portfolio company-level information disclosed:*** The Fee Disclosure Law requires disclosure with respect to a PPP's pro rata share of aggregate fees and expenses paid by all portfolio companies held by the Fund to the fund manager or related parties. Although some sponsors already track portfolio company-level information, this will likely be an additional burden for many sponsors.

- ***PPP's pro rata share of fees paid to Fund manager by portfolio companies, not total fees:*** Initial drafts of the law required disclosure of total fees paid to the Fund manager by Fund portfolio companies. This was revised to require only disclosure of the PPP's pro rata share of fees paid by the Fund investment vehicle through which the PPP invests. Arguably, providing just the PPP's pro rata share of these fees achieves the Fee Disclosure Law's goal of transparency on fees paid by a PPP. However, if, on the other hand, reduced profitability of the portfolio company as a whole is seen as a "cost" to investors, disclosing the entire amount would have provided greater insight into the impact of fees on PPPs. Where a Fund uses multiple investment vehicles to buy a portfolio company, the aggregate amount of fees borne by the portfolio company cannot be ascertained when only the PPP's pro rata share of a given vehicle is disclosed.

- ***How often and what form will reporting take?*** PPPs must require each Fund in which they invest to make the relevant disclosures at least annually. PPPs are then required to present a report on the information at least once annually at a meeting open to the public. There is no prescribed date by which the annual Fund or PPP reports must be made. It will be interesting to see whether the PPPs make the reports available on their websites, or whether the public will have to make individual requests to receive a copy.

- ***Is there a prescribed reporting form?*** Initial drafts of the legislation required information to be on a form prescribed by the PPP. However, the final bill allows a PPP to comply with the rule by independently calculating certain fee and expense information from other information contractually required to be provided by the Fund. This was likely a modification made after CalPERS called for greater leeway on calculating data that Funds are required to report. CalPERS' request was practical – the resulting modification allows greater flexibility when negotiating reporting items with a Fund manager, which will presumably increase a manager's appetite to engage with a California PPP.

- ***Are clawback provisions covered?*** Although the Fee Disclosure Law does require disclosure of carried interest paid by a PPP, it does not require disclosure on clawback provisions. Since clawback provisions impact the amount, timing and means of the return of excess carry to the PPP, disclosing these terms, together with a hypothetical clawback analysis assuming liquidation of the Fund at the time of the report, would have given extra depth to the carried interest information.

COVERED PARTIES AND ENFORCEMENT

- ***What alternative investments funds are covered?*** Initial drafts applied the legislation only to "private equity." This was later revised to conform to the approach of CPRA, which applies to "alternative investments." Both rules define this term as "private equity funds, venture funds, hedge funds or absolute return funds." At first blush, it would make sense for the legislation to apply to other strategies that the industry also labels as "alternative," such as energy, real estate, credit, royalty and infrastructure funds. However, the scope of the CPRA definition of "alternative investments" is still subject to debate, and further clarification is required to determine whether these types of funds are also covered by the new law. There is nothing to suggest that the Fee Disclosure Law applies to registered investment funds.

- ***What PPPs are covered?*** The Fee Disclosure Law applies to any California public pension or retirement system. Therefore, not only will the legislation apply to state-level plans, but also to plans at the county and city levels. Notable plans that fall under the law include CalPERS, CalSTRS, retirement systems governed by the County Employees Retirement Law of 1937 (e.g., OCERs), LACERS, LACERA and the University of California Retirement System.

- ***What types of compensation are covered?*** As noted above, the law requires disclosure of "fees" and "carried interest." The law does not define "fees" or directly address other forms of compensation paid to certain investment funds, such as incentive allocations commonly made to the general partners of hedge funds. It is unclear whether such other forms of compensation would be considered "fees" for purposes of the law.

- ***How will the Fee Disclosure Law be enforced?*** The law is phrased in terms of the information that a PPP must require a Fund to disclose. However, it does not purport to give California courts jurisdiction over actual Funds. Accordingly, the law will achieve its mandate only through its ability to require PPPs to demand the disclosure as part of its investment in a Fund. It is not clear what penalties would be imposed on a PPP that failed to comply with the law or who could enforce violations of the statute by a PPP.

IMPLICATIONS FOR CALIFORNIA PUBLIC PENSION PLANS

- ***Who bears the cost?*** The Fee Disclosure Law creates additional administrative burdens for plan investment staff with respect to requesting, analyzing and disclosing the information mandated by the law. PPPs will not be reimbursed by the state for the cost and expense to the plans of complying with the legislation.

- ***Will the Fee Disclosure Law impact access to Funds?*** PPPs voiced concern from the outset that managers of over-subscribed alternative vehicles would be reluctant to admit California PPPs as investors if they were required to accept the public disclosure of information covered by the legislation. It will be interesting to see whether smaller PPPs, in particular, experience difficulty gaining access to funds as a result of the new law.

- ***Will the Fee Disclosure Law impact fee negotiations?*** Fee negotiations, and especially special fee reductions, are sensitive topics for sponsors. CalSTRS argued that managers may not offer favorable fees to it if those lowered fees had to be disclosed to the public, including other investors. Until now, tiered MFN structures and other approaches have protected managers from disclosing the preferred fee deals given to some PPPs in light of their substantial commitments. Willingness to give fee breaks when amounts paid by the PPP will be disclosed to the public will be a new consideration with which sponsors must grapple.

- ***Other than disclosing to the public, what do PPPs have to do with the information they receive?*** PPPs will be left to determine what to do with the fee and expense information received from Funds. The Fee Disclosure Law does not mandate any analysis or set any guidelines concerning the reasonableness of expenses disclosed. Nevertheless, it would be wise for PPPs to conduct in-depth review and analysis in connection with reporting in anticipation of political and public scrutiny over investment decisions made.

Accordingly, PPPs should understand the numbers they are reporting and be able to explain them both individually and from the perspective of the holistic management of their complete investment portfolio.

IMPLICATIONS FOR SPONSORS

- ***How does the Fee Disclosure Law change the game?***

  - ***New mandates.*** Managers were formerly able to select among California PPPs based on their relative demands for increased fee disclosures. In addition, managers have been able to find work-arounds to FOIA laws such as CPRA by, for example, providing information to third-party consultants, who then process the information for the investor subject to FOIA concerns. These approaches will not be possible under the Fee Disclosure Law. If a manager cannot afford to ignore California PPPs as a source of capital, it should expect side letter requests addressing the legislation and be prepared to provide (and see public disclosure of) the information required by the new law. Sponsors could consider charging PPPs for the incremental costs associated with providing this information, as opposed to bearing such incremental costs themselves or charging them to the Fund.

  - ***Existing mandates.*** Even if a manager chooses not to accept subscriptions from California PPPs in the future, to the extent that a California PPP currently is an investor, that PPP is required to "undertake reasonable efforts" to obtain the information required by the Fee Disclosure Law with respect to that fund. Given the objections raised by some PPPs to the bill, it is unclear how hard they will push managers of current funds for information, especially since managers in general have no legal obligation to accommodate such requests. However, if the PPP does insist on information, and the Fund manager is not willing to provide it, a secondary sale may be the only practical solution.

- ***Will other states follow California's lead?*** No other state currently has a similar statute. However, initiatives like the Fee Disclosure Law have appeared in other states (e.g., Illinois, Kentucky, New Jersey and Alabama), and it is likely that this trend will continue. A patchwork of increasingly detailed and different standards could further burden and complicate the reporting obligations of fund managers.