

New Law Mandates Disclosure of Alternative Fund Fees By California Public Pensions

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To increase the transparency of fees and expenses paid to alternative funds, every California public pension plan must require each alternative fund in which they invest to make various disclosures, and California public pension plans are required to disclose that information during meetings open to the public.

Assembly Bill 2833 was signed into law by California Governor Jerry Brown on September 14, 2016. Beginning January 1, 2017, the new law mandates that California public pension plans (PPPs), whether at the state, county or city level, require all private equity funds, venture funds, hedge funds or absolute return funds, whether a limited partnership, limited liability company or similar legal structure (Alternative Funds), to make disclosures of fees and expenses paid by PPPs. In turn, the PPPs must disclose such information during meetings open to the public.

Disclosure Requirements

Every PPP must require each Alternative Fund it invests in to disclose the following information at least annually:

- The fees and expenses the PPP pays directly to the Alternative Fund, the fund manager or related parties;
- The PPP's pro rata share of fees and expenses (not already covered above) that are paid from the Alternative Fund to the fund manager or related parties, which may be independently calculated by the PPP based on information contractually required to be provided by the Alternative Fund to the PPP;
- The PPP's pro rata share of carried interest distributed to the fund manager or related parties;
- The PPP's pro rata share of the aggregate fees and expenses paid by all portfolio companies held by the Alternative Fund to the fund manager or related parties; and
- Certain identifying and financial information about the Alternative Fund, all of which is already required to be disclosed under Section 6254.26(b) of the California Public Records Act.

In turn, every PPP is required to disclose the information provided by each Alternative Fund in a report presented at a meeting open to the public at least on an annual basis. The report must also include the gross and net rate of return, since inception, of each Alternative Fund in which the PPP participates, which may be based on the PPP's own calculations or on calculations provided by the Alternative Fund.

The disclosure requirements call for dollar amounts of fees rather than percentage figures. Although earlier drafts of the legislation required a disclosure form prescribed by the PPPs, the final bill removed all references to a form, allowing greater flexibility when negotiating disclosure reporting.

The new law broadly defines "related party" to capture all fees that are directly or indirectly charged to PPPs and paid to:

- the Alternative Fund, fund manager, or general partner;
- their "related person" such as any current or former employee, manager, or partner of any related entity and any of their respective family members;
- an "operational person" such as any operational partner, senior advisor, or other consultant or employee whose primary activity for a relevant entity is to provide operational or back office support to any portfolio company of any Alternative Fund managed by a related person;
- any entity more than 10 percent of which is owned directly or indirectly by a related person or operational person; and
- any consulting, legal, or other service provider regularly engaged by portfolio companies of an Alternative Fund managed by a related person and that also provides advice or services to any related person or relevant entity.

Effective Date

The disclosure requirements under the new law apply to all new contracts a PPP enters 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. However, each PPP must undertake reasonable efforts to obtain the fee information for all existing contracts, and comply with the reporting requirements with respect to any information obtained after January 1, 2017, regardless of whether the PPP has made a new capital commitment on or after January 1, 2017.

Implications For Sponsors And PPPs

- *Fiscal Effect.* Administrative costs of compliance with the new law are expected across all PPPs to be in the range of \$800,000 annually, which will not be reimbursed to PPPs by the state.
- *Exclusion of PPPs.* Fund-by-fund disclosures could discourage fund managers from choosing PPPs, opting, instead, to accept other investors not subject to similar disclosure requirements.
- *Impact on Fees.* Alternative Funds that are oversubscribed and selective about investors may not offer discounted fees to PPPs if the fees are disclosed to the public, including other investors. This may change the landscape of fee negotiations significantly.

- *Fiduciary Obligations.* Fiduciaries may have to assess whether the additional information received pursuant to the new law implicates any further action by them in order for such fiduciaries to meet the standard of care they owe to their plan participants, such as the duty to compare and analyze fees, drive a harder bargain, seek comparable investments at lower fees or take other similar action.
- *Public Pension Plans Outside of California.* The disclosures required by the new law may be a precursor for fee transparency in other jurisdictions.

Remaining Questions Abound

What Alternative Funds are covered? Given the legislative intent of the new law and because closed-end real estate, credit and other alternative funds are typically considered “private equity funds,” these types of funds arguably fall within the purview of the new law, but the law is not clear. The legislative intent behind including “absolute return funds” in the definition of “alternative investment” is even less clear. While there should be no reason to list absolute return as a hedge fund strategy separately, there is no indication in the law of any intent to bring registered funds (absolute return or any other alternative strategy) within scope. The answer is also unsettled with respect to an Alternative Fund that is a “fund of funds” (an Alternative Fund with an investment strategy to hold a portfolio of other Alternative Funds).

What are fees? It is important to note that the new law does not define the term “fees” nor does it address other forms of compensation, except for carried interest, paid to an Alternative Fund or fund managers.

Application to Hedge Funds? Originally crafted for private equity funds, the term “hedge fund” also made it into the definition of “alternative investment.” While they are in scope, applying the terminology and requirements of the new law to hedge funds is at best a strained effort. Contracts in scope include subscription agreements, and any additional contribution to a hedge fund by an existing investor is captured under either a “new contract” or “new capital commitment.” It is less clear what is to be disclosed: interpreted broadly, “fees” may include incentive fees received by a hedge fund. However, the definition of “carried interest” is too specific to squarely include incentive allocations.

How will recycling be treated? In the case of capital contributions that are recycled through an Alternative Fund’s distribution scheme, it is unclear whether recycled contributions that exceed the initial capital commitment of a PPP would constitute a new capital commitment, thereby triggering the disclosure requirements.

How may fee disclosures be shared? While the new law provides that fee disclosures should be included in a report presented at a meeting open to the public at least on an annual basis, PPPs may want to consider how to appropriately respond to requests for such fee information outside of public meetings.

How will the new law be enforced? It is not clear how the new law will be enforced and whether penalties, if any, would be imposed on PPPs for non-compliance.

What constitutes “reasonable efforts”? A written request by a PPP to the Alternative Funds it invests in should conceivably constitute reasonable effort, but the new law provides no guidance on this point.

If you have any questions about the content of this Alert, please contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

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