NEW CALIFORNIA LAW MANDATING DISCLOSURE OF CERTAIN FEES AND EXPENSES

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Investment Management Alert

By: Cary J. Meer

The California Government Code has been amended to require additional public disclosure about investments by state or local California public pension plans (the "California Plans"). The amendment, which is the most significant amendment to the public disclosure of information about California Plan investments since 2005, will require that a California Plan disclose certain fee and expense information about its investments in any private fund that is an alternative investment vehicle. The intent of this amendment, which is set forth in Assembly Bill 2833 ("AB 2833"),[1] is to create greater transparency into the fees and expenses that California Plans pay with respect to their investments in private funds. AB 2833 coincides with the Securities and Exchange Commission's focus on fee and expense disclosure by private equity funds and recent enforcement actions regarding such disclosure.

AB 2833 is effective January 1, 2017, and will apply to contracts with an alternative investment vehicle that a California Plan enters into or, if an existing contract, makes a new capital commitment, on or after January 1, 2017. For all other existing contracts, California Plans are required to use reasonable efforts to get the information necessary to make the annual disclosure set forth in AB 2833.

The impact that the transparency imposed by this law will have on investments by California Plans remains to be seen. The legislative history includes the concern that the disclosure requirements may result in the exclusion of California Plans from certain private funds or may hamper a California Plan's ability to negotiate lower fees in such investments.

While AB 2833 generally uses terms that are typical for a private equity or venture capital fund, it also applies to hedge funds. The required disclosure reflects a more sophisticated understanding of private funds than does prior California legislation. The disclosure requirements specifically address fees and expenses that are paid to related parties, such as operational partners, senior advisors and other types of consultants. AB 2833 also specifies that carried interest would include allocations of profit that a fund manager receives in consideration for waiving fees.

PUBLIC DISCLOSURE REQUIREMENTS

Specifically, AB 2833 requires a California Plan to disclose the following information for each alternative investment vehicle (defined as a private equity fund, venture fund, hedge fund or absolute return fund) at least annually at an open meeting:

1. The fees and expenses the California Plan paid directly to the alternative investment vehicle, the fund manager or related parties;

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2. The California Plan's pro rata share of fees and expenses not covered by item (1), above, that are paid from the alternative investment vehicle to the fund manager or related parties;
3. The California Plan's pro rata share of carried interest distributed to the fund manager or related parties;
4. The California Plan's pro rata share of all fees and expenses paid by portfolio companies held within the alternative investment vehicle to the fund manager or related parties;
5. The gross and net rate of return of each alternative investment vehicle since inception; and
6. The information that is required to be disclosed in a public records request pursuant to Section 6254.26(b) of the California Public Records Act.[2]

Under AB 2833, a California Plan must require that each alternative investment vehicle provide the information set forth in items (1), (3), and (4), above, annually. A California Plan may report the information set forth in items (2) and (5), above, based on its own calculation or the alternative investment vehicle's calculation.

AB 2833 defines "carried interest" as any profit that is distributed from an alternative investment vehicle to the fund manager, general partner or related parties, including allocations of profit received by a fund manager in consideration for waiving fees.

Unlike the California Public Records Act, AB 2833 specifies that the disclosure should encompass payments made to related parties, including individuals such as operating partners, senior advisors and venture partners. The term "related parties" is used in items (1) through (4), above, and is defined broadly to include:

7. Any current or former employee, manager, or partner of any related entity that is involved in the investment activities or accounting and valuation functions of the relevant entity or any of their respective family members;
8. 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 investment vehicle, account or fund managed by a related party;
9. Any entity where at least 10% of the ownership is held directly or indirectly by a related party or operational person; and
10. Any consulting, legal or other service provider regularly engaged by portfolio companies of an alternative investment vehicle, account or fund managed by a related person that also provides advice or services to any related person or relevant entity.

STATES WITH SIMILAR LEGISLATION

A couple of other states are currently considering legislation to increase the transparency of the fees and expenses paid by the public pension plans in that state, while additional states have considered similar legislation that did not pass.[3] In addition, earlier this year, the Institutional Limited Partners Association released a fee reporting template, which was adopted to promote more uniform reporting practices in the private equity industry. If additional states adopt laws similar to those in California, it remains to be seen whether the disclosure required by these laws will be uniform.

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For further information regarding this alert, please contact the authors.

Notes:

[1] AB 2833 amends the California Government Code by adding new Section 7514.7 to the Code.

[2] Of AB 2833's disclosure categories (items (1) through (5), listed above), the only overlap with the required disclosure categories under the California Public Records Act are the following: “the net internal rate of return of each alternative investment vehicle since inception” and “the dollar amount of the total management fees and costs paid on an annual fiscal year-end basis, by the [California Plan] to each alternative investment vehicle.”

[3] For example, Illinois and Rhode Island are currently considering legislation regarding enhanced disclosure of fees and expenses, while Alabama, Kentucky and New Jersey have each considered, but have not passed, similar legislation.

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