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Letter From...

The NAPPA President

Erin Perales

Dear NAPPA Members:

Change and innovation are hallmarks of the public pension world. Certainly, the pandemic required us to quickly adapt to a more virtual, electronic, and contact-free world filled with uncertainty and continual adjustment. However, NAPPA members have always worked hard to learn and share innovative processes and stay abreast of new ideas and developing issues. The NAPPA organization serves our members by providing education, networking opportunities and access to a deep bench of highly knowledgeable professionals who can offer timely and valuable insights and resources.

Much of the success of NAPPA comes from its dedicated staff, who work hard to maintain high standards and core offerings for our membership, especially during the pandemic. For example, Executive Director Susie Dahl and her staff were able to avoid significant cancellation penalties by negotiating with hotels and vendors to move the February 2021 Winter Seminar/Section Meetings to October 2021 and the June 2021 Denver Legal Education Conference (LEC) to 2025. For the June 2021 Virtual LEC, they devoted considerable time and effort to deliver a successful three-day virtual educational conference and CLE credits for our members.

I highlight the impressive work of Susie and her staff because, after leading the organization for ten years, Susie has announced her retirement from NAPPA effective July 2022. Susie's considerable business acumen has greatly benefited the organization, and her attention to detail in budgeting and expenditures has provided a financial cushion for contingencies such as those we have experienced during the pandemic. We will greatly miss Susie when she leaves, but we are very thankful that she is leaving NAPPA in such a strong position.

I want to make you aware of two upcoming matters:

- Due to Susie's planned retirement, NAPPA is seeking a new Executive Director to continue to provide professional and business-oriented leadership. A posting with more information is on page three of this *NAPPA Report*. If you have a person in mind as a potential candidate for the position, we encourage you to contact us or pass along the information to that person.

- Moving the February 2021 Winter Seminar/Section Meetings to October 2021 led to NAPPA potentially having three conferences within a nine-month period (the October 2021 Winter Seminar/Section Meetings in Tempe, Arizona, the February 2022 Winter Seminar/Section Meetings in Washington, D.C., and the June 2022 Legal Education Conference in Louisville, Kentucky). Due to the continued uncertainty surrounding COVID-19 and its variants and a commitment to delivering high quality conferences, the NAPPA Board decided to cancel the February 2022 Winter Seminar/Section Meetings in Washington, D.C. The 2022 LEC in Louisville, Kentucky, is still on schedule and the Winter Seminar/Section Meetings will resume in Tucson, Arizona, in February 2023.

I would like to thank you for your support and membership in NAPPA. Our strength is in our collective knowledge and camaraderie, and through your continued involvement in this excellent legal organization we can leverage that strength now and long into the future.

Sincerely,

Erin Perales
NAPPA President

NAPPA Employment Opportunity

Association:	National Association of Public Pension Attorneys
Position:	Executive Director
Posted:	November 1, 2021
Application Deadline:	January 6, 2022
Final Interviews:	March 2022 (tentative)
Starting Date:	Summer 2022 (flexible)
Salary Range:	$50,000-$70,000 annually, part-time (approximately 16-20 hours per week)

About NAPPA:

The National Association of Public Pension Attorneys, NAPPA is the foremost professional and educational organization serving attorneys representing public pension fund clients. NAPPA provides educational opportunities and informational resources for its member attorneys, organizes and conducts educational conferences, and publishes a biannual newsletter. NAPPA was organized in 1987, and as of July 31, 2021, had 670 members.

NAPPA is governed by a nine-member executive board selected from the membership of the organization. The staff of the organization includes the Executive Director, Administrative Assistant, Administrative Technician and Administrative Aide (all of which are part-time). Additional information is available on the NAPPA website at www.nappa.org.

Position:

NAPPA is seeking candidates for the position of Executive Director. This is a part-time exempt position (approximately 16-20 hours per week) and reports to the Executive Board. Although the NAPPA administrative offices and staff are currently located in Jefferson City, MO, the organization will consider applicants from other geographic locations who are interested in working remotely.

The successful candidate will have senior management experience in a complex organization, e.g., pension fund, national association, law firm, insurance company, banking institution, or governmental agency. The candidate must also possess outstanding leadership attributes, the highest integrity and ethics, excellent communication skills, professional presence and maturity, and knowledge of issues concerning public pension plans.

Essential Activities:

- Represent NAPPA in the public pension community
- Work collaboratively with the Executive Board
- Organize, manage, and attend NAPPA educational meetings and conferences
- Edit and publish the biannual electronic newsletter
- Manage member relations and communications
- Maintain adequate accounting records, internal controls, audit processes, financial management, and tax reporting
- Evaluate, hire, and terminate service providers (e.g., hotels, caterers, accountants, auditors, IT providers, meeting procurement providers, etc.)
- Understand the culture and goals of NAPPA specifically and the public pension community generally
- Manage NAPPA staff and business operations
- Coordinate strategic planning for the organization

NAPPA Employment Opportunity *(continued)*

Minimum Qualifications:

- Bachelor's degree from an accredited college or university
- Ten years of experience in an executive role at a public pension fund or comparable management experience at an entity with common interests to the public pension industry
- Direct experience supervising staff both in-person and remotely
- Experience developing and managing a budget
- Experience reporting to or working closely with a board
- Strong computer skills
- Strong communications skills
- Must be a self-starter as well as possess the ability to work collaboratively

Desirable Qualifications:

- Bachelor's or master's degree in management, finance, economics, business, or related field
- Management experience in a public pension fund or association management experience
- Technology skills including familiarity with virtual conferencing applications
- Experience planning large group events (both live and virtual) and negotiating event contracts

Expected Competencies:

- Accountability: Accept personal responsibility for the quality and timeliness of work. Can be relied upon to achieve excellent results with minimal oversight and can be relied upon to report material issues to the Executive Board.
- Adaptability: Adapt easily to changing business needs, conditions, and work responsibilities. Adapt approach, goals, and methods to achieve successful solutions and results in dynamic situations.
- Research: Effectively identify, collect, organize, and document information in ways that make the information most useful for subsequent assessment, analysis, and evaluation by the Executive Board.
- Results Orientation and Initiative: Focus on results and desired outcomes and how best to achieve them. Identify what needs to be done and proactively take appropriate action to get the job done.

Background Check:

A background check will be required.

Application Deadline:

The deadline to apply is ***Monday, January 6, 2022***. To apply for the position, submit the following information by the January 6 deadline:

- Cover letter specifying how you meet the qualifications and competencies listed above (no more than two pages).
- Current resume.
- List of at least three professional references (current and past supervisors preferred with current contact information).

NAPPA Employment Opportunity *(continued)*

The application materials must be delivered to: Susie Dahl, NAPPA Executive Director, 2410 Hyde Park Road, Suite B, Jefferson City, MO 65109 or electronically to susie@nappa.org. Application materials will be screened for the purpose of determining who will be selected for an interview.

Non-Discrimination:

NAPPA is committed to being an equal opportunity employer for all individuals, regardless of race, color, gender, gender identity or expression, creed, national origin, age, disability, marital status, sexual orientation, veteran's status, or any other protected category pursuant to applicable federal, state, or local law.

Communications:

Upon application, candidates should **not** communicate with members of the Executive Board concerning the employment opportunity; doing so may result in disqualification. Questions from candidates should be addressed to NAPPA's Executive Director by mail, email, or telephone as follows:

Susie Dahl, NAPPA Executive Director
2410 Hyde Park Road, Suite B
Jefferson City, MO 65109
573-680-4891
susie@nappa.org

No UAAL? Washington's Best-of-Both Worlds Funding Method

By: Aaron Gutierrez

In the April 2020 edition of *The NAPPA Report*, I talked about the role of a plan's actuary. The main points were that your actuary can't tell the future any better than you can, and that the calculations, recommendations, and guidelines they produce are just educated advice, not decrees. You, or your board, get the final say.

The same can be said for your funding method.

Let me lead off by stressing that I am neither an actuary nor your plan's actuary. I would never presume to tell you what's right for your plan, and I am not suggesting you make a change. Instead, my hope is to inspire more inquiry and discussion about what is often an esoteric topic. Based on my conversations at every NAPPA conference since Nashville in 2014, we talk about funding policy a lot, but rarely at the level of detail I'm about to provide.

To put it another way, the ACM is comparably simpler than the EAN cost method because all plan costs are contained within the normal cost.

With that in mind, here are some of the important pieces of Washington's funding method. It's comprised of three main parts.

First, the funding method for Washington's open and ongoing plans does **not** use the Entry Age Normal (EAN) Cost Method (EANCM) to determine the plan funding costs. It's a difficult thing to research since valuations and other reports don't always tell the whole story, but Washington's use of a different cost method appears to be rare, if not unique.

Instead, we use the Aggregate Cost Method[1] (ACM) to determine the plan's normal cost for funding. Under the ACM, no Unfunded Actuarial Accrued Liability (UAAL) is created. That's the lay explanation, of course. To put it in actuarial language, no UAAL is amortized outside the normal cost. In other words, the UAAL equals zero under this method.

To be clear, that doesn't necessarily mean you're fully funding the plan just because there's no UAAL. The same contributions, assets, etc., when measured under another method, could still show a UAAL (for example in your reporting under GASB rules). It's just that the UAAL under the ACM will always equal zero because the method sets the actuarial accrued liability equal to the actuarial value of assets.

The point being, if you don't create a UAAL, then your funding policy doesn't have to separately manage or amortize a UAAL. To put it another way, the ACM is comparably simpler than the EAN cost method because all plan costs are contained within the normal cost.

However, the ACM, by itself, can result in a lot of volatility in the normal cost. If left unchecked, contributions could fall precipitously in good years (causing underfunding),[2] spike in bad years (causing unaffordability), and swing between extremes from year-to-year. Thus, Washington uses two other methods to establish a reasonably predictable funding path.

1. Minimum rates set at 80%[3] of the normal cost calculated under the EANCM.

   If the volatility is downward due to short-term investment gains, these minimum rates assure that the plan is not underfunded in good years. This happens because the EANCM does not change due to short-term asset performance.

2. Longer smoothing of investment gains/losses.

   If the volatility is upward due to short-term investment losses, the smoothing method (with annual investment gains/losses smoothed up to eight years) ensures that contribution rates do not spike. Technically the smoothing method helps with downward volatility as well, but the minimum rates

No UAAL? Washington's Best-of-Both Worlds Funding Method *(continued)*

described above provide a much more important backstop.

So, are there any drawbacks to this method? Not inherently, but as currently designed there is one challenge that needs to be managed: any large increase to the aggregate normal cost resulting from either benefit improvements or assumption changes. Our current policy doesn't address this automatically, so it's been up to the Legislature to decide how to manage the increase. For example, a few years back when Washington adopted new mortality assumptions, the Legislature chose to phase in the impacts (via small contribution rate increases over several biennia) rather than adopting the full rate increase all at once.

I suppose it's worth repeating that GASB still requires you to report your plan status using the EANCM for accounting/financial reporting purposes. So, while your financial reporting method and funding method do not have to be the same, it could be an extra cost to have your plan's actuary calculate another measure. That's largely moot for Washington, since the Office of the State Actuary is a legislative agency rather than a private firm on contract.

So, while your financial reporting method and funding method do not have to be the same, it could be an extra cost to have your plan's actuary calculate another measure.

To sum up, under Washington's funding policy for open and ongoing plans:

- Using the ACM means that no UAAL is created, and no amortization schedule is needed to manage that UAAL.
- Volatility is kept in check by minimum rates and a smoothing of investment gains/losses up to eight years.

It may not be perfect, but it utilizes the best pieces of two different cost methods to ensure a reasonably predictable funding path.

Does your system use a less common funding method? If so, please let me know. I'd like to hear about it.

Aaron Gutierrez *is Senior Policy Analyst at the Washington Office of the State Actuary.*

ENDNOTES:

[1]Not to be confused with other uses of "aggregate," such as "aggregate accrued liabilities."
[2]In other words, the various stakeholders can grow accustomed to the lower contribution rates that result from recognizing investment gains in good years. However, the market is always in flux, and good years can be followed by some very bad years. Those same stakeholders (including budget writers) may not be prepared and willing to ramp up contribution rates as quickly as needed to avoid underfunding in those bad years.
[3]There are two exceptions to this: Washington's WSPRS 1/2 system sets it at 70% of EAN, and the LEOFF 2 system is at 100% of EAN. Washington's closed legacy plans also use different methodology.

Federal Tax Legislative Forecast

By: Tony Roda

The 21st Century has already witnessed the enactment of two major pieces of federal tax law aimed broadly at retirement security—The Pension Protection Act of 2006, and 13 years later, The Setting Every Community Up for Retirement Enhancement Act, commonly known as the SECURE Act.[1] Now, just two years after the SECURE Act became law, Congress is once again poised to approve far-reaching retirement law changes.

In early May, the House Ways and Means Committee in a bipartisan vote approved H.R. 2954, The Securing a Strong Retirement Act, which is known as the SECURE Act 2.0. While full House action has not yet occurred, it is expected that the legislation, of course, first with considerable input from the Senate, will be enacted during this Congress.

The House Committee-approved version of SECURE 2.0 contains numerous changes to federal tax law affecting retirement plans, including defined benefit and defined contribution plans sponsored by state and local governments.

The House Committee-approved version of SECURE 2.0 contains numerous changes to federal tax law affecting retirement plans, including defined benefit and defined contribution plans sponsored by state and local governments. This article will explore likely changes in tax rules related to Required Minimum Distributions (RMDs), contribution limits to 457(b) and 403(b) plans, required use of the Roth method for catch up contributions, recovery of retirement plan overpayments, and the tax exclusion for retired public safety officers related to health and long-term care insurance premiums.

Required Minimum Distributions (RMDs)

Regarding RMDs, the original SECURE Act increased the age trigger from 70 ½ to 72, so if a person's 70th birthday is July 1, 2019, or later they do not have to take their first RMD until the year they reach 72. This was a mandatory provision that covered Internal Revenue Code (IRC) Section 401(a), 401(k), 403(b), governmental 457(b) plans, and traditional IRAs.

The pending SECURE 2.0 legislation would further increase the age trigger to 75, but for budgetary reasons would do so gradually—73 in 2022; 74 in 2029; and finally, 75 in 2032. Once again, the provision would be mandatory and cover the types of plans mentioned above.

The move to increase the age trigger is clearly popular among taxpayers, which is motivating Congress's sudden keen interest. However, for the vast majority of seniors the change is unlikely to affect their behavior. According to U.S. Treasury Department statistics, 80 percent of those required to take RMDs today withdraw more than the minimum amount each year. The implication is that they need the distributions to meet their day-to-day financial needs and pushing the age trigger to a later age will not change that basic equation. But, clearly, the trend is to give taxpayers the option of moving RMDs to later ages. Some in Congress have even suggested doing away with them entirely.

Given all the interest in RMDs, it's probably a good point to take a breath and think about why we have them. First, consider that the original tax treatment (deferral of pre-tax compensation or tax-deductible IRA contribution) lowers your taxes in those years and subsequently allows you to build your assets over an extended period of time.[2] In recognition that these tax qualified plans are retirement accounts, not estate planning tools, RMDs then force the account holder to withdraw at least some funds during their lifetime and pay taxes on the distributions.

From the standpoint of the federal treasury, RMDs also generate federal tax revenue sooner rather than later. Consequently, according to Congress's Joint Committee on Taxation (JCT), the provision to move the RMD age trigger to 75 would result in a revenue loss of almost $6.9 billion over 10 years.[3] This provision would have resulted in a much steeper revenue loss but for the fact

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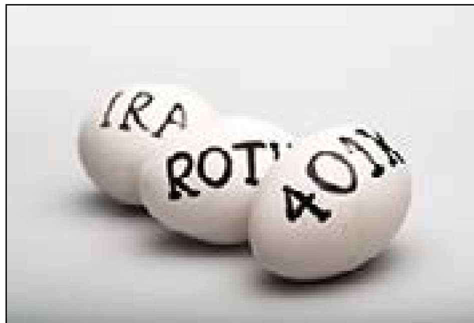
Federal Tax Legislative Forecast *(continued)*

that the age trigger increases are phased in, with the ultimate move to 75 not being made until the 10-year budget window is closed.

Annual Contribution Limits to DC Plans

Under employer-sponsored IRC Section 403(b), 457(b) governmental plans, and 401(k) plans, employees may elect to have contributions made to the plan, rather than receive the amounts in cash. This is called a "cash or deferred arrangement" (CODA) or more commonly an elective deferral.[4]



The term "Rothification" refers to imposing a requirement that contributions to defined contribution (DC) plans be made with after-tax, not pre-tax, dollars.

In 2021, the annual maximum elective deferral is $19,500 or, if less, the employee's compensation. This annual limit applies to total elective deferrals under all of the participant's 401(k) and 403(b) plans, but applies separately to any governmental 457(b) plan. Therefore, an employee covered by a governmental 457(b) plan and a 401(k) or 403(b) plan can contribute the full amount to each plan.

Plans also may allow employees who reach age 50 by the end of calendar year 2021 to elect to defer an additional $6,500 this year.[5] These additional contributions, known as catch-up contributions, are in recognition that the employee is approaching retirement age and may need to accelerate their savings in a short timeframe.

The SECURE Act 2.0 would increase the annual catch-up contribution limit for employees who have attained age 62, 63 or 64 by the end of the calendar year, but not age 65, from $6,500 (2021 annual limit) to $10,000 or the participant's compensation reduced by any other elective deferrals. The annual catch-up limit is permissive and specific to the retirement plan. However, it is expected that most plans would be amended, if necessary, to allow the expanded opportunity for retirement savings.

Roth Method for Catch-Up Contributions

The term "Rothification" refers to imposing a requirement that contributions to defined contribution (DC) plans be made with after-tax, not pre-tax, dollars. As a budget scoring maneuver, this requirement would accelerate taxes into earlier budget years and produce a revenue increase in the 10-year federal budget window. Rothification has been on the table in Congress in various forms for a number of years. The proposals would affect all DC plans sponsored by state and local governments, including 401(a) DC plans, 457(b) governmental, 403(b), and grandfathered 401(k) plans.

Many believe that this change would lead to reduced retirement savings. However, despite this concern, the SECURE Act 2.0 contains a provision requiring that all future, over-age-50, catch-up contributions be made under the Roth method.[6] Congress's JCT estimates that the Roth mandate for catch-up contributions would increase federal revenues by $13.2 billion over 10 years.[7] The provision, as currently written, would apply to tax years beginning after December 31, 2021.

Recovery of Retirement Plan Overpayments

The SECURE Act 2.0 contains a provision that is designed to add flexibility for pension plans to correct overpayments, which are defined as a qualification failure due to a payment to a participant that exceeds the amount payable to such individual under the plan or exceeds a limitation in the tax code or regulations.

Under current law, overpayments from DB plans are corrected by the plan sponsor taking reasonable steps to have the overpayment and appropriate interest returned by the recipient to the plan and then reducing future benefits, having the employer or another person contribute the amount of the overpayment with interest to the plan in lieu of seeking recoupment, or having

Federal Tax Legislative Forecast *(continued)*

a plan sponsor adopt a retroactive amendment to conform the plan documents to the plan's operations.

For DC plans and 403(b) plans, overpayments are "generally corrected by having the employer take reasonable steps to have the overpayments repaid to the plan, adjusted for earnings at the plan's earnings rate from the date of the distribution to the date of the correction of the overpayment."[8] If this does not occur, then the employer or another person must contribute the difference to make the plan whole.

For DC plans and 403(b) plans, overpayments are "generally corrected by having the employer take reasonable steps to have the overpayments repaid to the plan, adjusted for earnings at the plan's earnings rate from the date of the distribution to the date of the correction of the overpayment."[8]

The SECURE Act 2.0 would add to the current state-of-play by providing that plans would not fail to be qualified merely because (1) the plan fails to obtain payment from any participant, beneficiary, employer, plan sponsor, fiduciary, or other party on account of any inadvertent payment made by the plan; or (2) the plan sponsor amends the plan to increase past or future benefit payments to affected participants and beneficiaries in order to adjust for prior inadvertent benefit overpayments. However, the description of the bill is clear to point out that, "notwithstanding the foregoing, the plan may instead reduce future benefit payments to the correct amount provided for under the terms of the plan or seek recovery from the person or persons responsible for the overpayment."[9]

Tax Exclusion for Retired Public Safety Officers

IRC Section 402(l), which is commonly known as HELPS – The Healthcare Enhancement for Local Public Safety Act – allows retired public safety officers to exclude from their gross income, each year, up to $3,000 of their state or local retirement benefit, if the amounts are used to pay premiums for health care or long-term care insurance, and if the premiums are paid directly by the retirement system to the insurance provider.

The direct payment requirement has created an administrative burden for many retirement systems throughout the country. Simple changes from the standpoint of the insurance provider, such as switching their billing from monthly to quarterly, can be unworkable for retirement systems that process retirement distributions on a monthly basis. Also, some insurance providers will speak only to the insured retiree and not to the retirement system when billing issues arise. So, instead of a seamless process where premium increases and other billing matters are corrected quickly and efficiently, resolution of these matters can be frustrating and protracted. Senator Sherrod Brown (D-OH), who is a member of the tax-writing Finance Committee, is working with the public safety community to remedy this problem, including consideration of a full repeal of the direct payment requirement.

In addition, since enactment of the HELPS provision in 2006,[10] the annual exclusion cap of $3,000 has not been increased. Senator Brown is also looking at increasing the annual cap amount and indexing that new amount to inflation in subsequent years.

While this provision is not in the House version of the SECURE Act 2.0, Senator Brown is working to include these changes to HELPS in the Senate version of the legislation.

Closing

The SECURE Act 2.0 has a long way to travel before final Congressional approval and enactment into law. The full House must consider the legislation, and that will be prefaced by a managers' amendment on the House floor by Chairman Richard Neal (D-MA) of the Ways and Means Committee. Managers' amendments are often used to correct technical flaws in legislation or modify language to cover a heretofore unanticipated

Federal Tax Legislative Forecast *(continued)*

fact situation. They are rarely used to introduce brand new topics into a bill, but can do so. Also, the Senate Finance Committee and the full Senate will review the House-passed bill. Most observers believe that the Senate will opt to draft its own version of SECURE 2.0, but that it is likely to contain many of the provisions in the House bill.

The SECURE Act 2.0 legislation is certainly worth keeping an eye on as it moves through Congress.

The SECURE Act 2.0 legislation is certainly worth keeping an eye on as it moves through Congress.

***Tony Roda** is a Partner at Williams & Jensen.*

ENDNOTES:

[1]If you include this year's enactment of the $84 billion Emergency Pension Plan Relief Act, which will provide financial relief to the most endangered private sector, multiemployer pension plans, you would say three major pieces of legislation. This legislation, however, has no impact on state and local governmental retirement plans.
[2]This is not true for Roth accounts, which are funded by after-tax dollars and are tax-free at distribution. Accordingly, Roth accounts do not have RMDs.
[3]Joint Committee on Taxation, JCX-22-21, May 3, 2021.
[4]Internal Revenue Code Sec. 401(k)(11).
[5]The annual limit for catch-up contributions is indexed for inflation under Internal Revenue Code Sec. 414(v)(2)(C).
[6]H.R. 2954, 117th Congress, Section 603.
[7]Joint Committee on Taxation, supra note 3.
[8]Description of Provisions of H.R. 2954, Joint Committee on Taxation, May 5, 2021, p. 67.
[9]*Ibid* at p. 68.
[10]The HELPS provision was originally Section 845 of the Pension Protection Act of 2006, Public Law 109-280, August 17, 2006.

Secondary Transactions in Private Market Funds—Traps for the Unwary

By: Bryant Ferguson

Secondary transactions in private market funds, such as private equity funds, come in various forms and can be an important part of any institutional investor's toolbox. Institutional investors choose to participate in the secondary market for a variety of reasons, such as a seller seeking to reduce an unwieldy fund portfolio to focus on key strategic relationships with a limited number of sponsors, or a buyer hoping to add/increase exposure to high-performing sponsors or mitigate J-curve risks. For many institutional investors, secondary transactions are an unusual occurrence.

The focus of this article is on purchases and sales of a portfolio of private market funds (as opposed to a GP-led secondary transaction), which often involves a secondary fund sponsor as buyer and another institutional investor as seller. The information below highlights potential issues a secondary buyer or seller should consider as they undertake a secondary transaction.

Engaging outside experts, such as legal/tax counsel and investment consultants, prior to undertaking a secondary transaction can reduce the risk of a broken deal as a result of a disagreement over the LOI terms.

Engage Professional Advisors Prior to Beginning Secondary Process

Key issues are often negotiated before outside advisors are engaged. For example, a seller may wait to engage outside legal counsel until a buyer is found and the basic terms are documented, such as in a letter of intent (LOI). Once an LOI is signed, it is often difficult to seek to re-negotiate terms if professional advisers identify deficiencies in the LOI.

Engaging outside experts, such as legal/tax counsel and investment consultants, prior to undertaking a secondary transaction can reduce the risk of a broken deal as a result of a disagreement over the LOI terms.

For sellers, it is important to consider the seller's confidentiality obligations under the relevant fund documents, since prospective buyers often seek to review financial statements and other documents associated with the portfolio of funds being sold. Fund documents may not explicitly authorize sharing of information with a prospective purchaser, and sponsor consent may be required to engage in such information sharing. By engaging legal counsel prior to beginning the sale process, a seller can ensure it has the necessary consents in place to allow sharing of information with a potential buyer.

Secondary purchase and sale agreements typically require a seller to provide a broad range of documentation associated with the funds in the portfolio. Use of an outside investment consultant may be particularly useful to a seller in gathering all of the required information and documentation a buyer will require, such as financial statements and past tax forms (i.e., K-1s). These consultants may also be helpful in preparing (or confirming) schedules to the legal documents.

Be Cognizant of "Market" Terms

Secondary transactions often consist of a large player in the secondary market (e.g., a secondary fund sponsor) and an institutional investor who rarely engages in secondary transactions. As a result, an information disparity may exist, and large secondary players (and their outside counsel) often insist on terms more favorable to them on grounds that such terms are "market." In many cases, secondary fund sponsors are able to obtain more favorable terms because institutions (or their advisors) fail to recognize that there is a range of "market" terms that could lead to a better outcome for the sellers.

Secondary Transactions in Private Market Funds—Traps for the Unwary *(continued)*

Scrutinize Liabilities Retained by the Seller or Transferred to the Buyer

Secondary transactions often involve negotiations surrounding the liabilities retained by the seller (or taken on by the buyer) pertaining to the transferred interests. Sellers seek to limit the scope of liabilities they return while buyers would like to expand the liabilities sellers retain.

There is general agreement regarding certain liabilities that should be retained by the seller, such as those pertaining to LP clawbacks, losses arising from the seller's bad acts and taxes attributable to the seller. Nevertheless, secondary participants often spend significant time negotiating the scope of these and other liabilities. Addressing the scope of liabilities retained by the seller/transferred to the buyer in a preliminary term sheet can significantly streamline the negotiation process.

Secondary transactions often involve negotiations surrounding the liabilities retained by the seller (or taken on by the buyer) pertaining to the transferred interests.

One often overlooked issue is which party is responsible for prepaid management fees (i.e., management fees that are paid prior to the date the purchase price is set (the "Cutoff Date") but relate to periods after the Cutoff Date). Sellers, in particular, would likely seek a purchase price increase for management fees they have paid for periods after the Cutoff Date. It is possible that prepaid management fees are already included in a fund's net asset value and, thus, are already accounted for in the purchase price. This may not always be the case, however, and parties may wish to seek clarity on whether the purchase price will be adjusted if there are prepaid management fees not included within a fund's net asset value.

More generally, secondary participants will want to ensure that the excluded liabilities match up with any purchase price adjustments. By way of example, if the buyer receives a benefit from a distribution in the form of a purchase price reduction, it would seem reasonable for the buyer to be responsible for any taxes attributable to that distribution.

Availability of Side Letters

Governmental investors typically document certain terms required by legal, regulatory or policy mandates in side letters in connection with their primary investments. Challenges arise in secondary transactions concerning availability of side letter terms.

Governmental plans acting as sellers should consider whether certain provisions of their existing side letters should survive a transfer. Unless a side letter provides otherwise, a side letter will terminate once an investor ceases to hold an interest in the fund, and in some cases, may terminate if an investor ceases to hold an interest above a specified threshold (e.g., 50% of the original commitment). Examples of provisions that may need to survive a transfer include those addressing disclosure of information, sovereign immunity, and indemnification by the investor. If the side letter does not otherwise address survivability of required terms, the seller will likely need to negotiate language in the assignment agreement with the fund sponsor providing that required provisions in the seller's side letter will survive the transfer.

For governmental plans acting as buyers, so long as the plan has an existing investment in the fund being purchased, a sponsor is likely to confirm (typically in the assignment agreement) that the existing side letter will apply to the purchased interest. On the other hand, if the plan has no existing investment in the fund being purchased, obtaining side letter comfort on required issues may be a significant issue. Sponsors are often unwilling to enter into new side letters for interests purchased on the secondary market, so a governmental investor will want to carefully evaluate whether it is able to proceed with the purchase without

Secondary Transactions in Private Market Funds—Traps for the Unwary *(continued)*

a side letter addressing its legal, regulatory or policy matters.

Be Wary of Onerous U.S. Tax Compliance Obligations

Secondary transactions can trigger significant tax-related obligations: buyers must obtain satisfactory assurances they are not required to withhold U.S. taxes on the purchase price, while sellers may be asked to provide tax-related representations or documentation they are not equipped to provide.

Secondary transactions can be a profitable undertaking for an institutional investor, but such transactions involve risks that differ significantly from a typical primary investment in a private market fund.

Customary purchase and sale agreements used in secondary transactions often contain significant tax-related representations and covenants. Governmental pension plans and their advisors should be cautious in reviewing these provisions to ensure they are appropriate in light of the plan's U.S. tax status. Additionally, plans can mitigate the risk of onerous tax-related representations by outlining the scope of the representations in a preliminary term sheet.

Sellers should be aware of covenants to provide information with respect to funds that are "electing investment partnerships" under Internal Revenue Code section 743. Buyers often request this information to mitigate the risk of disallowed losses in connection with the purchased funds. It may be onerous for a seller to provide all the required information, particularly where non-U.S. funds are involved, so a seller should consult with legal counsel and tax advisers to assess whether the requested information can be provided. A seller can also reduce its exposure with respect to these covenants by agreeing to work "in good faith" (or similar standard) with the buyer, rather than agreeing to an unconditional obligation to provide the requested information.

U.S. governmental pension plans acting as buyers should also consider the tax profile of the seller—a seller who is a non-U.S. person or a UBTI-sensitive U.S. tax exempt entity may hold their interests through "blocked" funds. If a governmental pension plan is purchasing blocked funds as part of the portfolio (or if certain portfolio companies are held through blocked alternative investment vehicles), the plan could discuss with the sponsor whether the sponsor would allow the plan to transfer the newly acquired interests to an unblocked vehicle. Such a transfer is more likely to be accommodated where the plan already holds an interest in the fund being purchased (i.e., as a result of a primary investment in the same fund) but is unlikely in other cases.

Conclusion

Secondary transactions can be a profitable undertaking for an institutional investor, but such transactions involve risks that differ significantly from a typical primary investment in a private market fund. Secondary buyers and sellers can mitigate these risks by engaging competent outside advisors who are knowledgeable in such transactions.

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Don't Forget the "E" and the "S" in ESG: Securities Lawsuits Are No Longer Only About Corporate Governance

By: Serena Hallowell, Lance Oliver, and Erin Williams

Environmental, social, and governance—now called "ESG"—issues have long been the focus of litigation. But until recently, most securities litigation has focused on the "G" or corporate governance. That trend is changing. Investors are showing an increased interest and focus on the "E" and the "S" of ESG, environmental and social issues. In the past, these issues were peripheral to securities litigation. Now, social movements and climate change advocates have brought these issues to the forefront of the news, which has driven regulators and corporations to pay more attention; so too are investors. This has manifested in a number of ways. More money is flowing to ESG investment funds, companies are making more disclosures about their ESG practices, and securities litigation is being used with more frequency to hold companies accountable for failure to abide by ESG-related promises. This article explores the growing ESG landscape and the state of securities litigation focused on ESG-related disclosures.

In 2020, investment in ESG-friendly assets more than doubled, with substantial contributions from public pension funds.[1]

The Growing ESG Landscape

In 2020, investment in ESG-friendly assets more than doubled, with substantial contributions from public pension funds.[1] Indeed, funds that use ESG principles captured more than $50 billion in net new money from investors last year alone.[2] Because they hope to attract some of this money, corporations are increasingly including more in their public statements to investors about environmental sustainability, workplace diversity, and maintenance of a harassment-free workplace.

As some of this additional information is more general in nature, there is pressure from institutional investors to provide more specific information, like scoring metrics to help track performance and progress and ultimately provide investors with enough information to understand a company's ESG profile.

Understanding this need for information, the U.S. Securities and Exchange Commission (SEC) has also gotten more involved. Throughout 2021, the SEC has signaled its intent to ensure that companies are transparent about ESG and has indicated that it will propose a comprehensive ESG disclosure framework aimed at producing consistent and reliable data for investors. To that end, they have made clear that when a company does not disclose reliable or accurate information, it will be held accountable. For example, the SEC recently announced the creation of its Climate and ESG Task Force.[3] In discussing its purpose, the SEC stated that the task force "will work to proactively detect climate and ESG-related misconduct, including identifying any material gaps or misstatements in issuers' disclosure of climate risks under existing rules and analyzing disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."[4] Given the importance to investors, the SEC has recognized that "ESG is no different than any other subject matter … [j]ust as we've incorporated considerations related to, for example, cybersecurity and Fintech into our exam and enforcement processes as the risks and impacts of those issues became more apparent, we are now doing the same with respect to ESG."[5]

Even more recently, SEC staff has taken additional steps towards building out a disclosure framework. For example, it recently issued guidance in the form of a sample letter posted on the SEC website nudging companies to bolster their disclosures on climate-related risks in SEC filings.[6] An illustrative letter on the website seeks additional information on how climate change risks may impact a company's business. It also asks the company to explain why their climate-related disclosures in corporate social responsibility reports were more detailed than their SEC filings. The letter appears to preview some of the additional information that will eventually be required in SEC filings.

Don't Forget the "E" and the "S" in ESG: Securities Lawsuits Are No Longer Only About Corporate Governance *(continued)*

Private Securities Litigation Being Used as a Tool to Hold Companies Accountable

In that same vein, there have been more cases filed in recent years focusing on disclosures and conduct regarding diversity and inclusion, ethical business conduct, and environmental sustainability/climate risks. It has also become clear that just like every other securities action, courts are holding plaintiffs to a very high standard of pleading concrete misstatements or breaches of fiduciary duty.

The plaintiffs alleged that defendants falsely assured investors that OPKO celebrates diversity, prides itself on its diverse staff, and is committed to maintaining a workplace where discrimination is not tolerated, among other allegations.

For example, a number of suits have been dismissed in recent months that focused on corporate statements about prioritizing diversity and intolerance of discrimination. One such case was a shareholder derivative suit filed earlier this year against OPKO Health Inc. and OPKO's board of directors.[7] There, the plaintiffs alleged that defendants falsely assured investors that OPKO celebrates diversity, prides itself on its diverse staff, and is committed to maintaining a workplace where discrimination is not tolerated, among other allegations. In contrast, according to the OPKO complaint, the company's board consisted of "*zero* Black or Latinx members" and its management and leadership "have *zero* Black employees."[8] In an order issued August 31, 2021, Judge Cecilia Altonaga of the U.S. District Court for the Southern District of Florida dismissed the lawsuit, finding that the allegations were too conclusory and devoid of particularized facts to support the allegations.

Judge Altonaga explained that:

> Plaintiffs allege Defendants violated unspecified anti-discrimination laws and OPKO's Code of Conduct by refusing to nominate Black, Latinx, or other underrepresented individuals to the Board or executive management team …; Plaintiffs offer no particularized facts to animate these accusations. Instead, Plaintiffs point to a settled lawsuit against one of OPKO's subsidiaries as well as other companies' recent social justice initiatives.… These allegations have no bearing on whether *OPKO's* directors discriminated against underrepresented minorities when nominating individuals to serve on *OPKO's* Board or executive team.[9]

The OPKO decision came on the heels of the dismissal of another shareholder derivative action, which included fraud-based claims, against NortonLifeLock Inc. That suit alleged that despite the company's stated commitment to diversity and inclusion, there was no board diversity.[10] The NortonLifeLock court made clear at the outset of its opinion that it was not questioning "plaintiff's good faith in looking for legal recourse" or whether "there may be systemic under-representation in corporate boardrooms."[11] However, the court found that NortonLifeLock's statements regarding diversity were aspirational and not actionable.[12]

Although these suits, and some others filed in 2020/21 with similar allegations, were dismissed, other ESG-based actions brought in recent years have survived and created positive change. One example is the November 2020 shareholder settlement of *In re: Alphabet Inc. Shareholder Derivative Litigation*. There, the class members alleged Alphabet Inc. (Google LLC's parent company), as well as current and former board members and officers, participated in or acquiesced to a culture that fostered a long-standing pattern of sexual harassment and discrimination and in so doing, breached their fiduciary duties to shareholders and employees by reputationally and financially damaging the company.[13] Specifically, the shareholders claimed that senior Google executives were not only aware of allegations of sexual misconduct involving Andy Rubin, a former high-level Google executive, and two other male Google executives, but had determined that the allegations were actually credible. However,

Don't Forget the "E" and the "S" in ESG: Securities Lawsuits Are No Longer Only About Corporate Governance *(continued)*

rather than fire the executives, the company gave them significant exit packages all while concealing the true reason for their departure.[14] The complaint further alleged that the company "employed a *dual and contradictory standard*: If facing allegations about a high-level *male* executive at Google responsible for generating millions of dollars in revenue, Google would look the other way. And if caught, Google would quietly allow the male executive to resign, paying tens of millions of dollars to make the problem go away."[15] To the contrary, for its low-level employees, "Google acted more decisively, firing for cause and without golden parachutes. In this way, Alphabet and the Board maintained superficial compliance with its code of conduct, internal rules, and laws regarding sexual harassment."[16]

The SEC has been actively implementing rules regarding what ESG-related statements companies may issue, and companies have been making more ESG-related disclosures.

As part of Alphabet's settlement with its shareholders, the company agreed to establish a $310 million fund devoted to diversity, equity, and inclusion initiatives.[17] The company further agreed to implement a number of corporate governance measures aimed at ethical business conduct.[18] Among those measures, the company agreed to "maintain a robust program designed to prevent and address sexual harassment, sexual misconduct, and retaliation."[19]

On the environmental front, there have also been some successes in cases filed in the U.S. in recent years that address climate risks. One example, *Ramirez v. Exxon Mobil Corporation*[20] brought by a pension fund plaintiff, alleged Exxon failed to disclose climate risks. Specifically, the complaint focused on specific misstatements regarding, *inter alia*, the company's use of proxy costs of carbon in formulating business and investment plans.[21] The complaint's allegations were supported by expert declarations and internal Exxon documents. In sustaining the complaint, in part, the court found that the complaint and the internal documents sufficiently alleged Exxon stated a different proxy cost value in public statements than was actually applied in internal calculations.[22] A similar suit was filed more recently alleging derivative claims based on similar allegations against Exxon and an amended complaint was recently filed in that action on September 13, 2021.[23] No decision has been reached on whether the case may proceed.

The jury is still out, so to speak, as to the success of some of the more recent cases focused on the "E" and the "S" in ESG. But what is clear is that allegations supporting falsity of the statements or breaches of duty need to be specific and well pleaded in order to overcome or rebut the claim that allegations are merely aspirational or general in nature. This is nothing new, but courts are signaling that this is no less true in today's climate when seeking to hold companies accountable for ESG-related disclosures and conduct.

Conclusion

The SEC has been actively implementing rules regarding what ESG-related statements companies may issue, and companies have been making more ESG-related disclosures. These changes have come about in part because institutional investors are simply demanding more than profit at all costs from the companies in which they own stock. They still want profit, but understand it can be achieved with a conscience. These positive developments have laid the foundation for public pension funds to bring meritorious claims that hold companies accountable when they fall short of their ESG commitments. Pension funds should proactively discuss their litigation and ESG-related goals (including asset recovery and corporate reforms) with their securities fraud counsel to capitalize on these expanding opportunities.

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Don't Forget the "E" and the "S" in ESG: Securities Lawsuits Are No Longer Only About Corporate Governance *(continued)*

ENDNOTES:

[1]*See* Greg Iacurci, *Money invested in ESG funds more than doubles in a year*, CNBC (Feb. 11, 2021, 12:44 PM), https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html; *see also* Hazel Bradford, *Public funds taking the lead in spectacular boom of ESG*, Pensions & Investments (Aug. 19, 2019 12:00 AM), https://www.pionline.com/special-report-esg-investing/public-funds-taking-lead-spectacular-boom-esg (noting that "[p]ublic pension funds … accounted for 54% of the $8.6 trillion" of U.S. institutional investors' investments in ESG investments).
[2]Iacurci, *supra* note 1.
[3]Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.
[4]Allison Herren Lee, Acting Chair, U.S. Sec. & Exch. Comm'n, A Climate for Change; Meeting Investor Demand for Climate and ESG Information at the SEC (Mar. 15, 2021), https://www.sec.gov/news/speech/lee-climate-change.
[5]*Id.*
[6]U.S. Sec. & Exch. Comm'n, Sample Letter to Companies Regarding Climate Change Disclosures (Sept. 22, 2021), https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures#_ftnref1.
[7]*Lee v. Frost*, No. 1:21-cv-20885-CMA (S.D. Fla. Mar. 5, 2021).
[8]Compl. ¶ 4, *Lee v. Frost*, No. 1:21-cv-20885-CMA (S.D. Fla. Mar. 5, 2021), ECF No. 1 (emphases in original).
[9]Order at 14, *Lee v. Frost*, No. 1:21-cv-20885-CMA (S.D. Fla. Sept. 1, 2021), ECF No. 69 (emphases in original).
[10]*Esa v. NortonLifeLock Inc.*, No. 3:20-cv-05410-RS (N.D. Cal. Aug. 5, 2020).
[11]Order at 1, *Esa v. NortonLifeLock Inc.*, 3:20-cv-05410-RS (N.D. Cal. Aug. 30, 2021), ECF No. 69.
[12]*Id.* at 11.
[13]Am. Compl. ¶¶ 106, 251-56, *In re Alphabet Inc. S'holder Derivative Litig.*, No. 19CV341522 (Cal. Sup. Ct. Aug. 16, 2019).
[14]*See generally id.* ¶¶ 2-5.
[15]*Id.* ¶ 9.
[16]*Id.* ¶ 10.
[17]Order at 38-39, *In re Alphabet Inc. S'holder Derivative Litig.*, No. 19CV341522 (Cal. Sup. Ct. Nov. 30, 2020).
[18]*See generally id.* at 23-35.
[19]*Id.* at 23.
[20]No. 3:16-cv-03111-K (N.D. Tex. Nov. 7, 2016).
[21]Am. Compl. ¶¶ 5-10, 128-47, *Ramirez v. Exxon Mobil Corp.*, No. 3:16-cv-03111-K (N.D. Tex. July 26, 2017), ECF No. 36.
[22]*See generally* Order at 17-19, *Ramirez v. Exxon Mobil Corp.*, No. 3:16-cv-03111-K (N.D. Tex. Aug. 14, 2018), ECF No. 62.
[23]*See* Am. Compl., *Von Colditz v. Woods*, No. 3:19-cv-01067-K (N.D. Tex. Sept. 13, 2021), ECF No. 88 (document restricted).

The Challenge of Protecting Personally Identifiable Information When U.S. Pension Plans Invest in U.K. and Luxembourg Private Funds

By: Edyta Brozyniak, Tobias Niehl, and Yuliya Oryol

It has never been as challenging for U.S. public pension plans and other institutional investors to clear KYC/AML/CTF requirements in certain foreign jurisdictions. Investors must figure out how to navigate the often-contradictory requirements of administrators, on behalf of counterparties and fund managers, who conduct background checks and identity verifications by requiring prospective limited partners in private funds to provide personally identifiable information (**PII**) as part of the due diligence process.

For U.S. public pension plans, negotiations over PII are often mired in prolonged negotiations intended to allay the investors' privacy concerns while simultaneously satisfying the necessary customer due diligence checks that the administrators are obligated to conduct before admitting the investors into the funds.

In general, PII is any data that could potentially be used to identify a particular person. Examples may include the person's full name, social security number, driver's license number, passport number, or bank account information. Private investors are generally more comfortable providing such PII information to open brokerage accounts to trade securities or invest in private funds. However, U.S. public pension plans and other institutional investors are limited by law, internal policies and/or established practices with respect to the types of information that they can publically disclose and, as a result, have pushed back on this requirement on behalf of their employees and trustees who are required to provide certain PII as signatories to fund documents. For U.S. public pension plans, negotiations over PII are often mired in prolonged negotiations intended to allay the investors' privacy concerns while simultaneously satisfying the necessary customer due diligence checks that the administrators are obligated to conduct before admitting the investors into the funds.

Given that many U.S. public pension plans seek to invest in the private funds managed by the European fund managers, we examine the underlying legislation in Luxembourg and the U.K. to ascertain what duties these jurisdictions impose on fund managers and their administrators and propose some solutions for consideration.

Luxembourg

The Luxembourg investment funds are obligated to identify their investors and beneficial owners (**BOs**).[1] Luxembourg fund managers and their administrators will therefore request PII from investors, their representatives and, if applicable, their BOs.

For individuals representing legal entities, administrators will at the minimum request the full name of the individual and a copy of such individual's ID card or passport.

The BOs of investment funds and the BOs of any company registered with the Luxembourg Register of Trade and Companies (*Registre de commerce et des sociétés* **RCS**) must be disclosed in the Luxembourg register of beneficial owners (*Registre des bénéficiaires effectifs* **RBE**).[2] If the pension plan investing in a Luxembourg fund would hold over 25% in commitments in that fund, its board of directors would be considered the BO of the Luxembourg fund and the names of such directors would be entered in the register.

If a fund is set up as a private limited company (*société à responsabilité limité* **S.À R.L.**), its shareholders must be disclosed in the RCS. If any S.À R.L. shareholders are individuals, the RCS must show any such individual's surname(s), forename(s) and date and place of birth.

The United Kingdom

The U.K. has had regulations intended to prevent money laundering in place for nearly 30 years. Such regulations have been influenced by the European Money Laundering Directives and the international standards set by the Financial Action Task Force (**FATF**).

Two main pieces of legislation address money laundering in England and Wales:

The Challenge of Protecting Personally Identifiable Information When U.S. Pension Plans Invest in U.K. and Luxembourg Private Funds *(continued)*

1. Proceeds of Crime Act 2002; and
2. Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (**MLRs**).

The MLRs set out criminal offenses for their breach.

"Relevant persons" (including fund managers) acting in the course of business in the U.K. must comply with these regulations, and are obligated to have appropriate systems and controls in place.

The MLRs allow a risk-based approach to AML, aiming to increase the efficiency and effectiveness of the systems and controls that fund managers put in place.

The JMLSG Guidance sets out what customer due diligence information must be provided by various types of customers.

JMLSG Guidance

Since 2006, the Joint Money Laundering Steering Group (**JMLSG**), a private sector body that comprises the leading UK Trade Associations in the financial services industry, has published guidance (**JMLSG Guidance**) *"to assist those in financial industry sectors represented on JMLSG by their trade member bodies, to comply with their obligations in terms of UK anti-money laundering* (**AML**) *and counter terrorist financing* (**CTF**) *legislation and the regulations prescribed pursuant to legislation."*

Because a private sector body publishes the JMLSG Guidance, it is not legally binding even though it has the approval of the HM Treasury. The most recent JMLSG Guidance was issued in June 2020 (and amended in July 2020). It provides *"a base from which management can develop tailored policies and procedures that are appropriate for their business."*

Risk-Driven Approach

The general approach taken when complying with the duties under the legal and regulatory framework relating to the AML and CTF legislation is risk driven. Therefore, money management firms should have in place policies and procedures that are appropriate and proportionate to the risks identified. It is important to note that the fund managers have some discretion as to how they apply the requirements of the U.K. AML/CTF regimes in certain circumstances with respect to their products, services, transactions, and customers.

Overseas Governments and Public Sector Bodies

The JMLSG Guidance sets out what customer due diligence information must be provided by various types of customers. For customers who are U.K. or overseas governments based in jurisdictions that the firm has determined to be low risk (or their representatives), supranational organizations, governmental departments, public sector bodies, state-owned companies or local authorities, the approach to identification and verification may be tailored to the circumstances of the customer, reflecting the fund manager's determination of the level of money laundering/tax fraud (**ML/TF**) risks presented.

In this context, it is important to distinguish between bodies engaged in public administration and state-owned bodies that conduct business. The nature of the business relationships established with the fund managers will therefore differ. Public administration involves a different revenue/payment stream from that of most businesses, and may be funded from government sources, or from some other form of public revenues.

State-owned businesses, on the other hand, may engage in a wide range of activities, some of which may involve higher risk factors, leading to a different level of customer due diligence being appropriate. Such entities may be partly publicly funded or may derive some or all of their revenues from trading activities.

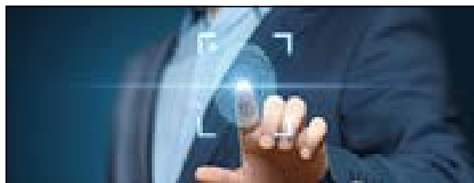
Where the fund manager determines that the business relationship presents a low degree of risk of ML/TF, as

The Challenge of Protecting Personally Identifiable Information When U.S. Pension Plans Invest in U.K. and Luxembourg Private Funds *(continued)*

may be the case with the U.S. public pension funds, standard due diligence measures may be applied. The JMLSG Guidance prescribes that the fund managers should obtain the following information about customers who are public sector bodies:

- full name of the entity
- nature and status of the entity
- address of the entity
- name of the home state authority
- names of directors (or equivalent)

The fund managers are also required to take appropriate steps to (i) understand the ownership of the customer, and the nature of its relationship with its home state authority; and (ii) be reasonably satisfied that the person the firm is dealing with is properly authorized by the customer and has authority to give instructions concerning the use or transfer of funds or assets.



Most U.S. public pension plans take the position that they are unable to provide PII in order to verify the identity of their signatories (either their employees or trustees) if the administrator requires government-issued identification for such individuals.

Signatories

For operational purposes, the fund manager is likely to have a list of those authorized to give instructions for the transfer of funds or assets, along with an appropriate instrument authorizing one or more directors (or equivalent) to give the firm such instructions. The identities of individual signatories must be verified on a risk-based approach.

Application

A study prepared by the U.K. Investment Management Association on the AML practices in the U.K. investment funds and investment management sectors in 2013 showed that most fund managers attempt to verify identities by alternative means before requesting documentary evidence from the customer. Such means comprise a combination of electronic checks and intermediary reliance.

For overseas public bodies/authorities, the fund managers uniformly require the signatory list. However, with respect to the verification of the signatories themselves, some fund managers apply a risk-based approach. Verification of an individual involves obtaining his/her full name, residential address, and date of birth.

Verification Requirements for U.S. Public Pension Plans

For those U.S. public pension plans investing in U.K. funds, the verification of the signatories is a cumbersome process. If the signatory's identity is to be verified from documents, such verification can be based on either a government-issued document which incorporates the individual's full name and photograph, and either his/her residential address or date of birth, or a government, court or local authority-issued document (without a photograph) which incorporates the person's full name.

In addition, there is a requirement for a second document—either a government-issued identification or a document issued by a judicial authority, a public sector body or authority, a regulated utility company, or another FCA-regulated firm in the U.K. financial services sector—which incorporates the customer's full name and his/her residential address or date of birth.

Alternative Approach to Verification for U.S. Public Pension Plans

Most U.S. public pension plans take the position that they are unable to provide PII in order to verify the identity of their signatories (either their employees or trustees) if the administrator requires government-issued identification for such individuals. For those U.S. public pension plans that have adopted these rules in written policy, there are real limitations on their negotiations with the fund managers or their administrators. In practice, if a compromise cannot be reached, such investors may be forced to forsake the investment.

Back

The Challenge of Protecting Personally Identifiable Information When U.S. Pension Plans Invest in U.K. and Luxembourg Private Funds *(continued)*

One alternative approach successfully utilized by many U.S. public pension plans is to provide an official employee identification badge in support of each individual's employment in lieu of copies of a driver's license, passport or utility bill. The individuals at issue here are employees of the governmental plan acting in their official capacities. As such, they are likely subject to the applicable state constitution where certain protections are afforded to employees of a public agency of that state. In fact, most state laws provide for a fundamental right to privacy, which should include the control of the disclosure of personal information. Furthermore, for the U.S. public pension plans that are subject to various public records and disclosure laws, PII may not be considered a public record and, therefore, may be exempt from the requirement of disclosure. In addition, most states treat an employee's home address, telephone numbers, and birth date within limited applicable exceptions to disclosure.

More established managers are often familiar with the verification process and may themselves suggest what supporting evidence can be provided in lieu of more traditional PII of individual government officials.

Furthermore, because the individuals in question are performing official duties in their capacities as public agency employees or trustees, they are unable to provide the requested government-issued identification or any other corroboration information, beyond submitting an official employee identification badge. In order to receive an employee identification badge, in most cases, the individual must be a current employee of the public pension plan or its sponsor and perform official duties in some official capacity. Prior to offering an individual employment, the governmental agency in question typically verifies all of the information provided by a prospective employee, which includes government-issued identification, and requires all prospective employees to submit fingerprints in order to conduct a criminal background check. In general, individuals whose identities cannot be verified or who fail a background check may not become employees of the plan. Although, of course, the employee or trustee may misrepresent his/her identity, the likelihood of this happening is extremely low particularly given that most state laws provide that it is a crime to provide false identification or otherwise misrepresent one's identity. In this regard, most of our clients have been able to successfully provide copies of work-issued badges without having to also provide administrators with additional identification, although we are aware that some administrators have also insisted during the negotiation process that the investor indemnify the manager in the event that it refuses to provide the required PII. Another approach is for the U.S. public pension plans to provide a "comfort letter" confirming the official capacities of the signatories. Such comfort letter may be issued internally by the plan's board or provided by an independent regulated entity (such as a bank). The type of documentation or information that is acceptable often varies from one manager to another.

We are aware of other creative methods by which managers and administrators have attempted to confirm the identities of the signatories, such as video conference calls where a manager or an administrator can confirm the identity of a signatory against his/her passport, but copies of the underlying documents are not provided to the manager or administrator.

Conclusion

Because the verification of signatories often proves to be a thorny issue when on-boarding U.S. public pension plans or other institutional investors, such verification is best approached at the onset of the fund review process so that the expectation of the parties with respect to what information is required to be provided by the investor, and what information is acceptable to the administrator, are addressed early on. More established managers are often familiar with the verification process and may themselves suggest what supporting evidence can be provided in lieu of more traditional PII of individual government officials.

The Challenge of Protecting Personally Identifiable Information When U.S. Pension Plans Invest in U.K. and Luxembourg Private Funds *(continued)*

Finally, as more U.S. public pension plans continue to resist providing PII, managers and their administrators will likely become more comfortable over time with the U.S. approach to PII and find other creative ways to work around the KYC/AML/CTF requirements in order to accept U.S. public pension plans and other institutional investors into the European funds.

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ENDNOTES:

[1]BO means any natural person who ultimately owns or controls the customer or any natural person for whom a transaction is executed or an activity is carried out.
[2]The following information on the beneficial owners of registered entities must be recorded and kept in the RBE:

1. name;
2. first name(s);
3. nationality (or nationalities);
4. the date of birth;
5. the month of birth;
6. the year of birth;
7. the place of birth;
8. the country of residence;
9. the precise private address or the precise professional address mentioning
    a. for addresses in the Grand Duchy of Luxembourg: the habitual residence listed in the national register of natural persons or, for business addresses, the locality, street and building number listed in the National Register of Localities and Streets, as provided for in Article 2(g) of the amended law of 25 July 2002 on the reorganisation of the administration of the land register and topography, as well as the postcode; and
    b. for addresses abroad: the locality, the street and the number of the building abroad, the postal code and the country;
10. for persons entered in the National Register of Natural Persons: the identification number provided for by the amended Act of 19 June 2013 on the identification of natural persons;
11. for non-resident persons not registered in the National Register of Natural Persons: a foreign identification number;
12. the nature of the effective interests held; and
13. the extent of the effective interests held.

Securities Class Action Litigation Fees and Costs

By: Brian J. Bartow and Brian Sytsma

Billions of dollars' worth of securities class actions are brought in federal court every year. Securities-fraud cases account for nearly half of all federal class actions and nearly three-quarters of all federal class action recoveries.[1] Attorney's fees and costs frequently amount to 20% or more of the settlement fund from these class action recoveries, in effect a tax on amounts due to the securities fraud victims: the investors.

Under the Federal Rules of Civil Procedure, the Court, sitting as a fiduciary to the class, is charged with ensuring that the fees and costs are reasonable.[2] In practice, however, that oversight is hampered by the absence of the adversary process in such fee applications. Invariably, class counsel submits an application for fees and costs along with the motion for court approval of the settlement and defendant issuer stands silent, leaving only class members to object if the fees and costs are excessive.[3] With some notable exceptions, such objections are rarely given weight by courts, which see them as an impediment to a significant settlement after a hard-fought litigation.

Public pension funds play an important role in putting downward pressure on plaintiff's attorney's fees in securities class action cases, which leads to an increase in total recovery for all shareholders.

Public pension funds play an important role in putting downward pressure on plaintiff's attorney's fees in securities class action cases, which leads to an increase in total recovery for all shareholders. This article focuses on strategies for increasing recoveries in securities class actions through the reduction of fees. It is a fundamental precept in the realm of private equities that, all things being equal, an expedient approach to increasing returns is to reduce fees. The same approach can be applied to attorneys' fees and costs in securities class action cases.

There are three principal stages in the litigation process where efforts can be applied to reasonably reduce fees: 1) fee negotiation; 2) billing oversight; and 3) fee challenges.[4]

Fee Negotiations and Agreements

Congress enacted the Private Securities Litigation Reform Act (PSLRA) in 1995 to limit frivolous lawsuits. One goal of the PSLRA was to increase the role of institutional shareholders in securities class actions.[5] The objective was to incentivize sophisticated investors with large financial stakes to oversee the litigation by giving them a presumptive advantage to serve as lead plaintiffs and rely less on judges and fee request objections with the hope these large investors would act in their economic self-interest by maximizing the net recoveries for the entire class.[6]

In theory, once appointed, the lead plaintiff is obligated to "select and retain" counsel to represent the class,[7] with Congress envisioning that institutional investors would negotiate fees as part of the process of selecting class counsel.[8] In practice, however, securities litigation firms may propose their clients to serve as lead plaintiff with the expectation that their clients will select them as putative class counsel, with no agreement as to fees prior to appointment. Given the relative size and exposure to most securities class action cases, public pension plans are well positioned to be presumptively appointed as lead plaintiff and thereby drive hard bargains when negotiating ex ante fee agreements by engaging in real arm's-length negotiations, rather than simply responding to a lawyer's fee proposal. Large institutional investors with large financial stakes, some of which are repeat players in securities litigation, have good information about the market for fees and considerable bargaining leverage because lawyers compete for the opportunities to represent them.[9]

When public pension plans serve as lead plaintiffs and there is evidence of an ex ante fee agreement, one leading study suggested the average fee request was just over 13 percent of gross recovery. By contrast, in cases again led by public pension plans but with no

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evidence of an ex ante fee agreement, the average fee request was about 22 percent, suggesting a stark difference between pension funds that act aggressively to reduce costs and those that do not.[10]

In negotiating a fee agreement, plan counsel should ensure that, in addition to the most advantageous rates, the agreement contains clauses requiring counsel to: a) submit contemporaneous bills for review; b) provide regular case updates, with significant advance warning of potential settlement negotiations; and c) provide significant advance visibility into the fees and costs applications to allow the plan time to evaluate and question assumptions contained in such applications.

Public pension funds should acquaint themselves with recent fee awards in similar types and size cases and consulting with fellow NAPPA inside counsel is a good place to start.

Two basic fee structures (also known as "fee grids") for securities class actions include the "increase/decrease" method and the "increase/increase" method. Under "increase/decrease," the fees calculated as a percentage of recovery decline as the size of the recovery grows, whereas under the "increase/increase" structure, the opposite occurs with the percentage fee rising as the amount of the recovery increases.[11] Within these fee structures there will be thresholds that set the percentage in reference to the settlement fund.

Anecdotal evidence suggests judges have viewed the more traditional "increase/decrease" approach as more attractive,[12] however institutional investors should at times consider more creative fee agreements, such as the "increase/increase" method to encourage attorneys to pursue cases, even strong ones, more vigorously.[13]

Another aspect public pension funds should consider when negotiating fee agreements with prospective class counsel is the relative strength of the case. Public pension funds should acquaint themselves with recent fee awards in similar types and size cases and consulting with fellow NAPPA inside counsel is a good place to start. When negotiating rates, consideration should be given to strong evidence of corporate wrongdoing that perhaps came to light prior to the involvement of plaintiffs' attorneys, such as SEC and other government investigations, resignation of top officers,[14] new reports, or even indictments. In other words, the more conclusive the evidence of wrongdoing, the lower the risk for plaintiffs' attorneys, which justifies lower percentages in the fee grid.

Case Oversight

In this stage, plan counsel should exercise the rights contained in the agreement to carefully review the time and tasks billed for reasonableness and accuracy and consistency with the case plan and updates.

Many large public pension funds have sophisticated legal staffs for overseeing litigation, and smaller funds will almost certainly at least have more resources to devote to monitoring the class counsel than small, individual investors who traditionally served as class representatives.[15] This monitoring includes, among other things, being an active participant in the litigation and reviewing attorneys' billing statements. Questions regarding billing should be addressed at the time of review.

Fee Challenge

When it comes to awarding fees, the courts enjoy broad discretion in awarding "reasonable attorney's fees,"[16] with the PRSLA's slight narrowing of this discretion mandating that awards not exceed "a reasonable percentage of the amount of any damages actually paid to the class."[17] If the public pension plan is lead plaintiff, it has a fiduciary duty to the class to ensure that the fee application is fair and reasonable.

Sometimes it appears that judges cut fees randomly, with very little explanation for why they did so,[18] and frequently rely on plaintiff's attorneys' compilations of unpublished orders, which would be carefully selected

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to support the fee the attorney requested.[19] Judges simply award the fees requested by plaintiffs' counsel in the vast majority of cases.[20]

In some infrequent instances, the fees requested by counsel may seem excessive or may be questionable for a number of reasons including:

- The complexity of the case,
- The length of the litigation and labor expended by counsel, or
- The magnitude and complexities of the litigation.

While not the usual instance, plan counsel should consider the possibility of objecting to excessive fees and costs applications where indicated, even if it may result in uncomfortable conversations in the Snack Shack.

Attorneys' Fees and the PSLRA

History has shown that public pension funds have generally succeeded in reducing attorney fees for all securities class action cases. Not only have investors gotten more "bang for the buck" through higher recoveries and lower fee awards in securities-fraud class actions when public pension funds serve as the lead plaintiffs,[21] but also studies suggest lower fees negotiated by institutional investors have also led to reduced fees for other securities class action fee awards, including those led by individual investors.[22] This is likely because judges seek to calibrate fees awarded in cases with public pension lead plaintiffs for other cases.[23]

Institutional investors and public pension plans specifically have played an important role in reducing attorney's fees in securities class actions and thereby saving more of the settlement for the benefit of themselves and their fellow investors.

Summary

Institutional investors and public pension plans specifically have played an important role in reducing attorney's fees in securities class actions and thereby saving more of the settlement for the benefit of themselves and their fellow investors. To maintain or perhaps even continue this downward trend, it's important for all public pension plans to continue:

- Negotiating hard bargains with plaintiffs' attorneys to obtain the "right lawyer" at the "right fee" to obtain the best result for the class to maximize net recoveries,
- Evaluating and leveraging the relative strength of the case to obtain the best fee structure terms possible, to include creative fee agreements, and
- Being an active and engaged participant in the litigation, maintaining proper oversight of class counsel, and even challenge fee awards when appropriate.

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ENDNOTES:

[1]*See* Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. Empirical Legal Stud. 811, 818 (2010).
[2]USCS Fed Rules Civ Proc R 23(h).
[3]USCS Fed Rules Civ Proc R 23(h)(2).
[4]Principal Author's Note: Over the years we have been represented by a number of gifted counsel, most if not all members of NAPPA, who have demonstrated the highest professional ethics as well as an understanding and a willingness to negotiate to find the proper balance between fair compensation for risk and effort and the fiduciary responsibility to maximize recoveries to pay pension benefits.
[5]*See* S. REP. NO. 104-98, at 11 (1995) ("The Committee intends to increase the likelihood that institutional investors will serve as lead plaintiffs ...").
[6]*See*, e.g., H.R. Rep. No. 104-369, at 32 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 731 (noting Congress's intent to "increase the likelihood that parties with significant holdings in issuers, whose interests are

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more strongly aligned with the class of shareholders, will participate in the litigation and exercise control over the selection and actions of plaintiff's counsel").

[7]15 USCS § 77z-1.

[8]*See* Choi, Erickson & Pritchard, *Working Hard or Making Work? Plaintiffs' Attorney Fees in Security Fraud Class Actions*, 17 J. Empirical Legal Stud. 438, 441 (2020).

[9]*See* Baker, Perino & Silver, *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 Colum. L. Rev. 1371, 1433 (2015).

[10]*Id*. at 1394.

[11]*See* Baker, Perino, & Silver, *19th Annual Institute for Law and Economic Policy Conference: The Economics of Aggregate Litigation: Setting Attorneys' Fees in Securities Class Actions: An Empirical Assessment*, 66 Vand. L. Rev. 1677, note 33 (2013).

[12]*Id*. at 1691.

[13]*See* Weiss and Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2107 (1995).

[14]*See* Choi et al., supra at 439.

[15]*See* Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, 9 J. Empirical Legal Stud. 368, 373-374 and note 5.

[16]USCS Fed Rules Civ Proc R 23.

[17]15 USCS § 78u-4.

[18]*See* Baker, Perino & Silver, *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 Colum. L. Rev. 1371, 1373 (2015).

[19]*See* Perino, at 371.

[20]*See* Choi et al., supra at 442.

[21]*See* Baker, Perino & Silver, *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 Colum. L. Rev. 1371, 1374 (2015).

[22]*See* Choi et al., *Working Hard or Making Work? Plaintiffs' Attorney Fees in Security Fraud Class Actions*, 17 J. Empirical Legal Stud. 438, 441 (2020).

[23]*See* Baker, Perino & Silver, *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 Colum. L. Rev. 1371, 1379 (2015).

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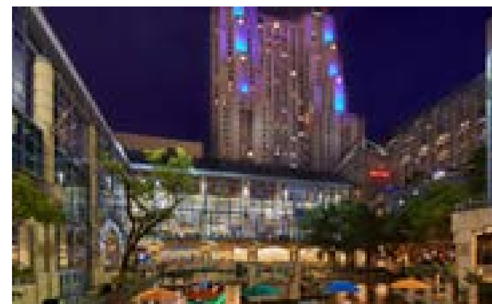

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