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NAPPA
National Association of Public Pension Attorneys
2410 Hyde Park Rd., Suite B
Jefferson City, MO 65109
Phone: (573) 616-1895
www.nappa.org

NATIONAL ASSOCIATION OF PUBLIC PENSION ATTORNEYS

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Message From the NAPPA President

Michael Herrera

Dear NAPPA Members,

I am honored and thrilled to serve as President of NAPPA for the 2018-2019 Association year. As I expect it does for many of you, NAPPA holds a special place in my heart. While it may seem unusual for a professional organization to evoke such emotional attachment, NAPPA isn't just any organization. I suspect that working as a public pension lawyer is not what many of us imagined growing up. It's certainly not the most glamorous or easy work. While rewarding, the work we do and the ever-changing environment in which we do it can be incredibly challenging. I am personally grateful for the steady and much needed community, education, resources, and support system NAPPA has provided since I joined over 18 years ago.

From its humble beginnings of just 20 members more than three decades ago, NAPPA has grown tremendously in both size and significance. Impressively, a record 384 members attended the 2018 Legal Education Conference in Savannah, Georgia. Yet, as NAPPA has grown, the organization—through its members and steady leadership over the years—has remained diligent and committed to its purpose of providing excellent educational opportunities and informational resources. As President, I will do my best to support and further this enduring and important mission for its more than 700 current attorney members.

I would also like to recognize and extend my congratulations to Ashley Dunning on being elected to serve as NAPPA Vice President (President Elect), and to Mary Beth Foley for being elected to her first full term on the Executive Board. I join Ashley, Mary Beth and all my fellow Board members in looking forward to a great year ahead. From the feedback we received, the 2018 Legal Education Conference was extremely successful. We are already working on the programs for the Winter Seminar that will take place next February in Tempe, Arizona, and the Legal Education Conference to be held next June in San Diego, California.

In this connection, the Board relies heavily on the participation and thoughtful feedback we receive from the membership. On behalf of the Board, I would like to thank the members who provide this feedback, and who give generously of their time and talent by serving on the various committees, working groups and affinity groups, write articles for the newsletter (*The NAPPA Report*), and who speak on panels at conferences. Your participation and contribution in all these areas is invaluable. The quality of our programs is due to the contributions and leadership that so many of you provide.

Of course, I would be remiss if I did not recognize that a lot of NAPPA's success is also due to the quality of the professional staff who support the Executive Board and the membership all year. I would like to recognize and thank NAPPA's Executive Director Susie Dahl, and her fantastic team of Karen Holterman, Brenda Faken, and Doris Dorge for their tireless work and dedicated service for the organization and its members.

Finally, while I am clearly bullish on NAPPA and its future, the Board and I understand there is always room and need for improvement and positive growth. We are constantly looking for ways to address and accomplish both for the organization. We are very interested in, and invite your feedback and suggestions on, how to make the organization even better. Please feel free to contact me or any member of the Board with your ideas. We welcome and look forward to the opportunity to continue to serve you.

Michael Herrera
Los Angeles County Employees' Retirement Association

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Errors and Omissions Corrections Law—Scope, Time and Equity

By: Laura M. Gilson

How can you fix an error or omission in the operations of a governmental pension system ("system") that causes undue harm to a member or the system? For example, how does a system adequately rectify miscalculation of a member's benefit or a missed deadline? Sometimes these errors are easily fixable, sometimes not. And sometimes, through the strict application of the law, the fix is worse than the error. Can we reasonably resolve errors or omissions by allowing equitable considerations when a strict application of the law creates a clearly unintended outcome?

This article discusses typical errors and omissions laws (hereafter, "error corrections law") and illustrates how some systems provide additional language in the law to expand the scope of what can be fixed, the time allowed to fix it, and the ability to do what is right by the system and the member.

Mistakes in the pension world orbit around divorce, retirement, disability, and death—all areas in which remedies in the law, such as penalties or damages, can be inadequate and insufficient.

When a system discovers that a mistake has been made which harms a member or the system, its laws and rules typically enable the system to correct the error. However, in certain circumstances, correcting an error creates an unintended, unconscionable, absurd, or overly harsh consequence, as discussed below. Mistakes in the pension world orbit around divorce, retirement, disability, and death—all areas in which remedies in the law, such as penalties or damages, can be inadequate and insufficient. There may be more equitable solutions, but system laws may not be agile enough to do what is right by all parties, forcing the system to instead correct the mistake and yet not resolve the problem. Inevitably, the member appeals and litigation follows, even when both parties know that the outcome of the litigation may be absurd. If the system can craft error corrections laws to provide an equitable remedy where appropriate, the parties could be spared from the costs and burden of litigation. A comprehensive statutory framework for correcting errors and omissions, which includes the authority to administer equitable relief, can allay overly punitive or absurd results where none was intended. What follows are examples of common mistakes and recommendations for statutory language to help prevent their reoccurrence.

A rudimentary error corrections law gives authority to the system to recapture overpayments or underpayments to a member. Because all systems have a fiduciary duty to manage money held in trust for the members, correcting the flow of cash to or from the system is always a priority. The Washington State Department of Retirement System's error corrections law is a prime example:

> "Should any error in such records result in any member, beneficiary, or other person or entity receiving more or less than he or she would have been entitled to had the records been correct, the director…shall adjust the payment…."[1]

But an error correction law narrowly focused on overpayments or underpayments can create overly harsh results in its enforcement. Consider the seminal case of Pennsylvania's *Kellams v Public School Employes' Retirement Board*.[2] In a refrain familiar to many pension systems, several retirees' pension benefits had been overpaid and the system demanded return of their mistakenly paid benefits. The Supreme Court of Pennsylvania observed that there was no fraud or mischief on the part of the retirees, and also acknowledged that the system was correctly pursuing the claim in accordance with the law, quoting the commonwealth court as follows:

> "…here the issue is not the correctness of the Commonwealth claim, it is whether it would be unconscionable to permit the Commonwealth to demand restitution in this unusual situation…[T]he Commonwealth persisted in its error over a number of years while the plaintiffs used the funds presumably for the purposes for which retirement payments are intended, i.e., to pay for living expenses after the income from gainful employment has ended."[3]

The court in its ruling recognized that an unconscionable outcome arose from the system's legal imperative to correct the error. While the court has the authority to consider inequities, a narrowly written error corrections law does not give the system such authority and therefore forces the parties to seek resolution through litigation. Perhaps in reaction to the ruling in *Kellams*, the Pennsylvania Public School Employees' System ("PSERS") thereafter enacted legislation that now allows the retirement system to evaluate the root of the error and consider the undue hardship.[4]

Expanding the scope of the error corrections law beyond benefits paid or payable may help a system address essential questions of fairness and equity (such as issues concerning benefit eligibility).

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Errors and Omissions Corrections Law—Scope, Time and Equity *(continued)*

The Kentucky Retirement System's error corrections law includes a wide range of pension issues that can be corrected:

> "(1)…, upon discovery of any error or omission in system records, the system shall correct all records *including, but not limited to* [emphasis added], membership in the system, service credit, member and employer contributions, and benefits paid or payable…."[5]

Similarly expansive scope in the error corrections laws are found in statutes governing the Indiana Public Retirement System, South Carolina's Public Employee Benefit Authority, and PSERS.[6]

Another common line of defense against mistakes is imposing a time limit on correcting errors. Time limits, or statutes of limitations, are "fair" to all parties.[9]

Nevertheless, unintended outcomes from correcting an error still arise regardless of how inclusive the error corrections language is, such as if correcting the error becomes impossible due to a member's change in circumstances (i.e., death or remarriage). A system that foresees these difficulties can build language into its law that allows flexibility and discretion for the system to assess reasonableness and fairness when addressing the error. For example, PSERS adds a discretionary lever for correcting underpayments and overpayments to the extent the board determines the fix is practicable:

> "Should any change or mistake in records result in any member, participant, beneficiary, survivor annuitant or successor payee receiving from the system or plan more or less than he would have been entitled to receive had the records been correct, …the board shall correct the error and if the error affects contributions to or payments from the system, *then so far as practicable* [emphasis added] shall adjust the payments…."[7]

That discretionary lever, the "so far as practicable" language, is further fleshed out in a waiver of adjustments provision that allows the Board to consider if the adjustment causes undue hardship to the member, beneficiary or survivor annuitant.[8] Thus, it can be construed that the Board has authority to utilize an equitable remedy by weighing the practicality of the remedy, as may be found in a particular case.

Another common line of defense against mistakes is imposing a time limit on correcting errors. Time limits, or statutes of limitations, are "fair" to all parties.[9] No doubt, stemming the loss by applying a cut-off date is a traditional and reasonable way to prevent parties from skewing facts that in their minds have intensified or mellowed with time, or prevent the omission of facts that are no longer producible.[10] Likewise, a system should not be haunted by its errors and omissions indefinitely. Adding a statute of limitations within the error corrections law sets the time limits within the context of a system's operations. Nonetheless, a strict time limit on redress can also cause, rather than alleviate, undue hardship for one or both parties. For example:

> A retiree receives a monthly benefit check for nine years, unaware that the retirement system miscalculated the original amount, and now the member has been overpaid by $223,000. The system wants the money returned and the member fights back. After the member loses the first two legal rounds to the system, a court agrees with the member and applies the one-year statute of limitations, barring the system from collecting amounts beyond the last year.[11]

The member did not make the mistake, but they also were not entitled to excess money, so the rest of the retirees ultimately paid for the erroneous windfall—a rather lopsided result for both the member and the system as the result of an incomplete statutory scheme for dealing with errors and omissions.

An expanded scope of application, language for practicality[12] and an integrated statute of limitations in the error corrections law allows the system to more ably and realistically deal with errors. However, a system could go a step further in acknowledging the potential for undue hardship or unintended consequences while correcting errors by placing language in the law that allows the system to seek an equitable remedy, such as in the Arkansas Teacher Retirement System's (ATRS) error corrections law.

ATRS crafted a law to recognize when an error or omission creates a "manifest injustice."[13] The designation of a manifest injustice explicitly allows ATRS to correct an error beyond the statute of limitations[14] and in any circumstance to correct or prevent a manifest injustice:

> "(e) The board or its designee may waive or modify the impact of a rule, provision, or law that does not violate federal law or jeopardize the tax-qualified status of the system to correct or prevent a *manifest injustice* [emphasis added] that would affect the system, benefit participant, or employer in a particular instance."[15]

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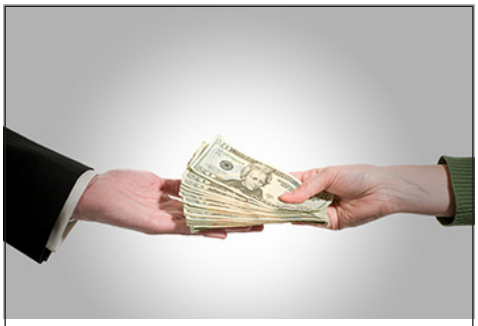
Errors and Omissions Corrections Law—Scope, Time and Equity *(continued)*

While the manifest injustice remedy can be considered when correcting any error, it is an extraordinary remedy and intended to be used sparingly and surgically. Any party can file a manifest injustice claim, including the system. The language of the statute is carefully crafted to ensure that ATRS does not violate federal law or jeopardize the tax-qualified status of the pension system.[16] The manifest injustice remedy is broader than the "so far as practicable" language found in other jurisdictions' error corrections laws[17] because it allows the system to weigh the degree of fault of the parties, the ambiguity in the law or facts, the costs and benefits to the system, the public interest in an expedited decision, the fundamental fairness of the remedy, and whether the status quo would result in an unconscionable outcome.[18] Consider the following:



In summary, because common mistakes are often compounded by the unique circumstances found in pension plans, namely, a wide array of issues spanning a large amount of time, a system may wish to develop its error corrections law to consider undue hardship and inequity.

> A system discovers that it misinterpreted a law which caused it to erroneously pay a $10,000 lump sum death benefit to 39 separate beneficiaries. The lost monies to the system exceeded $400,000, including interest. The system, under its typical error and corrections law, is required to correct the error and seek full repayment from the beneficiaries, who, in most cases, are now themselves deceased.

If the system has the authority through a manifest injustice finding to consider the undue hardship of collecting the wrongly distributed monies, the system is spared the nearly impossible task of recovering the overpayments.

An ATRS internal manifest injustice committee, comprised of the General Counsel, Chief Financial Officer and Membership Administrator ("committee"), reviews manifest injustice applications, evaluates the circumstances of the applicant, and proposes an equitable remedy, should the situation merit one. Remedies are proposed directly to the board or executive director, who then makes a final decision.[19]

One advantage of the "manifest injustice" model is that the equitable review can be administered under a separate rule from the administrative appeal process, and an aggrieved party can ask for a manifest injustice determination concurrent with or prior to filing an administrative appeal. The manifest injustice review is not a duplication of the administrative appeal; however, it can provide equitable relief when the situation merits.

In summary, because common mistakes are often compounded by the unique circumstances found in pension plans, namely, a wide array of issues spanning a large amount of time, a system may wish to develop its error corrections law to consider undue hardship and inequity. As discussed above, enacting a multi-layered error corrections law that includes: 1) a broad scope for correcting errors; 2) a related statute of limitations; and, 3) a strategy for resolving equitable issues can result in fairer outcomes for all parties, and likewise, reduce fruitless efforts, time, and money litigating the error or omission.

Laura M. Gilson *is General Counsel for the Arkansas Teacher Retirement System.*

ENDNOTES:

[1]RCW 41.50.130.
[2]391 A.2d 1139 (Pa. Cmwlth 1978), *aff'd*, 403 A.2d 1315 (Pa. 1979).
[3]486 Pa. 95, 97-98, 403 A. 2d 1315, 1316 (1979).
[4]24 Pa. C.S. § 8534(b) (Pennsylvania); *See also* South Carolina Code of Laws § 9-1-1670(A).
[5]Kentucky Revised Statute 61.685.
[6]*See* Ind. Code § 5-10.4-5-17 and Ind. Code § 5-10.3-8-5; and S.C. Public Employee Benefit Authority Interpretive Guidance No. 2017-02; and 24 Pa. C.S. § 8534(b).
[7]24 Pa. C.S. § 8534(b).
[8]24 Pa. C.S. § 8303.1.
[9]Tyler T. Ochoa and Andrew Wistrich, *The Puzzling Purposes of Statutes of Limitation*, 28 Pac. L. J. 453 (1997) at 483, available at: **http://digitalcommons.law.scu.edu/facpubs/81.**
[10]*Id.* at 471-483.
[11]Baldwin v. Milwaukee Co. & Employees' Ret. Sys., 2018 WL 1890493.
[12]24 Pa. C.S. § 8534(b).
[13]The term "manifest injustice" is defined in A.C.A. § 24-7-202(23), as referenced in the error corrections statute, A.C.A. § 24-7-205. *See also* Acts of Arkansas, 303 of 2013.
[14]A.C.A. § 24-7-205(d). *See also* Acts of Arkansas, 336 of 2013, 138 of 2011.
[15]A.C.A. § 24-7-205(e).
[16]*Id.*
[17]24 Pa. C.S. § 8534(b) (Pennsylvania); *See also* South Carolina Code of Laws § 9-1-1670(A).
[18]Arkansas Teacher Retirement System, Rule 17-1 Manifest Injustice.
[19]*Id.* at 17-1-2.

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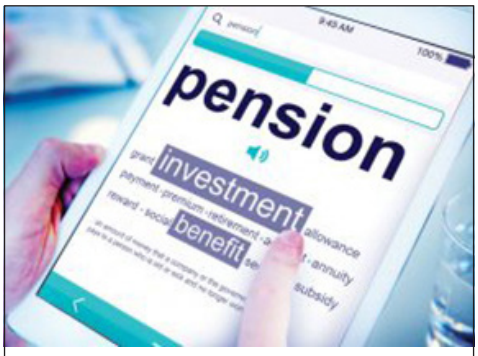
Federal Legislation on Infrastructure Investments

By: Tony Roda

Let me state at the outset that H.R. 6276, the Strengthening Pensions through Investment in Infrastructure Act, is new federal legislation and my public pension clients are still studying the intent and potential ramifications of the bill. This article, then, is meant to summarize and provide information on the overall issue and pending legislation in an effort to generally inform the public pension plan community.

Background

It's important to note that facilitating increased investment in infrastructure by public pension plans is not a novel concept. At least as far back as 2014, there have been meetings in Congress on the subject. I attended one of those meetings with staff of the Senate Finance Committee, which has jurisdiction over the federal tax code, and participated in teleconferences on the subject as well.



The assets held in trust by public pension plans appear to policymakers as a ready pool of investment dollars—potentially deep pockets and a partial way out of the funding dilemma.

In our modern political history, Congress has been singularly incapable of financing a comprehensive federal infrastructure bill. Given the lack of political support for an increase in the federal gasoline tax, a search for alternative means of financing has been underway for years. The assets held in trust by public pension plans appear to policymakers as a ready pool of investment dollars—potentially deep pockets and a partial way out of the funding dilemma. According to some investment experts, infrastructure investments would promote pension sustainability by providing long-term investment horizons, stable returns and inflation protection.

Arguments have been advanced that state and local governments are asset rich, but cash poor. While there has been some interest in privatizing governmental assets, this notion has been met with significant political opposition and has not taken root in many of our states or localities. As a result, maintaining public ownership of these assets appears to be the only viable path forward.

Proponents of greater participation by public plans argue that it would be a benefit to plans to have full or partial ownership of the actual infrastructure asset, and the revenue stream produced by that asset, rather than what amounts to a promise from the plan sponsor to pay the unfunded obligations of the pension fund. Others argue that these promises are backed by statutory and sometimes constitutional protections and, except for a few dire funding shortfalls, pension benefits are not in any real jeopardy.

Advocates also say that removing existing impediments to infrastructure investing by public plans does nothing more than create a voluntary option for plans. It is not a mandate and plan trustees would, of course, have to comply with their fiduciary responsibilities as prudent investors as well as the prohibited transaction rules under Internal Revenue Code (IRC) Section 503. Proponents of the legislation say that they have been in contact with the chief investment officers of some of the largest public plans in the country, who support the new legislation.

Ownership of public infrastructure property by public plans would likely be structured in a variety of ways, including: 1) complete ownership of the public asset, such as in the case of the New Jersey lottery which is 100 percent owned by three NJ pension plans; 2) complete ownership for a period of time with the intention to sell the property in the future; or, 3) creation of a limited liability company (LLC) or limited partnership (LP), which would hold title to the property and in which multiple plans would invest. In each case, it is anticipated that an operator with technical expertise would be hired by the plans (in the case of direct ownership) or the LLC or LP to actually manage the infrastructure property.

Impediment in Federal Tax Law

Advocates of federal legislation point to a barrier in the tax law that they assert creates an un-level playing field among public plans today. In 2010, a project to structure the purchase of certain infrastructure assets by a municipal pension plan was initiated. The project was pursued in part by seeking a private letter ruling (PLR) with the Department of the Treasury and the Internal Revenue Service (IRS) on the tax treatment of the transaction and certain future ramifications.

The process of obtaining a PLR is iterative, typically with several information requests and in-person meetings. Through these contacts it often becomes apparent whether Treasury-IRS will grant the request. During the meetings in 2010 and 2011, it became clear that Treasury-IRS were concerned about two issues and, as a consequence, would not issue the requested ruling.

First, a threshold matter was the question of whether the public pension plan designated to acquire the public infrastructure

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asset met the criteria of an instrumentality of one or more states or political subdivisions as outlined in Rev. Rul. 57-128. In particular, did the plan's governing structure satisfy prong four of the Ruling's six-part test: "...whether control and supervision of the organization is vested in public authority or authorities...."[1]

The second question was whether for purposes of the private business test under IRC Section 141 the acquisition by a public plan would trigger the arbitrage rule under IRC Section 148(b), which would result in the underlying bonds losing their tax-exempt status.

Regarding the first issue, it soon became clear that Treasury-IRS believed that the pension plan would fail prong four and that would be determinative. Specifically, the public pension plan that was designated to acquire the municipal asset did not have a majority of board members who were appointed or could be removed by the plan sponsor, the municipality. It was apparent that the PLR would not be granted and, therefore, as is the usual course of events, the request was withdrawn.

Federal Legislation

This experience laid the groundwork for what is now federal legislation, H.R. 6276, the Strengthening Pensions through Investment in Infrastructure Act (SPIIA). The bill was introduced on June 28, 2018, by Rep. Mike Bishop (R-MI), who serves on the House Ways and Means Committee, which has jurisdiction over federal tax law. The bill would make two changes to the tax code.

First, it would amend IRC Section 141(b) to state that use by a public pension fund of public infrastructure property shall not be treated as private business use. It goes on to define the term public pension fund as "a pension fund established or maintained for employees or former employees of a State, political subdivision of a State, or an agency or instrumentality thereof." The bill also contains a detailed definition of public infrastructure property.[2]

Second, the legislation would amend IRC Section 148(b) to state that the term "investment-type property" shall not include public infrastructure property, as defined above. This portion of the bill is the legislative parallel to a pending proposed regulation by Treasury-IRS, which would bring about the same result.[3] This clarification of tax law is crucial because without it the bonds used to finance the public infrastructure property would almost certainly be treated as arbitrage bonds and would lose their tax-exempt status.

Definition of Public Pension Fund (SPIIA)

As noted above, SPIIA would establish in IRC Section 141(b) a new definition of the term "public pension fund." A concern raised by some in the public pension plan community is that this new definition would be inserted into the tax code at the same time federal regulators are working to define the term "governmental plan" under IRC Section 414(d) and that the competing definitions would be confusing and potentially disruptive to the administration of federal tax law as it relates to state and local governmental pension plans.

Be aware, however, that the text of SPIIA is clear regarding the scope of the new Section 141(b) definitions, specifically stating that the definitions of public pension fund and public infrastructure property are "…[f]or purposes of this paragraph...." The paragraph and the section containing it pertain only to the private business test for private activity bonds.

Statutory definitions and regulatory interpretations thereof are fundamental to our community. A review of what is already underway on the Section 414(d) definition is instructive. As you will see, the issue of control of the governing board is a significant factor in the various tests.

Definition of Governmental Plan (the ANPRM)

In November 2011, Treasury-IRS released an Advance Notice of Proposed Rulemaking (ANPRM) announcing their intention to issue regulations defining the term "governmental plan" under IRC Section 414(d) and including a draft regulation.[4]

In part, the statutory language of Section 414(d) reads as follows:

> "…the term 'governmental plan' means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing."

Under the ANPRM's draft regulation, a facts and circumstances test would be used to determine whether an entity is an agency or instrumentality of the U.S. or of a State or political subdivision of a State. This test would be based on five main factors and eight other factors. The main factors are as follows: 1) control of the entity's governing board or body; 2) public nomination and election of members of the governing board or body; 3) responsibility of the State or political subdivision for the entity's

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debts and liabilities, including benefits; 4) the entity's employees are treated in the same manner as the employees of the State or political subdivision, except for benefits; and, 5) the delegation of sovereign powers. (Emphasis added).

The other factors to be examined are as follows: 1) control of the entity's operations by the State or political subdivision; 2) direct funding through tax revenues or other public sources; 3) specific enabling statute; 4) treatment of the entity as a governmental entity for federal tax purposes; 5) whether the entity is determined by state law to be agency or instrumentality; 6) court determination that the entity is an agency or instrumentality; 7) State or political subdivision has ownership interest and no private interests are involved; and, 8) the entity serves a governmental purpose. (Emphasis added).

Charter Schools (Treasury Notice 2015-7)

Of the approximately 2,300 comments received on the ANPRM, some 2,000 comments were submitted by the charter school community. The comments centered on the question of whether participation by employees of a charter school would cause a governmental plan to fail to meet the definition outlined in the ANPRM.

On January 23, 2015, the Treasury and IRS released Treasury Notice 2015-7, which provides further information and direction on the charter school topic. The Notice announces the anticipation that Treasury-IRS will issue proposed regulations that would create a five-part test (actually (a)-(e) in the Notice) that would need to be satisfied to meet the definition of a "public charter school."

A summary of the five-part (a-e) test for a public charter school follows:

a. Non-sectarian independent public school serving governmental purpose by providing tuition-free elementary or secondary education, or both;

b. Established and operated in accordance with a specific State statute;

c. Participation in the State or local retirement plan is expressly required or permissible under applicable law;

d. The entity satisfies a multi-part test to ensure that it is controlled by a State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State; (Emphasis added) and,

e. All financial interests of ownership must be held by a State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State.

Conclusion

Anyone who drives on our nation's roads, travels through an airport, over bridges or on our waterways, knows that our country needs to modernize its infrastructure. Some public pension plans have already been very active in this area of investment. The question before our community today is whether the Strengthening Pensions through Investment in Infrastructure Act, H.R. 6276, would be beneficial to state and local governmental pension plans. It is a question worth our time and thoughtful consideration.

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

ENDNOTES:

[1]See also Rev. Rul. 89-49, which reads, in part: "One of the most important factors to be considered in determining whether an organization is an agency or instrumentality of the United States or any state or political subdivision is the degree of control that the federal or state government has over the organization's everyday operations."
[2]H.R. 6276 (115th Congress), Section 2, "The term public infrastructure property means property with the following characteristics: (I) Consists of roads, bridges, tunnels, docks, wharves, ports, harbors, airports, rail stations, mass transit or commuting centers, water infrastructure (including sewage, waste water, storm water, and solid waste treatment), heating, cooling, or electric utility production, municipal buildings, or other real or tangible property that is used for an essential government function (within the meaning of Section 115). (II) Provides services to the general public or is available for general public use. (III) If rates are charged for use of or services provided by such property, such rates are subject to State or local governmental regulatory or contractual control, limitation, or approval."
[3]83 Federal Register 27302 (2018).
[4]76 Federal Register 69172 (2011).

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The Australian Securities Class Action Landscape and Potential Changes Ahead

By: Javier Bleichmar, Erin Woods, and Kendra Schramm

Australia is the second most active jurisdiction for largescale securities class actions, although far fewer cases are filed there each year than in the United States. Some recent cases have produced eight to nine figure settlements for class members.

Australian lawmakers are considering a slate of reforms that could upend current practices, particularly with respect to the litigation funding industry and how courts manage competing cases.

The key proposals discussed below could do much to simplify participation for American investors.[1]

Background

Australia enacted class action procedures more than 25 years ago. These procedures permit both "opt-in" and "opt-out" class actions, and there is no certification requirement.

American pension funds may be missing out on compensation from Australian class action settlements. Outside securities counsel should assist with these claims as part of their non-U.S. litigation services.

In an opt-in or "closed" class action, investors must take affirmative steps to register, often prior to or during the early stages of litigation. An opt-in class usually includes all investors who purchased a specific security during the relevant period and signed a written agreement with a particular third-party litigation funder.[2] This strategy is used by funders to ensure that all class members are contractually obligated to pay a funding fee and a pro rata share of legal costs from any recovery. In some but certainly not all cases, the class is "re-opened" prior to mediation, giving investors another chance to register, and sometimes to do so without signing a funding agreement.

In an opt-out or "open" class action, investors are not required to sign a funding agreement at any stage. In those cases, just like in U.S. cases, all investors who purchased a specific security during the relevant period are class members, and are bound by any judgment or class settlement unless they request exclusion.

All class members must submit a registration form setting forth their eligible transactions, in order to receive a payment from a class settlement. These registration forms resemble proof of claim forms filed in connection with class action settlements in the United States and Canada. Under Australian procedure, however, courts frequently set claim registration deadlines in advance of mediation; putative class members must submit a form before any settlement is announced, rather than after.

As a condition of accepting any compensation, "unfunded" class members (those who have not signed an agreement) may be required to consent to a reduction of their compensation in an amount equal to the funding fees and legal costs owed by "funded" class members (those who have signed an agreement). Courts can also award fees and costs out of class settlement funds.

Litigation Funding

One common concern is that Australia is a cost-shifting or "loser pays" jurisdiction; if a plaintiff is unsuccessful, then the court usually issues an "adverse costs order" requiring the plaintiff to cover the defendant's reasonable costs. But, in a class action, that only applies to the representative plaintiff. An investor who does not take an active role in a litigation is not liable for adverse costs simply by remaining as a class member or by submitting a registration form to indicate an interest in future compensation.

Class actions generally allow investors to participate in legal actions and obtain recoveries that would be too costly to pursue on an individual basis. While American class action lawyers are able to increase access to justice—by taking on the costs and financial risk of litigation, in exchange for contingency fees paid by all who benefit—Australian law bars lawyers from entering into percentage-based contingency fee arrangements. Accordingly, Australian class action lawyers often need to team up with third-party litigation funders.

In nearly all Australian securities class actions, a commercial funder agrees to advance the legal costs incurred by the representative plaintiff, and take on the risk of having to pay adverse costs, in exchange for fees payable out of any recovery.[4]

Lawyers and funders often "book build" before litigation, soliciting potential class members to register pursuant to a written funding agreement.[5] In some cases, investors are allowed to register an interest, and may submit their trading data for loss analysis, without signing an agreement upfront. This process is used to gauge whether enough interest exists to make a case profitable.

Funding fees usually range from 20% to 45% of a class settlement; additional charges may apply if, for example, there is more than one defendant or there is an appeal.[6] On top of these fees, funders are reimbursed for all legal costs, and some

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also charge project management fees for investigating the claims, conducting a book build, monitoring the litigation, etc.

The Australian funding market has matured over the last two decades, from just a few providers to at least two dozen, including several that are based overseas. At present, commercial funders are not subject to regulation or capital requirements, like other financial services providers, and they are not bound by professional ethical obligations to courts or class members, like lawyers.

If adopted, these reforms could put an end to closed class actions and bring the Australian regime into line with the familiar opt-out model that investors see in the United States and Canada.

Recently, in a few securities class actions, courts have assumed the power to scrutinize or even reject contractual funding terms, and to impose "reasonable" fees on all class members—including those who never signed an agreement—pursuant to "common fund" orders. This trend has created uncertainty about the extent to which a particular court might vary funding terms and the range of fees that it might ultimately award.

Key Proposals:

- Regulating the litigation funding industry by imposing, for example, mandatory licensing (qualified on both character and organizational competence), minimum capital requirements, financial reporting and auditing, general obligations to class members, and/or standard contract terms.
- Clarifying the power of courts to issue common fund orders, and to review and vary all legal costs and funding fees to be deducted from class settlement funds, to ensure they are fair and reasonable, and possibly imposing statutory caps.[7]

Competing Class Actions

It has become common for defendants to face multiple class actions that assert similar claims. Because Australia does not have a process for selecting a lead case, courts have had to manage competing class actions on a case-by-case basis.

Some courts have found that, where there are two sets of lawyers and funders, different strategies and funding models might offer true alternatives, and class members should be allowed to choose.[8]

In the recent *GetSwift* litigation, the court found that three class actions were substantially the same and assumed the power to pick a winner; it stayed two cases and allowed only one to proceed.[9]

It is notable that the *GetSwift* court selected a common fund proposal; the winning funder had not conducted a book build and its client had not yet filed a statement of claim. In contrast, the losing funders had written agreements with 208 and 103 putative class members, respectively.

Key Proposals:

- Requiring all class actions to be filed as open class actions, and possibly conferring exclusive jurisdiction on federal courts.[10]
- Clarifying the power of courts to decide which of several competing class actions will proceed, and possibly introducing formal carriage motions and criteria.[11]

Takeaways

These reforms could protect class members against unfair or disproportionate cost burdens and ensure consistency and predictability in court rulings with respect to both fees and competing class actions.

Forcing lawyers and funders to compete for cases could also drive down fees and, thus, increase the recoveries flowing to class members.

Moreover, reforms that reduce, or even eliminate, the prospect of closed class actions, and the risk of overlapping or competing class actions being allowed to proceed, could bring to an end the practice of book building. It is possible that under a new regime, investors would no longer need to spend time comparing sets of lawyers and funders, and might never again sign a funding agreement! (At least for an *Australian* securities litigation.)

Of course, some of the potential reforms might not be favorable to investors.[12] Lawmakers could, for example, restrict the types of claims asserted in securities class actions, namely those based on breaches of the continuous disclosure obligations of entities listed on public exchanges and those relating to misleading or deceptive conduct.[13]

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The Australian Law Reform Commission (ALRC) is reviewing public comments on the proposals and is expected to issue its final report and recommendations by December 21, 2018. Then it will be up to the Parliament to act.

American investors should continue to watch this space for recovery opportunities in the meantime.

***Javier Bleichmar** is a Partner and **Erin Woods** and **Kendra Schramm** are Of Counsel in the New York office of Bleichmar Fonti & Auld LLP.*

ENDNOTES:

[1]See Australian Law Reform Commission ("ALRC"), Inquiry into Class Action Proceedings and Third-Party Litigation Funders: Discussion Paper, June 2018; Victorian Law Reform Commission ("VLRC"), Access to Justice—Litigation Funding and Group Proceedings: Report, Mar. 2018.

[2]Closed class actions are not expressly contemplated by the relevant Commonwealth statute, but generally are permitted by the courts. Many commentators have noted that this practice appears contrary to legislative intent and the goal of enhancing both access to justice and judicial efficiency through class litigation.

[3]Plaintiffs can be ordered to post security to ensure that they have sufficient assets to cover any adverse costs. Adverse costs are set according to a standard scale, and typically are less than what a defendant actually paid.

[4]Historically, such arrangements were proscribed as both maintenance (providing financial assistance to a litigant) and champerty (sharing proceeds of litigation).

[5]Securities class actions are promoted through various channels, including direct outreach to large investors and announcements distributed by intermediaries, such as custodian banks and claims filing vendors.

[6]Funding agreements often include fee grids; lower rates may apply if the action is resolved quickly and/or if the settlement amount exceeds a certain threshold. In addition, a discount may be offered to investors who held a large number of shares. Some agreements also set floors, to ensure a minimum return on investment for the funder.

[7]Lawmakers could lift the ban on contingency fees for lawyers, subject to some restrictions, such as fee caps for unsophisticated class members or court approval. That said, this type of reform might be relevant to just a handful of law firms with the capital and risk appetite to prosecute a complex securities class action without outside funding or insurance.

The ALRC's Discussion Paper asks whether, instead of statutory caps, there should be a rebuttable presumption that the maximum portion of fees and commission paid from any one settlement or judgment sum is 49.9%.

[8]*See* McKay Super Solutions Pty. Ltd. v. Bellamy's Australia Ltd. [2017] FCA 947 (Aug. 18, 2017).

[9]*See* Perera v. GetSwift Ltd. [2018] FCA 732 (May 23, 2018). This decision is subject to appeal.

In another recent litigation, the federal court transferred four competing class actions to the state court, where a fifth class action was pending. *See* Wileypark Pty. Ltd. v. AMP Ltd. [2018] FCAFC 143 (Aug. 29, 2018).

[10]The VLRC's Report proposes establishing a national judicial panel to facilitate coordination of related class actions that are filed in different jurisdictions, similar to the U.S. Judicial Panel on Multidistrict Litigation.

[11]The ALRC's Discussion Paper suggests that the Canadian carriage motion, and its various selection criteria, may provide a useful model.

[12]The ALRC's Discussion Paper proposes that the government review the legal and economic impact of investor claims. It notes concerns, for example, about the availability and cost of directors and officers insurance, and the possibility that companies will relocate offshore for more favorable conditions.

[13]Once an entity is, or becomes, aware of information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell the Australian Securities Exchange that information.

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The Search for Missing Participants in Governmental Plans

By: Jennifer Stokes and Sarah Bhagwandin

Participants in retirement plans who "go missing" present significant challenges for plan sponsors. Although plan sponsors have a fiduciary duty to participants, and as part of that duty, must make an effort to locate missing participants and distribute their benefits, plan sponsors have little guidance regarding what steps they must take to meet their duties. The agencies regulating retirement plans, the Internal Revenue Service (IRS), Department of Labor (DOL), and Pension Benefit Guaranty Corporation (PBGC), have provided disjointed and generally uncoordinated direction regarding what level of search will satisfy a plan sponsor's duties. Until the governing agencies issue comprehensive guidance, plan sponsors are well advised to adopt procedures for searching for missing participants that synthesizes the patch-work of existing available guidance.

Participants can be considered "missing" in a variety of circumstances, including situations when the plan sponsor has a valid address. For example, if a participant fails to respond to a plan notice, make a benefit election, or cash a benefit check, even where the plan sponsor uses a correct address, the participant is "missing" for administration purposes. In contrast, in some instances a plan sponsor may have stale contact information. Stale contact information may be the result of a participant who terminates employment and fails to provide the employer with updated address information. It may arise when payroll records are inaccurate, perhaps in connection with a plan that has merged into the employer's plan or as a result of corporate acquisition. In all of these instances, the plan sponsor must resolve the issue, preferably with the result of providing the benefit owed under the plan to the participant.

What steps must a governmental plan take to meet its legal obligations to participants when they are missing? The short answer is that it is not always clear. Qualified retirement plans that are governmental plans must comply with plan qualification rules under the Internal Revenue Code of 1986, as amended (Code), and look to the IRS for guidance. While the IRS has not issued comprehensive guidance regarding the steps a plan sponsor should take to locate a missing participant, the IRS's Employee Plans Compliance Resolution System (EPCRS)[1] provides correction principles for failures that may involve missing participants. In addition, the IRS recently issued a memorandum to IRS examiners providing instruction regarding how to handle failures to make required minimum distributions (RMDs) to participants who are missing.

The DOL and the PBGC have issued limited guidance as well, although the guidance for both agencies is limited to terminating plans. The DOL's Field Assistance Bulletin (FAB) 2014-01 addresses missing participants in a terminating defined contribution plan. The PBGC's missing participants program (Missing Participants Program) is available to terminating single-employer defined benefit plans, and, as expanded effective January 22, 2018, to certain terminating defined contribution plans, multiemployer plans, and small professional service defined benefit plans.

The lack of guidance for addressing missing participants in ongoing plans is problematic for plan sponsors, especially as the DOL has been challenging compliance with fiduciary duties and qualified plan rules relating to RMDs where benefits have not been paid to participants who cannot be found. Without direct and comprehensive guidance from the governing agencies regarding how to address missing participants in the administration of an ongoing plan, plan sponsors have uncertainty as to whether they are meeting their duties.

Governmental plan sponsors seeking to adopt best practices with respect to locating plan participants should look to IRS guidance in combination with guidance issued by the PBGC and the DOL. Although the PBGC and DOL do not regulate governmental plans, and the guidance those agencies have issued relates to terminating plans, ongoing defined contribution and defined benefit plans, as well as governmental plans, may look to the guidance in developing their own policies for addressing missing participants.

IRS Guidance

The IRS's correction principles under EPCRS provide that a plan failure is not corrected unless correction is made with respect to all participants and beneficiaries.[2] The procedures require that corrections should take into account certain principles, including that plan sponsors should take reasonable actions to locate lost participants. In relevant part, EPCRS provides as follows:

> "…Reasonable actions must be taken to find all current and former participants and beneficiaries to whom additional benefits are due, but who have not been located after a mailing to the last known address. In general, such actions include, but are not limited to, a mailing to the individual's last known address using certified mail, and, if that is unsuccessful, an additional search method, such as the use of a commercial locator service, a credit reporting agency, or Internet search tools. Depending on the facts and circumstances, the use of more than one of these additional search methods may be appropriate."[3]

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In addition, the IRS recently issued guidance in a field directive to plan examiners on how to treat a qualified plan that fails to commence RMDs to missing participants.[4] The memorandum directs plan examiners not to challenge a qualified plan for a violation of the RMD requirements relating to missing participants if the plan has taken the following steps to locate a missing participant or beneficiary:

1. Searched plan and related plan sponsor records, publicly available records or directories for alternative contact information;
2. Used any of the following search methods: a) commercial locator service; b) a credit reporting agency; or, c) a proprietary internet search tool for locating individuals; and
3. Attempted contact via U.S. Postal Service certified mail to the last known mailing address and through appropriate means for any address or contact information (including e-mail addresses and telephone numbers).

Governmental plan sponsors seeking to adopt best practices with respect to locating plan participants should look to IRS guidance in combination with guidance issued by the PBGC and the DOL.

This most recent guidance is directed to EP Examiners only and is not definitive guidance for plan sponsors. Further, the memorandum focuses on RMDs and does not address other qualification issues. Nonetheless, it provides insight into steps the IRS will consider reasonable for a plan sponsor to take to locate a missing participant.[5]

Of current concern to plan sponsors and their advisors is the DOL's recent position in certain audits that failure to distribute RMDs to missing participants is a breach of fiduciary duty and a failure to administer a plan in compliance with plan terms.[6] This is concerning because although the RMD rules are governed by the Internal Revenue Code, over which the DOL has no enforcement authority, DOL has been raising the issue of missed RMDs owed to missing participants in recent audits. The governing agencies must coordinate their differing approaches so that plan sponsors have certainty about what qualifies as a prudent process for locating participants.

PBGC Missing Participants Program

The PBGC maintains a program to hold retirement benefits for missing participants in terminated retirement plans and to assist participants in receiving those benefits. The Missing Participants Program, which was limited to terminated single-employer defined benefit pension plans subject to Title IV of ERISA, has been expanded under a Final Rule published by the PBGC on December 22, 2017 to include most terminated defined contribution plans, multiemployer plans covered by Title IV of ERISA, and certain small defined benefit plans.[7]

Governmental plan sponsors can gain insights from the PBGC's Missing Participants Program regarding what might qualify as a prudent process for attempting to locate missing participants because the PBGC requires that a plan first conduct a diligent search for each missing participant before utilizing the program.[8] The PBGC provides that a plan administrator has conducted a "diligent search" if it uses one of the following two methods within the time frame required by the program:[9]

1. A commercial locator service; or
2. For a distributee whose normal retirement benefit is not more than $50 per month, the records search method. The records search method includes the following:[10]
   a. Searching the plan's records;
   b. Searching plan sponsor's records;
   c. Searching records of each retirement or welfare plan of the plan sponsor;
   d. Contacting each beneficiary of the distributee identified from the foregoing records; and,
   e. Using an internet search method for which no fee is charged.

While the Missing Participants Program is not available to and will not directly impact an ongoing plan or a governmental plan not subject to Title IV of ERISA, the steps it sets out are instructive for developing policies for both.

Department of Labor Guidance

The DOL's most recent guidance regarding missing participants, Field Assistance Bulletin (FAB) 2014-01, outlines procedures for dealing with missing participants in terminating defined contribution plans.

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The FAB begins by describing some of the issues faced by plan sponsors terminating a defined contribution plan with missing participants. For example, a plan administrator is required to distribute all of a plan's assets as soon as administratively feasible after plan termination; the plan administrator has a responsibility to contact participants to obtain distribution instructions; and the plan administrator has a fiduciary obligation to search for missing participants and distribute their benefits. Under the FAB, after a plan fiduciary reasonably determines that a participant cannot be located, the fiduciary may distribute the benefit, including in a direct rollover to an individual retirement account (IRA) for the missing participant. Once a benefit is distributed pursuant to the requirements of the FAB, the individual ceases to be a participant under the plan and the distributed assets cease to be plan assets under ERISA.

Unlike the rules under the PBGC Missing Participants Program, which allows plan sponsors to select a method based on the value of the benefit, FAB 2014-01 provides that fiduciaries of terminating defined contribution plans must take all of the following steps to find a missing participant before treating the search as exhaustive:

1. **Certified Mail.** The DOL provides a model notice that could be used for this purpose.
2. **Related Plan and Employer Records.** Plan fiduciaries of the terminated plan must ask both the employer and administrator of related plans to search their records. If there are privacy concerns, the plan fiduciary may request that the employer or other plan fiduciary contact or forward a letter to the missing participant requesting that the missing participant contact the searching plan fiduciary.
3. **Designated Plan Beneficiary.** Plan fiduciaries must try to contact any individual that the missing participant has designated as a beneficiary to find updated contact information for the missing participant. If there are privacy concerns, the plan fiduciary may request that the designated beneficiary contact or forward a letter to the missing participant or beneficiary.
4. **Free Electronic Search Tools.** Plan fiduciaries must make reasonable use of Internet search tools that do not charge a fee. Such online services include Internet search engines, public record databases (such as those for licenses, mortgages and real estate taxes), obituaries, and social media.

The guidance from all three agencies requires steps a plan sponsor must take to meet its duty to search for missing participants. In each case, the plan sponsor must determine whether its efforts have been reasonable or whether additional steps are warranted.

On a periodic basis, such as annually, plans will want to identify terminated participants who will have a benefit due them, including benefits under the terms of the plan and RMDs. Prior to the benefit commencement date, the plan should determine whether there is accurate contact information for the participant. If the participant's contact information cannot be confirmed, the plan should begin a search process under its policies for the participant. Search methods under a sponsor's policies are likely to include attempted contact through certified mail to the last known address; a search of available records, including plan and sponsor records, records of other plans of the sponsor, and publicly available records; free Internet search tools as well as search tools for a fee, such as a commercial locator service, to the extent reasonable under the circumstances; and contacting beneficiaries who may be identified.

Jennifer Stokes *is a Partner with Bryan Cave Leighton Paisner LLP and* ***Sarah Bhagwandin*** *is Counsel with Bryan Cave Leighton Paisner LLP.*

ENDNOTES:

[1]Rev. Proc. 2016-51
[2]Rev. Proc. 2016-51, Section 6.02
[3]Rev. Proc. 2016-51, Section 6.02(5)(d)
[4]Memorandum for Employee Plans (EP) Examinations Employees, from Acting Direct EP Examinations, dated October 19, 2017. This memo, which applies to IRS examinations opened on or after October 19, 2017, will be incorporated into Internal Review Manual Section 4.71.1 (Employee Plan Examination of Returns) by October 19, 2019.
[5]Required minimum distributions generally are minimum amounts that must be distributed to a plan participant annually starting with the year that the participant reaches age 70 ½ or, if later, the year in which he or she retires. Code section 401(a)(9). RMD rules apply to all employer sponsored retirement plans, including governmental plans. However, governmental plans are required to comply with a reasonable and good faith interpretation of Code section 401(a)(9). Treas. Reg. 1.401(a)(9)-1.
[6]Governmental plans may be subject to fiduciary duties under applicable state law and enforcement actions from state agencies, which may look to guidance under the fiduciary rules of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and analogous enforcement by the DOL. A governmental plan's failure to comply with a reasonable good faith interpretation of the RMD rules may result in disqualification of the plan.
[7]82 FR 60800
[8]82 FR 60800
[9]82 FR 60800, section 4050.104
[10]*Id.*

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Insider Trading: Avoiding the Misuse of Material Non-Public Information

By: Joseph Indelicato and Peter Mixon

Question: What do Martha Stewart, Jeff Skilling, Raj Rajaratnam, and public pension systems have in common?

Answer: They are all subject to the federal insider trading laws.

While the insider trading convictions of Ms. Stewart, Mr. Skilling and Mr. Rajaratnam are well known, the potential exposure of public pension systems is not. Public pension systems are generally exempt from many of the laws regulating investment companies and securities issuers but these exemptions do not apply to the anti-fraud provisions of federal securities statutes and the regulations promulgated thereunder by the Securities and Exchange Commission ("SEC"). Section 10(b) of the Exchange Act (15 U.S.C. Section 78j(b)) and SEC Rule 10b-5 (17 CFR Section 240.10b-5) prohibit the purchase or sale of securities on the basis of material, non-public information ("MNPI") in breach of a duty of trust or confidence. This prohibition applies to three classes of persons: 1) company "insiders" who acquire this information through a relationship of confidence; 2) company "outsiders" who misappropriate or misuse this information provided in confidence; and, 3) "tippees" of either person. These prohibitions cover trades made by the institutions—proprietary trades—as well as trades made by individuals on a personal basis. In addition, "controlling persons" who fail to take reasonable steps to prevent insider trading by their employees are subject to substantial penalties under Section 21A of the Exchange Act. Finally, personal trading by plan employees on the basis of MNPI received in the course of their employment is also a breach of their fiduciary duties as well as applicable state laws.

Section 10(b) of the Exchange Act (15 U.S.C. Section 78j(b)) and SEC Rule 10b-5 (17 CFR Section 240.10b-5) prohibit the purchase or sale of securities on the basis of material, non-public information ("MNPI") in breach of a duty of trust or confidence.

The federal securities laws also provide certain safe harbors for institutional investors. To mitigate the risks of insider trading violations, the New York State Teachers' Retirement System ("NYSTRS") has taken affirmative steps to fit within these safe harbors. These include adoption of investment policies and procedures that are designed to isolate MNPI, prevent system trades on the basis of this information, and preclude individual employees from trading on the basis of MNPI for their own personal account. While not always easy to implement, these policies and procedures should substantially reduce the risk of proprietary trading on MNPI and secondary liability for employees' insider trading. They should also fulfill the Board's fiduciary duty of reasonable prudence in overseeing plan operations and legal compliance.

Insider Trading Prohibitions

There are in general two primary theories of insider trading liability under Section 10(b). Under the "traditional theory," an employee, director, or other insider of the corporation trades in the securities of the corporation using material information not available to the public. (See *Dirks v. SEC*, 463 U.S. 646, 654-655 (1983)). Since public pension systems typically do not issue securities, the traditional theory is unlikely to be applied to proprietary trades made by the plan.

Under the "misappropriation theory," a person outside of the corporation misappropriates confidential information for the purpose of trading in corporate securities in breach of a duty owed to the source of the information. Because the outsider trades on confidential information entrusted to him for non-trading purposes, the trader is effectively defrauding the principal by using this information. The misappropriation theory thus premises liability on a "fiduciary-turned-trader's" deception of those who entrusted him with access to confidential information. This theory is "designed to protect the integrity of the security markets against abuses by 'outsiders' … who have access to confidential information …, but who owe no fiduciary or other duty to the corporation's shareholders." (*U.S. v. O'Hagan*, 521 U.S. 642, 653 (1997) (internal quotations omitted)).

The misappropriation theory is based on a relationship of "trust or confidence" by the party obtaining access to MNPI about a particular company. The SEC has issued a rule that lists the types of relationships that will be presumed "confidential" for purposes of this theory. These include: a) an agreement to maintain information in confidence; and, b) a history or practice between the parties of sharing confidences that the communicator reasonably expects the recipient to maintain. (17 C.F.R. 240.10b5-2.)

Even though it might not be a common occurrence, public pension systems may obtain MNPI in a variety of circumstances.

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For example, hedge funds that invest in private securities issued by a public company might disclose this information to their limited partners in the course of reporting performance results. Other examples might include knowledge of an impending tender offer by a private equity or hedge fund, knowledge of a new bond offering by a publicly-owned portfolio company, or MNPI obtained from a publicly-traded company as part of underwriting an asset-based lending program. Even if the institution does not specifically intend to use this information to trade in securities, subsequent proprietary trades in these securities would, at a minimum, raise the specter of insider trading liability.

The federal securities statutes and rules create two types of insider trading risks: (1) trading in public securities by the system on the basis of MNPI, and (2) failing to prevent foreseeable insider trading by individuals employed by the plan.

For institutional traders like public pension systems, the SEC has adopted a rule that provides a "safe harbor" from insider trading liability for the institution. Under this rule, the institution will not be liable if it demonstrates: a) the person making the investment trade decision was not aware of the MNPI; and, b) the institution had implemented reasonable policies and procedures to ensure that individuals making trading decisions would not violate the insider trading laws. (17 C.F.R. § 240.10b5-1(c)(2)). The latter policies "may include those that restrict any purchase, sale, and causing any purchase or sale, of any security as to which the [entity] has material nonpublic information, or those that prevent such individuals from becoming aware of such information." (*Id.*)

Controlling Person Liability

In addition to proprietary trading violations, public pension systems also face potential secondary exposure if they fail to properly oversee employees who engage in insider trading. Under Section 20 of the Securities Act, an entity that "controls" any person who violates the insider trading rules shall be liable to the same extent as the controlled person, unless the controlling person acted in "good faith" and did not "induce" the acts constituting the securities law violation. (15 U.S.C., § 78t(a)).

Section 21A of the Exchange Act also authorizes the SEC to impose civil penalties on employers, as "controlling persons," in an amount not exceeding the greater of $1 million or three times the amount of profit gained, or loss avoided, as a result of the controlled person's insider trading violation. (15 U.S.C., § 78u-1(a)). To establish a violation of Section 21A, the SEC must establish either of the following: a) the controlling person knew or recklessly disregarded that the controlled person was likely to engage in insider trading and failed to take appropriate steps before the violation occurred; or, b) the controlling person knowingly or recklessly failed to establish, maintain, or enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the controlled persons. (15 U.S.C., § 78u-1(b)(1)). Thus, establishing appropriate policies and procedures to prevent an employee from misusing MNPI is critical to avoiding secondary exposure under Section 21A.

Alabama Retirement Systems Investigation

The SEC is not ignoring insider trading at public pension systems. Several years ago, the SEC conducted an insider trading investigation of the Retirement Systems of Alabama ("RSA") and issued a public report. (SEC Report of Investigation, Release No. 57446 (March 6, 2008)). In brief, an RSA consultant obtained access to MNPI about a publicly-traded company during the process of evaluating a potential purchase of the company's stock by RSA. The consultant executed a confidentiality agreement with the company and agreed that any parties receiving the MNPI would be bound by its terms. The consultant shared the MNPI with RSA but neglected to obtain a confidentiality agreement from RSA. RSA then purchased shares of the company on the open market in advance of a public announcement of its tender offer. The SEC concluded that RSA had violated the insider trading prohibitions and issued a public report outlining its findings. Notably, the SEC concluded that had a reasonable compliance program been in place at RSA, the system would likely not have run afoul of the insider trading prohibitions. The SEC decided to issue a public report "to emphasize the responsibilities of all investment professionals, including large public retirement systems …, under the federal securities laws and to highlight the risks they undertake when they operate without a compliance program." (*Id.*)

Overview of Insider Trading Issues

The federal securities statutes and rules create two types of insider trading risks: 1) trading in public securities *by the system* on the

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basis of MNPI; and, 2) failing to prevent foreseeable insider trading *by individuals* employed by the plan. To address the first risk of proprietary trading, public pension systems have generally used one of two models of investment policies and procedures. In the first, the system essentially *assumes* that any MNPI obtained by private equity (or other) system personnel will be attributed to the public market traders on agency theories. In this model, the system sets up two basic processes: First, the system discourages and highly regulates the initial receipt of MNPI by anyone on staff within the system. When it is received, the model requires immediate documentation of the receipt of this information, identification of the personnel who have it, and warnings by the Legal or Compliance Office to the recipients about improper dissemination and improper use, as well as the penalties that may be imposed. Second, the system maintains a list of the securities that the MNPI concerns and precludes any inside staff from actively trading in these securities on behalf of the system. Passive trades, on conditions consistent with federal statutes and SEC regulations allowing trading in these circumstances, are allowed.

In the second model, MNPI is "*walled off*" from the public traders with the object of preventing the actual traders from knowing and trading on the basis of MNPI. In this model, the system regulates the receipt, as in the first, by documenting the receipt of MNPI, the persons who have it, and provides warnings about improper dissemination and use. Under this model, persons who have MNPI must obtain prior written consent of the General Counsel or the Chief Compliance Officer to disseminate the information to anyone else in the system and any further dissemination is documented along with accompanying justification. Like the first model, restricted trading lists of the affected securities are maintained, but not for the purpose of precluding proprietary trades. Instead, these lists are used to monitor and prevent, if necessary, inappropriate trading by system employees.

Under both models, the system also would adopt a personal trading policy designed to prevent individual employees from trading for their personal benefit on the basis of MNPI. These policies vary in their details, but they typically include the following elements: a) adoption of an institutional policy limiting the dissemination and use of MNPI within the organization and precluding personal use of such information; b) implementation of employee training on the policy and federal securities laws; and, c) creation of a pre-clearance, monitoring, and reporting system for personal trades made by selected employees.

These policies vary in their details, but they typically include the following elements: a) adoption of an institutional policy limiting the dissemination and use of MNPI within the organization and precluding personal use of such information; b) implementation of employee training on the policy and federal securities laws; and, c) creation of a pre-clearance, monitoring, and reporting system for personal trades made by selected employees.

NYSTRS Policies

Several large state pension plans have taken the lead in adopting policies designed to limit their exposure to these insider trading risks. NYSTRS, a system that manages over $117 billion of assets, including over $91 billion in publicly traded domestic and foreign securities, is one of these systems. NYSTRS' employees who work on investment-related matters may have access to information about NYSTRS' pending investment transactions, as well as MNPI in connection with these investments. From a proprietary trading perspective, the system has adopted policies that preclude system investment staff from making internal system trades in the securities which the MNPI concerns. The policy also authorizes the General Counsel to set up, monitor and enforce appropriate walls or other informational barriers to prevent the inappropriate dissemination of MNPI within the system.

The policy also covers potential misuse of MNPI by NYSTRS investment staff in their personal trading. NYSTRS staff face inherent conflicts of interest when they trade in securities for their own personal accounts while NYSTRS is also trading in the same securities. Such employees can potentially exploit such information for their own personal benefit through front-running or insider trading. It is of course unlawful for NYSTRS employees to engage in personal securities transactions in violation of the insider trading rules under federal securities laws, and they would also violate their fiduciary duties owed to NYSTRS if they do so.

To meet industry best practices, and as directed by the NYSTRS Board, in 2014 NYSTRS embarked on a 4-year-long effort to design, adopt and implement comprehensive personal trading and monitoring procedures for its covered employees and their

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related persons. These efforts were led by NYSTRS' Legal and Risk departments, with input from the Human Resources and Internal Audit departments. NYSTRS consulted with two other major pension systems, and studied the personal trading policies of ten other public pension systems and numerous financial institutions and investment advisers. In designing its procedures, NYSTRS was also advised by two major law firms. Since the proposed policies also covered the activities of individual employees, NYSTRS engaged with employees and their associations on the parameters of these policies and procedures.

Results of the Process

In the spring of 2018, NYSTRS completed this process and implemented its *Personal Monitoring and Trading Procedures* ("Personal Trading Procedures") and *Material Non-Public Information Procedures* ("MNPI Procedures"). The Personal Trading Procedures contain provisions reasonably necessary to detect and prevent covered employees and their related persons from engaging in personal trading in violation of applicable law. Currently, NYSTRS' employees who work in investments, and those with access to investment-related information, are covered under the Personal Trading Procedures. In conjunction with the implementation of the Personal Trading Procedures, NYSTRS selected and contracted with a commercial vendor to provide an electronic trading monitoring platform through which covered employees' and their related persons' personal trades are pre-cleared and reported, and through which personal trading records and periodic employee attestations are maintained. The MNPI Procedures contain provisions reasonably necessary to detect and prevent the misuse of MNPI by NYSTRS employees, and supplement NYSTRS' pre-existing general *Code of Ethics*.

Conclusion

Like Ms. Stewart, Mr. Skilling and Mr. Rajaratnam, public pension systems are not exempt from the long arm of the federal securities laws. As the RSA report demonstrates, the SEC is vitally interested in enforcing these laws against all institutional investors including public pension systems. Public pension systems that take proactive measures to create and implement appropriate policies and procedures, similar to the approach taken by NYSTRS, will be in a position to prevent insider trading and mitigate these risks.

Joseph Indelicato *is the General Counsel of the New York State Teachers' Retirement System.*

Peter Mixon *is a Partner at the firm of Nossaman, LLP.*

Mark Your Calendar!

2019 Winter Seminar - Tempe, AZ
Tempe Mission Palms Hotel
Wednesday, February 20 - Friday, February 22, 2019

2019 Legal Education Conference - San Diego, CA
Sheraton San Diego Hotel
Tuesday, June 25 - Friday, June 28, 2019
New Member Education Sessions on Tuesday, June 25th

2020 Winter Seminar - Tempe, AZ
Tempe Mission Palms Hotel
Wednesday, February 19 - Friday, February 21, 2020

2020 Legal Education Conference - Fort Lauderdale, FL
Fort Lauderdale Marriott Harbor Beach
Tuesday, June 23 - Friday, June 26, 2020
New Member Education Sessions on Tuesday, June 23rd

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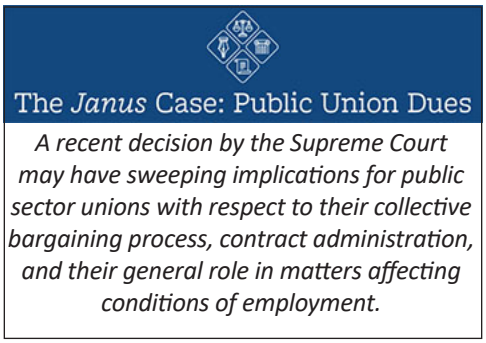
Supreme Court: Public Sector Unions May Not Charge Nonmembers Agency Fees (*Janus v. AFSCME*)

By: Danielle Smith

A recent decision by the Supreme Court may have sweeping implications for public sector unions with respect to their collective bargaining process, contract administration, and their general role in matters affecting conditions of employment. In *Janus v. Am. Fed'n of State, Cty., & Mun. Employees, Council 31*, 138 S. Ct. 2448, 201 L. Ed. 2d 924 (2018) [*Janus*], the Supreme Court held that Illinois' practice of requiring state employees who choose not to join a public-sector union ("nonmembers") to nonetheless pay a percentage of the full union dues (i.e., an "agency fee" or "fair share" fee) violated the free speech rights of the nonmembers by compelling them to subsidize private speech on matters of substantial public concern.[1]



Summary

Janus was a civil action alleging that, as state employees, plaintiffs were forced to pay compulsory union fees to the unions as a condition of their employment pursuant to Illinois' Public Labor Relations Act ("IPLRA"), 5 ILCS 315/6, and that this collection of compulsory fees from them violated their rights under the First Amendment to the United States Constitution.[2] In a 5-4 split decision led by Justice Samuel A. Alito, the Supreme Court ultimately agreed with plaintiffs, overruled *Abood v. Detroit Bd. of Ed.*, 431 U.S. 209 (1977) [*Abood*], which had previously held that such fees did not violate the First Amendment, and reversed the Seventh Circuit and district court judgments that ruled in favor of the defendant unions. As the Supreme Court put it, "strong reasons" existed to overturn the precedent set by *Abood*,[3] including the First Amendment rights of nonconsenting public-sector employees, the "abandon[ment]" by *Abood's* proponents of its reasoning, the decision's "lack of workability," its "conflicts with other First Amendment decisions," and the erosion of *Abood's* underpinnings by subsequent developments.[4]

Background: *Abood v. Detroit Bd. of Ed.*

In *Janus*, the Supreme Court was asked to overrule the precedent primarily set by *Abood*, decided in 1977. In *Abood*, the Supreme Court considered the constitutional validity of a Michigan law that permitted unions and local government employers to agree to an arrangement whereby every employee represented by a union—even nonmembers—must pay to the union, as a condition of employment, a service fee equal in amount to union dues.[5] The Court held that nonmembers could be required to pay for the portion of union expenditures related to collective-bargaining activities, but not for union expenditures used "for political and ideological purposes unrelated to collective bargaining," drawing a distinction between what has come to be known as "chargeable" versus "nonchargeable" expenditures.[6]

The Court cited two governmental interests that it believed were advanced by permitting the requirement of compulsory union fees on nonmembers. The first was the "desirability of labor peace," since exclusive union representation avoids "[t]he confusion and conflict that could arise" if, for instance, multiple unions representing employees in the same bargaining unit fought for conflicting employment terms.[7] The second governmental interest was to prevent the risk of "free riders" (i.e., those who "refuse to contribute to the union while obtaining benefits of union representation that necessarily accrue to all employees").[8]

Janus's Procedural History

Janus began when plaintiff Bruce Rauner ("Rauner"), Governor of Illinois, filed an action in the U. S. District Court for the Northern District of Illinois on February 9, 2015 seeking a declaratory judgment that the "Fair Share Contract Provisions" under the Illinois Public Labor Relations Act ("IPLRA"), 5 ILCS 315/6(e), were unconstitutional,[9] and that the Governor's Executive Order 15-13 (prohibiting the deduction of "fair share" fees from the paychecks of state employees) was within the Governor's powers under the Illinois constitution.[10] At the core of the complaint was the claim that the fee deductions from persons who were not union members constituted coerced political speech in violation of the First Amendment. The defendants were the American Federation of State, County, and Municipal Employees ("AFSCME"), Council 31, AFL-CIO, and 24 other labor organizations representing state employees. The Illinois Attorney General and the Director of Illinois' Department of Central Management Services ("CMS") intervened as defendants, and together with the union defendants, moved to dismiss the action.

The district court granted the defendants' motion to dismiss, finding that the court lacked subject matter jurisdiction over the action as

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the case did not "arise under federal law" pursuant to 28 U.S.C. § 1331,[11] and that Rauner, as governor, lacked standing to challenge the constitutionality of the fair share provisions of the IPLRA.[12]

In dismissing Rauner's action, the district court simultaneously permitted the amended complaint of intervening plaintiffs Mark Janus, Brian Trygg, and Marie Quigley—three state employees—to be treated as the operative complaint in a new lawsuit.[13] Of the three employees, only Janus and Trygg proceeded with filing a Second Amended Complaint, this time bringing claims pursuant to 42 U.S.C. § 1983 to redress the alleged deprivation of rights under the First and Fourteenth Amendments caused by compulsory union fees. The defendants once again moved to dismiss, and the district court ultimately found that the Supreme Court's decision in *Abood v. Detroit Board of Education*, 431 U.S. 209 (1977), which upheld the constitutionality of such fees, remained valid and binding precedent.[14]

In its opinion, the Supreme Court held that "[t]he First Amendment is violated when money is taken from nonconsenting employees for a public-sector union."[19]

On appeal to the Seventh Circuit Court of Appeals, plaintiffs acknowledged that, because *Abood* was binding precedent, they could not prevail in either the district court or in the Seventh Circuit, and would have to travel through the two lower courts before they could seek review by the Supreme Court.[15] The Seventh Circuit held that Trygg's claim was precluded due to an earlier legal challenge he had made to his union's "fair share" fees, citing *Abner v. Illinois Dep't of Transp.*, 674 F.3d 716, 719 (7th Cir. 2012), leaving only Janus's claim—which the court decided was properly dismissed pursuant to *Abood*.

The Supreme Court's Decision

The case proceeded to the Supreme Court following Janus's petition for writ of certiorari, filed on June 6, 2017.[16] Illinois' Attorney General and CMS Director ("State Respondents") and AFSCME led their opposition briefs with a jurisdictional challenge based on the fact that Plaintiffs had originally moved to intervene in Rauner's lawsuit, which was dismissed. The Supreme Court rejected this argument, finding nothing wrong with the district court's earlier decision to treat the employee plaintiffs' motion to intervene as the operative complaint in a new lawsuit.[17] State Respondents and AFSCME also cited the longstanding precedent set by *Abood*, including the decision's "free rider" rationale, and the necessity of agency fees caused by unions' statutory obligation to fairly represent the interests of all public employees in a bargaining unit.[18]

In its opinion, the Supreme Court held that "[t]he First Amendment is violated when money is taken from nonconsenting employees for a public-sector union."[19] The Court challenged the reasoning underlying *Abood's* two main justifications for compulsory agency fees: "labor peace" and "free riders." It held that there was not necessarily a link between the "designation of a union as the exclusive representative of all the employees in a unit and the exaction of agency fees."[20] In other words, there is no reason why a union cannot act as the exclusive representative of a set of employees while not requiring all employees to pay an agency fee. As to *Abood's* and Respondents' free rider argument, the Court decided that "avoiding free riders is not a compelling interest." Once agency fees are placed in the First Amendment context, it is not permissible for the "government to compel a person to pay for another party's speech just because the government thinks that the speech furthers the interests of the person who does not want to pay."[21]

Among other criticisms, the Court also found that *Abood's* distinction between chargeable and nonchargeable expenditures was not workable as a practical matter, and took issue with *Abood's* reliance on *Ry. Emp. Dep't v. Hanson*, 351 U.S. 225 (1956) and *Int'l Ass'n of Machinists v. Street*, 367 U.S. 740 (1961), "both of which involved private-sector collective-bargaining agreements where the government merely authorized agency fees."[22]

Janus's Effect on Collective Bargaining

In anticipation of some of the issues arising from the decision, the Supreme Court's decision included some clarification on the following matters:

- *Negotiation of Contracts:* Citing *Steele v. Louisville & Nashville R. Co.*, 323 U.S. 192, 202–203 (1944), the Supreme Court stated that unions still "may not negotiate a collective-bargaining agreement that discriminates against nonmembers."[23]

- *Representation of Nonmembers in Grievance Proceedings*: The Court acknowledged that the decision raised the issue that the representation of nonmembers in disciplinary matters could impose a burden on unions, but reasoned that there were less restrictive means of eliminating that burden, including the suggestion that individual

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nonmembers "could be required to pay for that service or could be denied union representation altogether."[24]

- *Duty of Fair Representation*: Unions are still bound by the duty of fair representation. In response to the argument that it would be unfair to require a union to continue to bear the duty of fair representation, the Court reasoned that this duty is "a necessary concomitant of the authority that a union seeks when it chooses to serve as the exclusive representative of all the employees in a unit."[25]

Conclusion and Remaining Questions

The full impact of *Janus* on state and local government employers, bargaining units, and public employees remains to be seen. The precise scope of the duty of fair representation to nonmembers in a bargaining unit, for instance, remains an open question. At least in New York, the state Public Employment Relations Board has already adopted an emergency rule allowing for "expedited treatment of cases which present issues of law relating to the scope of the duty of fair representation," in recognition that *Janus* could "destabilize collective bargaining throughout the State for not just the State but for counties, municipalities, towns, and villages and raise significant questions about the duty of fair representation that a union owes to non-members."[26]

Exactly what the dismantling of the existing agency fee scheme should look like is also an important question. At the time *Janus* was decided, "more than 20 states ha[d] enacted statutes permitting the collection of fair-share fees."[27] The State Respondents also argued that "[a]n untold number of employment contracts have been negotiated pursuant to those laws. Those contracts, in turn, cover millions of public employees represented by unions that agreed to represent them in return for a guarantee that they would be adequately compensated for the services they were obligated by law to provide to members and non-members alike throughout the duration of the agreement."[28]

Of particular interest to public pensions might be the Court's statements pointing to Illinois' growing "unfunded pension and retiree healthcare liabilities," "[u]nsustainable collective bargaining agreements," and the "political debate over public spending and debt" as part of the developments that have given "collective-bargaining issues a political valence that *Abood* did not fully appreciate."[29] In other words, the perception of unrestrained public employee benefits being a matter of great public concern could bring increasing scrutiny—and with it, additional First Amendment or other constitutional challenges—to longstanding pension funding arrangements.

Danielle Smith *is an Associate with Hagens Berman Sobol Shapiro LLP.*

ENDNOTES:

[1]*Janus* at 2487.
[2]Second Amended Complaint at ¶¶ 1-2, *Janus v. AFSCME, et al.*, No. 1:15-cv-01235 (N.D. Ill. July 21, 2016), ECF No. 145.
[3]*Janus* at 2460.
[4]*Id.* at 2458, 2460, 2479, and 2486.
[5]*Abood* at 211.
[6]*Id.* at 209, 232, 236; *Janus* at 2460-61.
[7]*Id.* at 224.
[8]*Id.* at 222.
[9]Complaint for Declaratory Judgment, at 21, *Rauner v. AFSCME, et al.*, No. 1:15-cv-01235 (N.D. Ill. Feb. 9, 2015), ECF No. 1.
[10]*Id.*; *see also* Ill. Exec. Order No. 15-13 (Feb. 9, 2015), https://www2.illinois.gov/Documents/ExecOrders/2015/ExecutiveOrder2015-13.pdf.
[11]Order, *Rauner v. AFSCME, et al.*, No. 15 C 1235, 2015 WL 2385698, at *2 (N.D. Ill. May 19, 2015).
[12]*Id.* at *3.
[13]*Id.* at *5.
[14]Order at 1-2, *Janus v. AFSCME, et al.*, No. 1:15-cv-01235 (N.D. Ill. Sept. 13, 2016), ECF No. 150.
[15]*Janus v. AFSCME*, 851 F.3d 746, 747–48 (7th Cir.), *cert. granted sub nom. Janus v. Am. Fed'n*, 138 S. Ct. 54, 198 L. Ed. 2d 780 (2017), and *rev'd and remanded*, 138 S. Ct. 2448, 201 L. Ed. 2d 924 (2018).
[16]Petition for Writ of Certiorari, *Janus v. AFSCME*, 138 S. Ct. 2448, 201 L. Ed. 2d 924 (2018), 2017 WL 2546472 (U.S.).
[17]*Janus* at 2462.
[18]Brief of Respondents Lisa Madigan and Michael Hoffman at 2, 6, *Janus v. AFSCME*, 138 S. Ct. 2448, 201 L. Ed. 2d 924 (2018), 2017 WL 3485654 (U.S.), 2, 6; Brief of Respondent AFSCME at 24, *Janus v. AFSCME*, 138 S. Ct. 2448, 201 L. Ed. 2d 924 (2018), 2017 WL 3500027 (U.S.), 24.
[19]*Janus* at 2459.
[20]*Id.* at 2465-66.
[21]*Id.* at 2466-67.
[22]*Id.* at 2458.
[23]*Id.* at 2468.
[24]*Id.* at 2468–69, *citing Harris v. Quinn*, 134 S. Ct. 2618, 2622, 189 L. Ed. 2d 620 (2014).
[25]*Id.*
[26]*See* 2018 NY REG TEXT 500969 (NS).
[27]Brief of Respondent-Appellees Lisa Madigan and Michael Hoffman at 17, *Janus v. AFSCME*, 138 S. Ct. 2448, 201 L. Ed. 2d 924 (2018), 2017 WL 3485654 (U.S.), 17, citing Brief of Petitioner Mark Janus at 9, 138 S. Ct. 2448, 201 L. Ed. 2d 924 (2018), 2017 WL 2546472 (U.S.), 9.
[28]*Id.*
[29]*Janus* at 2483.

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Emerging Trends in Private Equity

By: Rett Hatcher and Megan Jackson

Many public pension plans depend upon alternative investments to drive returns in their portfolio. However, changes in the private equity industry, including the predominance of large, established private equity managers in the marketplace, have made limited partner access to and influence over private equity funds much more limited. In this tightly competitive market, private equity managers are increasing fees, which can be difficult for investment counsel to public pension plans to negotiate. However, investment counsel can improve overall fund economics by closely monitoring how fees and expenses are calculated and considering alterative, lower fee structures and investment options.

Investors are increasingly turning to large, established private equity firms like Blackstone, Apollo and TPG to deploy their private equity dollars.[1] Many investors consider these top quartile performers to be comparatively "safe" investments. Smaller private equity firms are being weeded out, as investors increasingly look to top performers.

Market Trends

Investors are increasingly turning to large, established private equity firms like Blackstone, Apollo and TPG to deploy their private equity dollars.[1] Many investors consider these top quartile performers to be comparatively "safe" investments, and smaller private equity firms are being weeded out. According to Preqin, only 921 private equity funds had final closings in 2017, which is the fewest since 2012 and represents a 26% decrease from 2016.[2] As a result, smaller and mid-sized private equity firms have struggled and consolidated with larger firms. Overall, there are fewer private equity managers in the marketplace.

As a related trend, private equity managers are raising larger funds than ever before. The established private equity managers are raising mega-funds between $10 – 20 billion, with Apollo Global Management LLC raising a record $24.7 billion fund in 2017. This increase in fund size is not limited to the large, established managers. The average size of a private equity fund reached nearly $500 million in 2017, compared to around $346 million in 2016 and $300 million in 2015.[3] While larger funds can accommodate more investors, any single investor will have less relative influence on the fund and fund documentation.

Market Conditions Driving Increase in Fees

As investors compete for access to large funds, the large fund managers have increased their management fees. Mega-funds managed by Apollo Global Management LLC and Blackstone Group have all raised management fees, even as they take home more in management fees because of fund size. For these mega-funds, management fees are around 1.5% during the investment period. For mid-sized funds, management fees are typically 2% of capital. Management fees are charged on committed capital during the investment period. At the end of the investment period or upon the formation of a successor fund, management fees generally drop down. There has been a noticeable increase in management fee rates in the post-investment period in particular. For example, Apollo, Blackstone, TPG and Hellman & Friedman are charging investors more in management fees during the post-investment period than they did in their prior funds, increasing the management fee rate from 0.75% in their previous funds to 1.25% in their new funds.[4]

Implication for Lawyers

In this environment, it can be difficult for investment counsel to negotiate fees. It is unlikely that a single limited partner will be able to negotiate the topline management fee rate. While managers have often provided fee breaks for early closers and large investors, there is some evidence that even those incentives are being pulled back. TPG, for example, offered a management fee discount of 25% for early closers investing at least $400 million in its 2015 fund. In its most recent fund, this discount has been reduced to 10%.

Monitor Fees & Expenses

Although market trends are working against limited partners, public plan investment counsel may negotiate terms that will impact the overall economics of the investor's participation in the fund:

Define the Management Fee Base

Management fees are typically 1.5%-2% of capital (depending on the size of the fund). While some private equity managers will charge management fees on *all* capital commitments, some will exclude commitments used to pay for partnership expenses, which investment counsel may negotiate. Realized losses, write-offs, and write-downs are also typically deducted

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from the management fee base. Investment counsel should also confirm that any commitments by the general partner, manager and affiliates are similarly excluded. Amounts borrowed on a subscription line are often included in the management fee base post-commitment period. Investment counsel should closely review the management fee base to ensure the manager is only charging management fees on those assets that are actually invested for the benefit of limited partners.

Capture all Management Fee Offsets

If the general partner receives fees from portfolio companies (*e.g.*, transaction fees, monitoring fees, break-up fees and directors' fees), then those portfolio fees should offset the management fees. Portfolio fee offsets range from 80%-100% of the value of portfolio fees received, depending on the maturity of the manager.

In negotiating portfolio fees, investment counsel should cast a wide net and capture all possible fee income and all possible recipients, including the general partner's affiliates, the manager, the manager's affiliates and their respective employees, members, directors, and partners.

In negotiating portfolio fees, investment counsel should cast a wide net and capture all possible fee income and all possible recipients, including the general partner's affiliates, the manager, the manager's affiliates and their respective employees, members, directors, and partners. Fee offsets should also capture all types of fees. For example, the general partner may receive termination fees paid in lieu of ongoing monitoring fees, which should also offset management fees.

Investment counsel should also confirm that fees received from both current and former portfolio companies offset management fees. For example, the general partner could sell a portfolio company but the portfolio company may still have a contractual obligation (*e.g.*, consulting fee) to pay the general partner or its affiliates. These fees should offset management fees since they benefit the general partner at the direct or indirect expense of the fund.

Finally, we note management fee offsets from portfolio fees are often allocated to the fund, parallel funds and co-investors in accordance with their respective investments in the portfolio company. Investment counsel should request that portfolio fees are allocated only to the fund and any parallel funds that pay management fees. It is inappropriate for fee offsets to be allocated to co-investors or parallel funds that do not pay management fees.

Expense Shifting

Another way for investment counsel to negotiate improved economics is to closely track the private equity fund's expenses. There are two main types of fund expenses: organizational expenses and operating expenses. Organizational expenses are the costs a manager may incur in organizing the fund, such as forming the entity, drafting the initial documentation and fundraising. Organizational expenses are subject to a cap, which varies depending on the size of the fund—roughly 0.09%-0.10% of fund size for mid-sized funds or around 0.05% of fund size for mega-funds. Operational expenses are the costs a manager may incur in the ongoing operation of the fund and are not subject to a cap. The fund should not pay for the general partner's or manager's overhead expenses, including compensation, rent, utilities, general travel, books and records maintenance, and any placement agents. However, there is a trend of managers charging more manager expenses (previously borne out of management fees) to the partnership. For example, managers may try to shift travel costs and fees for industry specific advisors to the fund. In addition, managers may charge regulatory compliance, registration and insurance expenses to the fund, which should be tightly limited to those expenses directly related to the fund in particular. Investment counsel should closely review the definition of operational and organizational expenses to confirm they directly relate to their purported purpose.

Reporting

In addition to negotiating limitations on fees and expenses, investment counsel may improve monitoring of these expenses by requesting enhanced reporting. Many public pension plans have requested disclosure of fees, expenses and carried interest on the Institutional Limited Partners Association (ILPA) Fee Template, which allows limited partners to compare fees across peer funds and monitor ongoing expenses for reporting to stakeholders. Enhanced disclosure is increasingly demanded by public plan investors[5] and supported by regulators.[6]

Low(er) Fee Alternatives

Negotiating fees and monitoring expenses are not the only way to minimize the costs of private equity. Public plan investors

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are increasingly turning to lower fee alternatives to the typical commingled private equity fund.

Co-Investments

Many investors are seeking to reduce aggregate fees or participating in co-investment vehicles that will co-invest alongside a manger's main fund on a no fee/no carry basis. In addition to lower fees, the benefits of co-investing include a favorable risk-return profile, J-curve mitigation, and the ability to tailor portfolios. However, public plan investors may face challenges in negotiating and timely executing co-investment transactions, as investors will need to make decisions quickly and sometimes with incomplete information, and there is risk that managers may reserve more attractive investment opportunities for the main fund.

Investors are choosing funds of one because managers are generally willing to provide more favorable terms in a fund of one than in a commingled fund.

Funds of One/Separately Managed Accounts

Many investors are increasingly pursuing "funds of one" or separately managed accounts.[7] Funds of one are limited partnerships owned by a single investor or small group of investors which may invest alongside a manager's comingled fund or invest in a strategy designed for the investor. Investors are choosing funds of one because managers are generally willing to provide more favorable terms in a fund of one than in a commingled fund. Limited partners can negotiate attractive terms because funds of one typically involve only a single investor that makes a sizable capital commitment. Also, on the business side, investors like funds of one because the investor can create a unique portfolio that aligns with its specific needs, such as certain geographic exposure of cash-flow profile.

Strategic Partnerships

Some larger public plan investors are looking to minimize the number of relationships they have with private equity managers and build deeper relationships with only a handful of managers through strategic partnerships. Although the terms of strategic partnerships vary widely, public plan investors may choose to invest in multiple products with the same investment manager and relationship manager. From the investor's perspective, the due diligence process is streamlined, as the manager is already vetted. Also, the manager is familiar with the unique legal requirements of the public plan investor, which expedites negotiations. Finally, managers are often willing to provide more favorable fee and governance terms to public plan investors in strategic partnerships, similar to a fund of one.

Secondary Interests

The market for secondaries is strong and growing, as buyers are looking to invest in existing assets and sellers are looking for liquidity or to rebalance their allocation to private equity. Recent regulatory changes (*i.e.*, Basel III, Solvency II, and the Volcker Rule) have made participation in private equity funds complicated for certain investors. As a result, many have turned to the secondary market as a means of decreasing their private equity holdings. As a result, in 2017, there were 35 secondary market funds that closed, raising a combined $40 billion. It is estimated that the volume of sales will increase 18% this year from 2017.[8]

In addition to traditional secondary strategies, investment counsel should familiarize themselves with non-traditional secondary strategies which are now being deployed. These include preferred capital funds, portfolio debt providers, private equity backed securitizations, and secondary direct funds. While the markets and strategies continue to evolve, the fee factors remain the same. Does the manager have a track record? Is there availability of information? What is the structure of the investment? Investment counsel should carefully review the terms of the fund documentation in this new and exciting area.

Recent trends in the private equity industry, including a market shift in favor of large, established managers, has allowed them to raise fees without deterring public plan investors. To limit the impact of these market changes, investment counsel may consider negotiating key terms in private equity fund documents that improve fund economics. In addition, investors may consider low fee alternatives to commingled fund structures, such as co-investments, funds of one and strategic partnerships.

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Emerging Trends in Private Equity *(continued)*

Rett Hatcher *is Deputy Director of Arkansas Teacher Retirement System and* ***Megan Jackson*** *is Shareholder at Reinhart Boerner Van Deuren s.c.*

ENDNOTES:

[1]Benjamin Horney, *5 PE Trends to Watch Out for in 2018*, Law360 (Jan. 1, 2018), **https://www.law360.com/articles/994412/5-pe-trends-to-watch-out-for-in-2018**.

[2]*Id.*; Preqin, *Private Equity Fundraising in 2017: A Global Story*, Value Walk (Feb. 8, 2018), **https://www.valuewalk.com/2018/02/private-equity-fundraising-2017-global-story/**.

[3]Horney, *supra* note 1.

[4]Sabrina Willmer & Heather Perlberg, *TPG Joins Apollo, Blackstone in Raising Fees as Money Flows*, Bloomberg (July 17, 2018), **https://www.bloomberg.com/news/articles/2018-07-17/tpg-joins-apollo-blackstone-in-raising-fees-as-money-pours-in**.

To limit the impact of these market changes, investment counsel may consider negotiating key terms in private equity fund documents that may improve fund economics.

[5]Sarah Rundell, *PSRS/PEERS Wants Fees Perfectly Clear*, top1000funds.com (Sept. 24, 2018), **https://www.top1000funds.com/2018/09/psrs-peers-wants-fees-perfectly-clear/?utm_medium=email&utm_campaign=Top1000%20825&utm_content=Top1000%20825+CID_2656357e48247d87bcc47b0fb6f0a6e3&utm_source=Campaign%20Monitor&utm_term=READ%20MORE**.

[6]*Coachman Energy Partners LLC*, Investment Advisers Act of 1940 Release No. 4743 (SEC Aug. 14, 2017) (order), **https://www.sec.gov/litigation/admin/2017/ia-4743.pdf**.

[7]Benjamin Horney, *How Attys Can Capitalize on the 'Funds of One' Craze in PE*, Law360 (May 14, 2018), **https://www.law360.com/articles/1043249/how-attys-can-capitalize-on-the-funds-of-one-craze-in-pe**.

[8]Preqin, *The Secondary Market in 2017*, **http://docs.preqin.com/reports/Preqin-Secondary-Market-in-2017-February-2018.pdf**.

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The New Partnership Audit Regime and What It Means for Tax-Exempt Investors

By: James Canup

Effective January 1, 2018, the new centralized audit regime for all partnerships and LLCs taxed as partnerships went into effect. The aim of the new regime is to make it easier for the IRS to conduct audits of partnerships by letting the IRS focus for both audit and collection on the partnership and not on the individual partners. The IRS can now deal exclusively with the Partnership Representative who is given substantial powers not given to the "tax matters partner" under prior law.

The aim of the new regime is to make it easier for the IRS to conduct audits of partnerships by letting the IRS focus for both audit and collection on the partnership and not on the individual partners.

Under the new audit regime any adjustments to the partnership's income, gain, loss, deduction, credit and the like and any allocable share of those items are made at the partnership level. More importantly, any underpayment is likewise assessed and collected at the partnership level, absent certain elections made by the Partnership Representative.

The Partnership Representative now has exclusive authority to bind the partnership and deal with the IRS on the following:

- waiving any statute of limitations or other defenses;
- conducting all communications with the IRS;
- settling the tax liability of all partners; and
- deciding whether to allocate any IRS assessment among the partners or paying the tax on the partners' behalf at the partnership level.

In addition, there is no requirement that the IRS contact any of the partners or provide the partners with any right of appeal.

What Can be Done?

First, tax-exempt partners should understand who is named as the Partnership Representative under the partnership agreement (or operating agreement in the case of an LLC). Does that party, who need not be a partner, understand the nature of the partnership and more importantly the make-up of the partnership? For public pension fund investors in a partnership it is important that the Partnership Representative understands the tax-exempt status of those investors. The Partnership Representative should be aware of the partnership's constituents. Tax-exempt investors will need to determine whether the Partnership Representative should be required to be knowledgeable of the issues that can arise when tax-exempt partners invest in a partnership, especially in a mixed pool of taxable and tax-exempt partners.

The partnership agreement should be reviewed to determine if it provides that the Partnership Representative is required to inform, or if appropriate seek approval from, the partners on the following matters:

- electing out of the new audit regime if the partnership meets the requirements to make such an election;
- notifying the partners when communications from the IRS occur;
- seeking comment and response from the partners to any IRS inquiries in a timely manner;
- permitting a partner's attorney or accountant to participate in any audit;
- deciding when to either waive the statute of limitations in connection with, or settle, an IRS audit;
- informing the IRS that some (or all) of the partners are tax-exempt entities that should not be taxed at the presumed highest possible tax bracket absent proof to the contrary;
- allocating any tax to be paid by the partnership or making an election to "push out" any tax payments; and
- requiring former partners to be liable for any taxes assessed and collected on income earned when they held a partnership interest.

Not all of the above items will necessarily be included in the agreement or any side letter. At a minimum the agreement or side letter should provide that any tax costs related to tax-exempt income should not be allocated to a tax-exempt partner so that the tax-exempt partner is not funding any tax liabilities on income that would otherwise be tax-exempt. In addition, the Partnership

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Representative should be directed to advise the IRS of the tax-exempt status of its partners prior to the conclusion of any audit.

However, even if these matters are addressed in the agreement, the IRS is not bound by any such provisions. Therefore, tax-exempt partners may want to consider whether the partnership agreement should also include a mechanism for any dispute resolution involving these matters if the Partnership Representative does not comply with the agreement. The partners may also want to consider whether the partnership should obtain an errors and omissions insurance policy to cover any inappropriate taxes, penalties and interest caused by the Partnership Representative's failure to follow any requirements that may be found in the partnership agreement.

Since tax-exempt entities often invest through partnerships to diversify their portfolios, the effect of the new centralized audit regime on their position as investors should be understood. This makes a review of the partnership provisions, including those provisions addressing the duties and obligations of the Partnership Representative under the new regime, all the more important. Some of the concerns raised above can be addressed in the partnership agreement or through a side letter so that the concerns of tax-exempt investors such as public pension funds can be properly addressed before any IRS audit occurs.

James Canup *is a Partner at Hirschler Fleischer.*

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