NOSSAMAN LLP

SACRS ATTORNEYS BREAKOUT SESSION

Conflicts of Interest in Private Fund Investments

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Why Conflicts Matter to Public Pension Plans

1. **Fiduciary duties (California Constitution & Applicable law)**
   - Retirement system board members and investment staff with discretionary authority or responsibility over investing owe fiduciary duties to retirement system members and beneficiaries, and they also have ethical responsibilities required of public officers and employees under California law. Investment documents must address fiduciary duties of managers to the extent such discretionary authority and responsibilities is delegated.
2. **Contractual duties**
   - Delaware LPAs may modify or eliminate GP fiduciary duties (DRULPA §17-1101(d)) — freedom of contract – but cannot eliminate implied contractual covenant of good faith and fair dealing. Retirement system's duties stay fixed while the GP's can be contracted away.
3. **Limited regulatory backstop**
   - The SEC's 2023 Private Fund Adviser Rules were vacated by the Fifth Circuit (June 2024); LPs rely on state law, the Advisers Act (anti-fraud regime and Form ADV disclosures), and negotiated terms.
4. **Public accountability**
   - Disclosure laws, pay to play restrictions, other conflict of interest ethical requirements, and Board policies.

Common GP Conflicts

Where LP Interests and Manager Interests Typically Diverge

Fees & Expenses

Affiliate service-provider fees, monitoring/transaction fees, broken-deal costs, GP overhead shifted to the fund

Allocation

Allocating deals, co-investment and expenses among flagship, successor, parallel and co-invest vehicles

Cross-Fund Transactions

Cross-trades, follow-ons into another fund's portfolio company, principal transactions

GP-Led Secondaries

Continuation vehicles where the GP sits on both sides of the price and rolls carry

Successor Funds & Time

Raising a new fund before the current one is invested; key-persons' time & attention to fund

Pay-to-Play & Ethical Rules

Placement agent fees, political contributions, gifts, and financial interests can influence investment decisions

GP-Led Secondaries/Continuation Vehicles & Cross-Fund Deals (Manager/GP is on both sides)

GP Conflicts

- GP sets or influences price for both selling fund and buying vehicle
- GP crystallizes carry and resets fees/carry in the new vehicle
- Compressed election windows pressure LPs to sell or roll
- Cross-trades and follow-ons can favor the newer fund (or rescue the older one)

LP Protections

- LPAC consent required for all affiliated/cross-fund transactions
- Independent fairness opinion or valuation; competitive price discovery
- Status-quo option (roll on existing terms) and adequate election period (e.g., 20+ business days)
- GP rolls portion of crystallized carry
- Full access to information and disclosure of GP's economics

Key LPA and Side Letter Terms for Managing Conflicts

LPAC	Voting seat; conflict-approval mandate; LPAC may retain independent counsel at fund expense; members exculpated
Successor funds	No new fund until 70–75% invested or committed; key-person and time-commitment covenants
Pay-to-play	Disclosure of use of placement agents per Cal. Gov. Code § 7513.85 et seq. and Plan's placement agent policy; Manager must agree to comply with placement agent policy
Fiduciary duties	Contractual fiduciary duties; narrow exculpation/indemnity (carve out gross negligence, fraud, willful misconduct, violations of securities laws, material LPA breach)
Annual Disclosures	Annual disclosures of fund level information per Cal. Gov. Code § 7928.710(c)(1) - (9) & Cal. Gov. Code § 7514.7 (annually by July 31); ILPA reporting template
Policies Statutes & Established Practices	MFNs; Public Disclosures; Placement Agent Disclosures; No direct indemnification; No waiver of sovereign immunity; Ethical Guidelines; Local venue & jurisdiction; No Waiver of Jury; No disclosures of PII; No Tax Withholdings

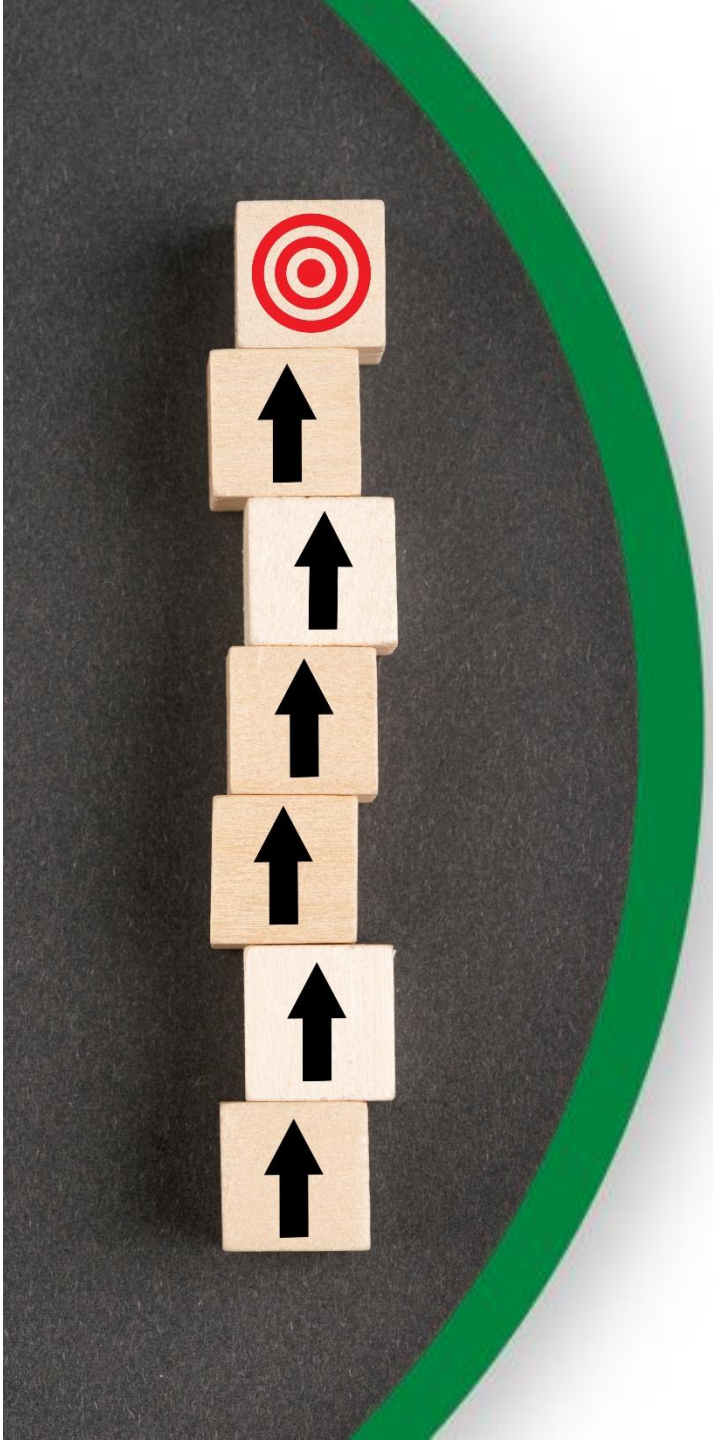
Continuation Vehicles – Conflict Mitigation

Rolling LPs – Continue with Investment

- GP will form new private fund (after negotiation of material terms with anchor)
- Quick timeline to review and negotiate
- Fund terms should track terms of underlying fund (but not always)
- LPA, Subscription Agreement & Sub Booklet (typically no PPM)
- Side letters should have at minimum same applicable material terms
- Request new terms if change in law or plan's policies/practices

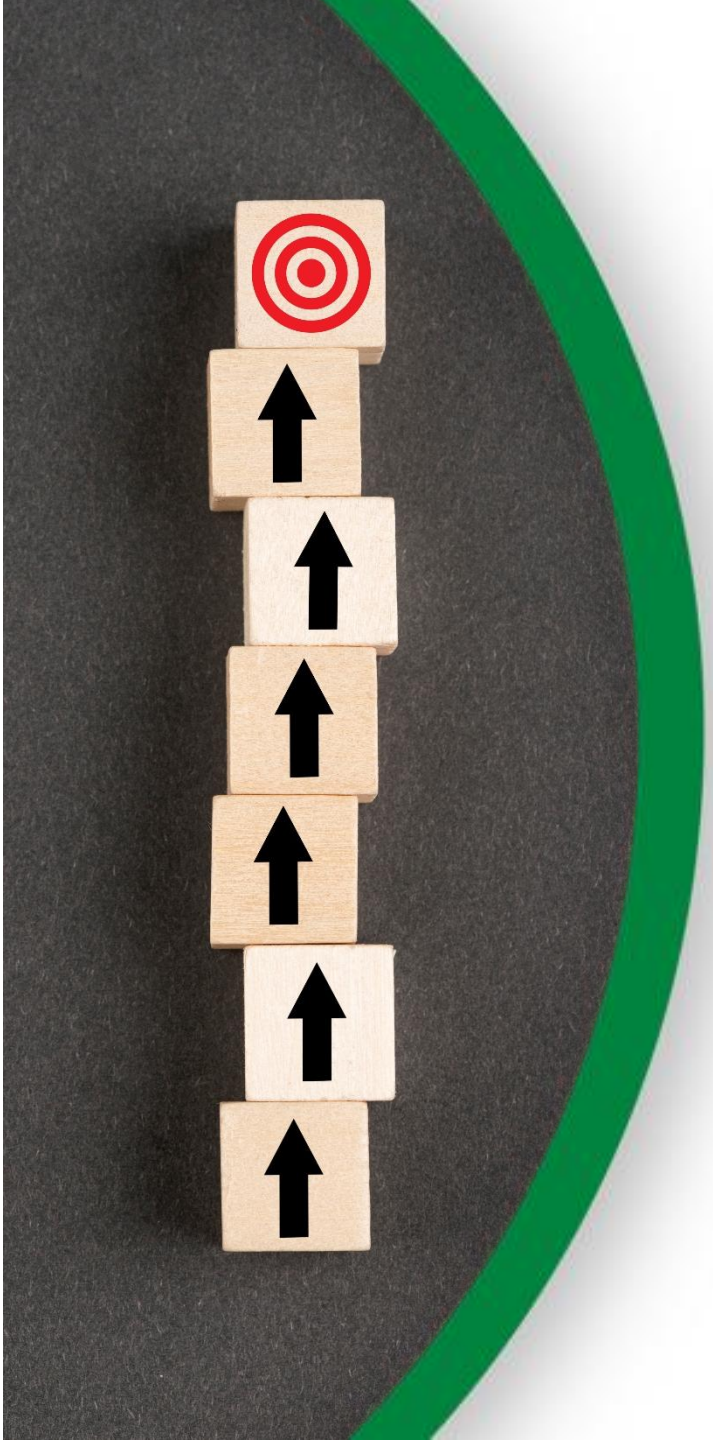
Selling LPs – Sale of Entire Interest for Cash

- Read consent forms carefully
- Include representations and warranties
- Include waivers of rights
- Current fund side letter may not apply to the consent form
- Existing LP will be considered a selling LP if do not execute new sub booklet
- Whether sign consent form or not, still will be considered selling LP of entire fund interest



Conflict of Interest "Small Shareholder" Exception Under Political Reform Act

- The "small share holder exception" in the Political Reform Act ("PRA"):
  - The official's only financial interest in the business in an "investment interest" under Section 87103(a) valued at $25,000 or less; and
  - The official's interest in the business is less than one percent of the business's shares, ***unless***
  - The decision may result in an increase or decrease in the entity's annual gross revenues, or the value of the entity's assets or liabilities, in an amount equal to or more than:
  - $1,000,000; or
  - 5% of the entity's annual gross revenues and the increase or decrease is at least $10,000.



Conflict of Interest "Small Shareholder" Exception Under Political Reform Act

- Thus, in circumstances of an investment in excess of $1 million, the PRA requires disclosure and recusal of a trustee or staff member from such a decision even where they own stock in the company that is valued at less than **$25,000**. (See generally, FPPC enforcement actions.)

Conflict of Interest "Small Shareholder" Exception Under Gov. Code sec. 1090

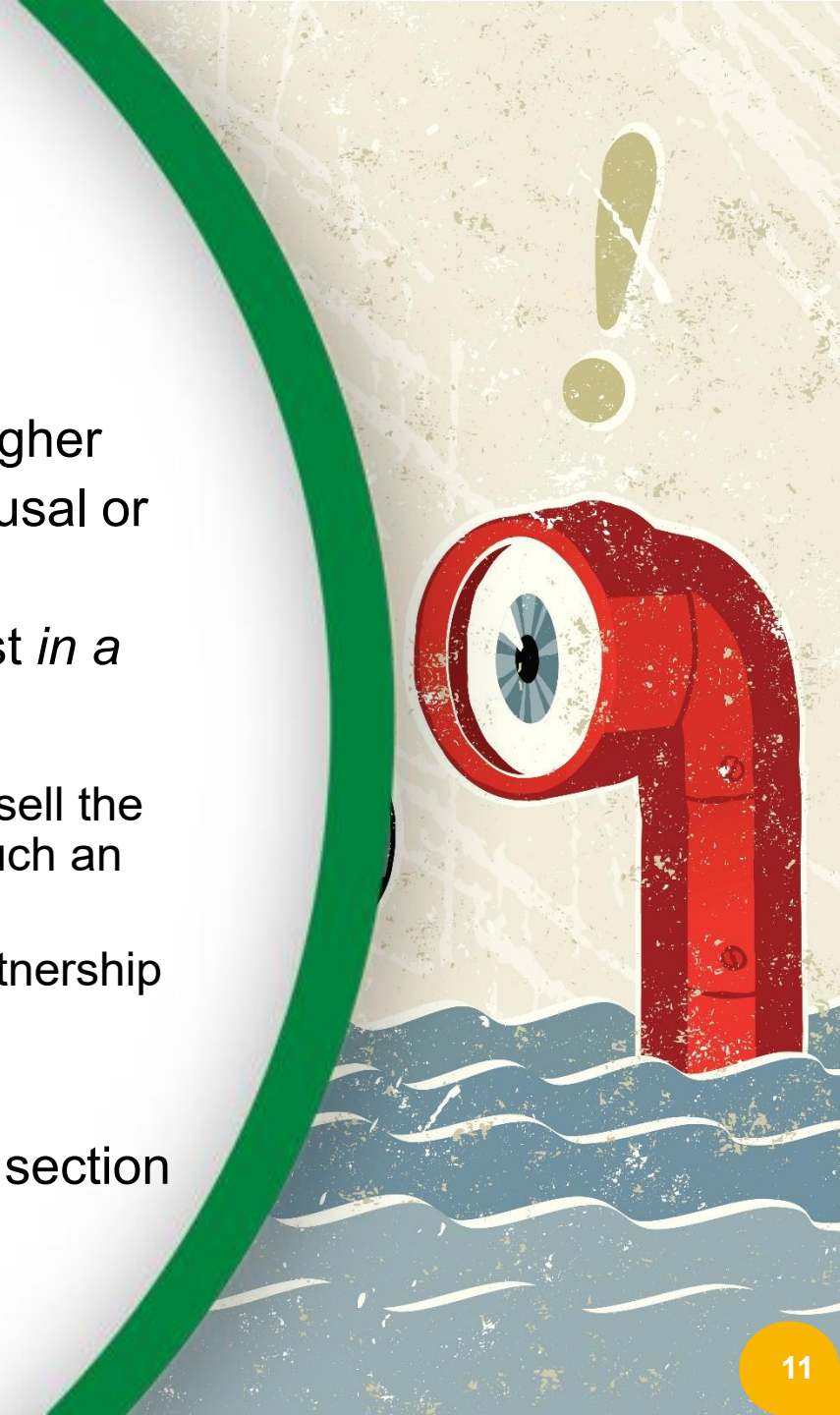
- "Non-Interests" exceptions under section 1091.5 applicable to investment:
  - "The ownership of less than 3 percent of the shares of a corporation for profit, provided that the total annual income to him or her from dividends, including the value of stock dividends, from the corporation does not exceed 5 percent of his or her total annual income, and any other payments made to him or her by the corporation do not exceed 5 percent of his or her total annual income." (1091.5(a)(1))

Conflict of Interest "Small Shareholder" Exception Under Gov. Code sec. 1090

- "Remote" interests under section 1091 include 18 exceptions, including, among others:
  - employees or agents of the contracting party who have at least three years of prior employment, where the contracting party has at least 10 employees, the official owns less than 3% of its stock, and did not participate in the bid ((1091(b)(2));
  - attorneys, or owners, officers, employees, or agents of firms providing services as stockbrokers, insurance agents or brokers, or real estate agents or brokers, provided they receive no remuneration from the contract and hold at least a 10% ownership interest in the firm (1091(b)(6));
  - persons owning less than 3% of shares in a for-profit contracting party, where that ownership derives from employment (1091(b)(14)); and
  - owners or partners of firms serving as appointed members of unelected boards or commissions of the contracting agency, subject to recusal from advising on or participating in the contract. (1091(b)(17).)

Conflict of Interest "Small Shareholder" 1090 Exceptions

- While section 1090 "small shareholder exceptions" have much higher financial thresholds than the PRA and thus would not require recusal or other actions as to stock ownership below those thresholds, that exception does not apply to a public official or employee's interest *in a limited partnership*, in which CCCERA also is invested.
  - As to a limited partnership interest, then, the trustee would need to sell the interest or resign from the board for CCCERA to be able to make such an investment in the same fund.
  - Similarly, trustees and staff are not permitted to invest in limited partnership in which CCCERA already is invested.
    - (See *Plescia Opinion* (89 Ops. Cal. Atty. Gen. 69 (2006).)
- Note the enhanced risk of potential conflicted transactions under section 1090 with private markets potentially opening to retail investors



Conflict of Interest – "Remote" Interest Exceptions under Section 1090

- A specific "remote" (or non) interest provision must apply for recusal to be a sufficient remedy, and courts and the Attorney General tend to apply such statutory provisions narrowly (i.e., only to those financial interests that are directly addressed in the exceptions).
- A governing board may not avoid a Section 1090 conflict by adopting a policy delegating its authority to a non-board member where the governing board retains review and control over said delegated authorities. (See *Aghazarian Opinion,* 87 Ops. Cal. Atty. Gen. 9 (2004).)

Consequences of violation of Section 1090

- Contract is void
- Profits obtained in violation of section 1090 are subject to disgorgement
- Board member recusal is **NOT** a permissible remedy (unless a remote interest exception directly applies)
- Board member with a material financial interest as defined by section 1090, and where a remote interest exception does not apply, must either timely dispose of financial interest or resign from Board
- Violation is subject to felony prosecution that, if proven, can result in imprisonment of the public official and fines

Questions?



Thank you



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