Private Equity Investment by Public Pension Plans: The Need for Transparency and Recourse

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A record number of public pension plans are turning to private equity as a way to diversify their portfolios and maximize returns for their beneficiaries. However, the lack of transparency and uniform disclosure requirements governing private equity firms leave public pension plans exposed to unforeseen risks and without any recourse. This article identifies and discusses some of the risks private equity poses and explores possible solutions to better protect public pension plans from fraud in the private equity space.

Background - The Rise of Public Equity

Public pension plans are increasingly turning to private equity as a way to diversify their investment portfolios and provide the greatest return for their beneficiaries. According to a study issued by the American Investment Council ("AIC") in July 2019[1] that surveyed over 165 U.S. public pension plans, 91% of plans had at least some exposure to private equity. Collectively, those private equity investments accounted for approximately 8.7% of public pension plan portfolios as opposed to 48.1% of investments in traditional public equities on a dollar weighted basis.

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However, those figures are likely to increase as more and more companies are turning to private equity as a way to raise capital. In recent years, U.S. companies have raised almost twice as much equity through private offerings than through initial public offerings ("IPOs"), resulting in over $4.1 trillion of capital invested in private equity in 2019. Furthermore, the number of U.S. public companies has also been steadily declining, as have the number of IPOs—with only 159 in 2019 as compared to 192 in 2018.

Private equity also is an attractive option for public pension plans looking to achieve maximum returns while diversifying their portfolios. According to the AIC study, in 2018, private equity continued to provide a strong return on investment, with a median annualized return of 10.2% over a 10-year period as compared to 8.5% for public equities. Thus, private equity returns frequently outpace the S&P 500. Private equity also provides much needed diversification because the longer-term nature of private equity investments make them less susceptible to the increased volatility the equity markets have experienced recently.

The Need for Increased Transparency and Recourse

While private equity investments often provide excellent returns and help diversify public pension plan portfolios, such investments are not without significant risks. As investments in private equity have increased exponentially, two issues related to the lack of transparency and recourse in the private equity space have come to the forefront that must be addressed to reduce the risk of fraud: (1) the lack of standardized disclosure requirements; and (2) the common practice of private equity funds including language in their investment agreements with public pension plans that limits liability for fraudulent behavior.

First, the lack of standardized disclosures by private equity firms creates a number of risks for public pension plans. Unlike public equities, private equity firms are not subject to the stringent mandatory disclosure requirements that typically allow institutional investors to perform required due diligence on their investments and shop around for the most suitable investment given their pension plans' needs and requirements. Different private equity firms report fees, historical and expected returns, and asset values using different formulas and standards. Likewise, some private equity firms break out fees and expenses investors have paid while others obscure such information making it harder to identify. Accordingly, the lack of any standardized reporting requirement makes it extremely difficult for investors to make direct comparisons about the performance, risks, and returns of potential private equity investments.

While institutional investors' capital resources put them in a strong position to demand fulsome and transparent fee and performance-related disclosures from private equity firms prior to and during the term of the investment, the current outsized demand for private equity investment opportunities makes it easier for firms to push back against investors who require such information. Implementation of mandatory standardized

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disclosures would allow pension plan administrators to accurately assess the risks and performance of private equity investments and choose the best investments for their plans without having to walk away from potentially good investments because the private equity firms will not provide the information required for some pension plan administrators to fulfill their fiduciary duties.

Recently, increased scrutiny from politicians is adding momentum to the push for standardized private equity reporting. To that end, Democratic Senator and former presidential candidate Elizabeth Warren proposed a significant overhaul in the regulation of the private equity industry, including standardized disclosure for private equity firms. Under the legislation, private equity firms would be required to disclose fees and returns so that investors could monitor their investments and choose the best investment for their needs using an apples-to-apples comparison. However, such regulations are unlikely to be adopted without bi-partisan support, leaving public pension plans with the task of wading through convoluted and often misleading disclosures for the foreseeable future.

The lack of transparent, standardized disclosures and prevalence of exculpatory language in LPAs in the private equity space poses problems for public pension plans that must fulfill their own fiduciary duties in investigating and allocating pension plan capital to achieve maximum returns for their beneficiaries.

Second, private equity firms have been increasingly including language in the limited partnership agreements ("LPAs") entered into with public pension plans that seek to disclaim or reduce the fiduciary duties owed to investors, exposing investors to an increased risk of fraud. For example, private equity firms have started including language in LPAs (which are typically governed under Delaware law) that reduce their legal exposure at the expense of investors including contractual terms that: (1) explicitly eliminate their fiduciary duty to investors and permit the manager to act in its "sole discretion" in favor of their own interests over the interests of investors; (2) serve as a broad waiver of conflicts of interests and insider dealing; and (3) allow the firm to seek indemnification for any SEC enforcement actions from the investors in the fund or directly from the fund's capital.

According to a poll issued by the Institutional Limited Partners Association ("ILPA") in late October 2018, of 89 private equity investors and investor groups, 69% had been faced with reduced fiduciary duties in the LPAs they were required to sign in order to invest, and 54% saw an increased frequency in reduced fiduciary duties in LPAs.[2] Critically, 42% of investors responding to the poll had been forced to walk away from an investment because the private equity firm would not enter into the agreement without including language that limited their fiduciary duties. This creates an impasse where a public pension plan may be foreclosed from investing with a potentially promising private equity firm because the firm refuses to adhere to the same level of fiduciary duties that other investment managers owe to pension plans and their beneficiaries. The implementation of increased regulations requiring private equity firms to adopt heightened fiduciary duties, disclose any conflicts of interests, and require the firms themselves to bear the cost of any SEC enforcement actions or settlements would significantly reduce the risk of fraud.

Last year, the SEC issued an interpretation addressing the standard of conduct and fiduciary duty that investment advisers (including private equity firms) owe to their clients under the Advisers Act of 1940 ("Advisers Act").[3] The interpretation sets forth guidelines confirming that private equity firms owe investors a duty of care and a duty of loyalty under the anti-fraud provisions of the Advisers Act and may not put their interests ahead of that of their clients. However, it is yet to be seen how the SEC interpretation will play out in practice. Market commenters have noted that the SEC interpretation does not significantly change the playing field because it merely summarizes the existing law in the area and does not carry the same weight as a new rulemaking.[4] For example, the interpretation may still leave room for private equity firms to contract out of certain fiduciary duties noting: "an adviser's federal fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the relationship." Accordingly, while the SEC interpretation is an important first step, it remains to be seen how closely private equity firms will adhere to the interpretation's guidelines and whether the SEC will enforce the interpretation rigorously.

Best Practices for Addressing These Issues

The lack of transparent, standardized disclosures and prevalence of exculpatory language in LPAs in the private equity space poses problems for public pension plans that must fulfill their

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own fiduciary duties in investigating and allocating pension plan capital to achieve maximum returns for their beneficiaries. However, there are a number of things public pension plans can and should do to minimize the risk of fraud posed by these issues.

First and foremost, there are a number of third-party providers that can help advise public pension plans and provide much needed clarity in the otherwise opaque world of private equity. Investment managers and consultants, securities law firms, and trade associations all provide advisory services that can help public pension plans assess and vet potential investments and related agreements prior to investment. Likewise, many of these groups can also help public pension plans assess their options if they believe they are the victim of fraud in relation to one of their private equity investments. The SEC interpretation discussed above may serve as a helpful foothold for institutional investors seeking recourse against fraudulent private equity firms through litigation.

Most recently, the ILPA released updated principles for best practices, which set forth important guidelines that institutional investors can follow when entering into LPAs with private equity firms.

Public pension plans can also choose to invest with private equity firms that have agreed to some level of standardization in their financial disclosures. Indeed, as the need for transparency in private equity reporting increases, new coalitions and trade groups have begun forming that push for standardization in private equity disclosures. These groups, which work closely with many of the most sophisticated institutional investors, have leveraged participation by those investors as a way of convincing private equity firms to standardize their disclosures, especially if these firms want access to institutional investor capital. Participating in associations such as ILPA and the Adopting Data Standards Initiative ("ADSI"), all of which attempt to perform this function, may help reduce the risk of fraud posed by differing disclosure standards.

Finally, with respect to ensuring that private equity firms are adhering to their fiduciary duties, a number of trade associations have published best practices for public pension plans to follow when entering into LPAs with private equity firms. Most recently, the ILPA released updated principles for best practices, which set forth important guidelines that institutional investors can follow when entering into LPAs with private equity firms.[5] Best practices set forth in the ILPA principles include that "gross negligence, fraud, and willful misconduct" or breach of the agreement should be the minimum in terms of the exculpation standard agreed to by investors. And that private equity firms should clearly, affirmatively, and prominently disclose the standard of care they owe to the private equity fund, as a whole, as well as the individual investors within that fund, including any standard owed under statute. Public pension plan administrators would be wise to familiarize themselves with some of the principles set forth in the ILPA principles and include such principles in LPA negotiations with private equity firms to ensure that they are protected from potential fraud.

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ENDNOTES:

[1]*See* American Investment Council, Public Pension Study, July 2019.
[2]*See* ILPA Follow Up Letter On Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18, **https://ilpa.org/wp-content/uploads/2018/12/ILPA-Follow-Up-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-11.21.18.pdf**.
[3]*See* "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (June 5, 2019), **https://www.sec.gov/rules/interp/2019/ia-5248.pdf**.
[4]*See* New SEC Interpretation of Advisers Acts **https://corpgov.law.harvard.edu/2019/06/27/new-sec-interpretation-of-advisers-acts/**.
[5]ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners, **https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf**.