

CALIFORNIA REGULATES INVESTMENT MANAGERS' PLACEMENT AGENTS AND SOLICITORS AS LOBBYISTS

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Investment Management Alert

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Effective January 1, 2011, placement agents (as defined below) who act as intermediaries in connection with a potential investment by a California state public pension system must register with the California Secretary of State as lobbyists, while placement agents who act in connection with a potential investment by a local California pension system will be required to register as lobbyists and file reports with the locality if required by a local government agency. In addition, placement agents may not accept contingent fees in connection with an investment by a California state public pension system. California state public pension systems include the California Public Employees' Retirement System ("CalPERS") and the California State Teachers' Retirement System ("CalSTRS"). Local government agencies are authorized to adopt their own regulations, including requirements regarding contingent fees.

The new law, Assembly Bill 1743 ("AB 1743"), was sponsored in part by CalPERS. AB 1743 amends the California Political Reform Act of 1974 (the "Reform Act") and other sections of the California Government Code.^[1] The legislative history indicates that AB 1743 was drafted to increase transparency in the investment of public pension money and to increase public confidence that the investment decisions of boards of public pension systems are made in an impartial manner. Public pension plans in California and throughout the country have been subject to scrutiny from prosecutions and enforcement actions that have shed light on payments allegedly received by placement agents and officials of public pension plans in order to influence the investment decisions of those officials.

In summary, AB 1743, with limited exceptions, requires that internal and external solicitors for external managers and their managed funds, including hedge, venture capital and private equity funds, register as lobbyists and comply with the Reform Act, and it prohibits them from accepting contingent fees in connection with investments by state public pension systems.

Definition of a Placement Agent and Exclusions from the Definition

AB 1743 expands the definition of placement agent to include:

Any person hired, engaged, or retained by, or serving for the benefit of or on behalf of, an external manager, or on behalf of another placement agent, who acts or has acted for compensation as a finder, solicitor, marketer, consultant, broker, or other intermediary in connection with the offer or sale of the securities, assets, or services of an external manager to a board^[2] or an investment vehicle, either directly

or indirectly.^[3]

The amendments provide that an external manager is:

1. a person (which includes both individuals and entities) who is seeking to be, or is, retained by a board to manage a portfolio of securities or other assets for compensation; or
2. a person who is engaged, or proposes to be engaged, in the business of investing, reinvesting, owning, holding or trading securities or other assets and who offers or sells, or has offered or sold, securities to a board.

Thus, the definition of “external manager” includes not just the manager of a fund but also the employees of the manager and the fund itself. The legislative history indicates that the second prong was added to make the definition consistent with the definition of “placement agent.” Taken together, these definitions also mean that employees and other individuals associated with “external managers” (and not just third party solicitors) can be “placement agents.”

AB 1743 excludes certain employees and other individuals associated with external managers from the definition of “placement agent.”^[4] Accordingly, “placement agent” does not include: (i) employees, officers, directors, equity/holders, partners, members or trustees of an external manager who spend at least one-third of their time managing the assets or securities of the external manager; or (ii) individuals who are employees, officers or directors of an external manager or an affiliate of the external manager, with respect to the investment solicitation of state pension systems (including CalPERS or CalSTRS), if the external manager is subject to each of the following requirements:

3. The external manager is registered as an investment adviser or a broker-dealer with the SEC, or if exempt from or not subject to such registration, any appropriate state securities regulator;
4. The external manager has been selected through a competitive bidding process, and is providing services pursuant to a contract executed as a result of that process; and
5. The external manager has agreed to a prudent person fiduciary standard of care when managing the portfolio assets of the California state public retirement system.

Effects of the Amendments

Registration as a Lobbyist. Placement agents are prohibited from acting in connection with potential investments by state pension systems unless they are registered as lobbyists with the California Secretary of State and in full compliance with the Reform Act. Among other provisions, the Reform Act requires that lobbyists, either the firm and/or the individual, as applicable:

- File a registration form and photograph of each individual lobbyist with the Secretary of State and pay a \$50 registration fee per lobbyist. The registration is valid for two years.
- Take an ethics course prior to the initial registration of the individual lobbyist or renewal of that registration.

- File quarterly lobbying disclosure statements with the California Secretary of State. Among other things, a quarterly disclosure statement reports the legislative or administrative actions that were “actively lobbied” and the itemized expenses incurred or arranged during that quarter.
- Are prohibited from making gifts over \$10 per month to officials of any government agencies to whom the lobbyist is registered to lobby.
- Must report all campaign contributions over \$100, and are prohibited from making contributions to officers of the state agency to whom the lobbyist is registered to lobby.
- Have a recordkeeping system to ensure the accuracy and reliability of all information in connection with lobbying activity.
- May be selected for an audit by the Franchise Tax Board.

Registration as a Lobbyist Employer. An external manager that uses a third party or internal staff as a placement agent to solicit state pension plan systems may be required to register as a “lobbyist employer.” It would then be required to file, among other items, various information about its placement agents, including compensation, and its political contributions.

Local Public Pension System Requirements. As noted above, placement agents acting in connection with potential investments by local public pension systems will be required to register as lobbyists if required by a local government agency, as well as comply with other requirements developed by the local government agency. External managers and placement agents that intend to conduct business with local public pension systems should determine whether the applicable local government agency has adopted such a law.

Prohibition on Contingent Fees. In addition, AB 1743 prohibits placement agents from accepting contingent fees (such as success fees for an engagement) in connection with a contract for the investment of state public retirement system assets^[5] on behalf of a state public retirement system.

Non-Contingent Fees for Other Services. AB 1743 provides that there is otherwise no prohibition on the payment of fees (other than contingent fees) for contractual services provided to an investment manager by a placement agent, as defined in the Reform Act, that is registered with the SEC and regulated by FINRA (thus covering federally registered broker-dealers). This provision appears to be intended to allow broker-dealers that are placement agents to charge commissions and mark-ups/downs on securities transactions effected on behalf of public pension plans and to make it clear that broker-dealers may be placement agents and charge non-contingent fees.^[6]

Penalties

A person who knowingly or willfully violates the Reform Act, among other things, is subject to a misdemeanor. A person may also be subject to a fine of up to the greater of \$10,000 or three times the amount that the person failed to report properly or unlawfully contributed, expended, gave or received.

Notes:

^[1] AB 1743, which was signed into law on September 30, 2010, amends the Reform Act and the Public Pension and Retirement Plan chapter of the California Government Code (the “Pension Plan Law”). While the

amendments to the Reform Act and the Pension Plan Law generally parallel each other, there are some nuanced distinctions between the definitions in the amendments to the Reform Act and the Pension Plan Law. See *e.g.*, footnote 3 below. The Pension Plan Law governs state and local pension plan systems while the Reform Act regulates lobbyists.

[2] “Board” is defined to mean “the retirement board of public pension or retirement system,” as defined in the California Constitution. This definition includes the boards of CalPERS and CalSTRS.

[3] The Pension Plan Law provides that a placement agent may be either an individual or an entity, while the Reform Act limits a placement agent to an individual. The reason for the difference is not clear, and the effect is ambiguous. The Legislative Counsel Digest for an earlier draft of the bill indicates that “individual” was added to the definition to cover individuals acting independently. The digest for the final bill, however, simply states that the bill defines placement agent in a similar way “except that the definition would be limited to an individual...” An “investment vehicle” is a domestic or foreign entity constituting or managed by an external manager in which a board (as defined above) is the majority investor and that is organized in order to invest with, or retain the investment management services of, other external managers. Separately, AB 1743 covers minority investments by public pension plans in private funds because the latter fall within the definition of “external managers,” as noted below.

[4] The exclusion from the definition of “placement agent” does not affect broker-dealer registration requirements if applicable.

[5] A “contract for the investment of state public retirement system” assets appears to be intended to include the engagement of an external manager as a portfolio manager for the retirement plan system.

[6] Since the definition of “placement agent” under the Reform Act is limited to individuals (as noted above in footnote 3), the intent and practical effect of this fee provision is ambiguous: almost all broker-dealers are entities that would not be “placement agents” under the Reform Act definition. Nonetheless, the California legislature defined “placement agent” under the Pension Plan Law broadly to include entities, thus requiring entities as well as individuals acting as placement agents to register as lobbyists under and comply with, the Reform Act. Thus, it is likely that the legislature intended the provision regarding non-contingent fees for contractual services provided to investment managers to apply to all broker-dealers that act as placement agents, not just those that are individuals. Limiting the provision to placement agents as defined in the Reform Act, however, leaves open some doubt as to the provision's intended meaning.

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