UPDATE ON PROPOSED AMENDMENTS TO CALIFORNIA LOBBYIST REGISTRATION REQUIREMENTS FOR PLACEMENT AGENTS

Date: May 18, 2011

Investment Management Alert

By: Cary J. Meer, Sonia R. Gioseffi, David Mishel

The California legislature is considering amendments to the California Political Reform Act and other sections of the California Government Code (in SB 398) to clear up some of the ambiguities in AB 1743, the law enacted in 2010 that requires "placement agents" in connection with investments by California retirement systems under certain circumstances to register with the state of California as lobbyists. The issues leading to the proposals were: (1) a concern in the securities brokerage industry that the definition of "external manager" coupled with the definition of "placement agent" could be interpreted in a way that would subject routine trading transactions between broker-dealers and state retirement systems to the provisions of the Political Reform Act; (2) the language of the competitive bidding exception was in the past tense, raising a concern whether the exception applied during the process and whether it only applied to those selected in the competitive bidding process but not those who competed but were not selected; and (3) confusion relating to the extent of the application of local government requirements to local pension plans.

To resolve these issues, SB 398 would:

- revise the definitions of "external manager" and of "placement agent" and add a definition of "investment fund" to eliminate the concern about routine trading transactions;
- clarify the competitive bidding exception to the definition of "placement agent" to make clear that the exception applies during the competitive bidding process, and not only once selected; and
- make the competitive bidding exception applicable to the requirements of local governments with respect to local plans.

For more information about AB 1743 and its implications, please see our prior alerts on this subject:

- California Regulates Investment Managers' Placement Agents and Solicitors as Lobbyists
- Update on California Lobbyist Registration Requirements for Placement Agents and Registration and Disclosure Requirements for Lobbying Firms and Lobbyist Employers

This alert is based on the version of SB 398 that is current as of the date of this alert. Note that SB 398 is in draft form and has not yet been approved by the state Senate, and it will also need to be adopted by the state assembly. By its current terms, SB 398 would go into effect immediately if and when adopted.

Definitions of "External Manager" and "Placement Agent"

The current definition of “external manager” is (1) a person who is seeking to be, or is, retained by the retirement board of a public pension or retirement system 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, or owning, holding, or trading securities or other assets and who offers or sells, or has offered or sold, securities to a board.[1] The current definition of “placement agent” is a person (including entities but only individuals in the Political Reform Act) 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 or an investment vehicle (as defined).[2]

As the current definition of “external manager” includes, among other persons, a person engaged or who proposes to engage in trading and who offers or sells securities to a board, the securities brokerage industry was concerned that brokers engaged in normal trading transactions with pension plans would fall within the definition of “placement agent” and therefore would have to register as lobbyists, and that their commissions or mark-ups/mark-downs would be prohibited contingent compensation.[3]

The proposed amendments would address this concern by changing the definitions of “external manager” and of “placement agent” and by adding a definition of “investment fund.” The proposed amendments would define an “external manager,” in part, as a person who manages an investment fund (as newly defined) and who offers or sells, or who has offered or sold, an ownership interest in the investment fund to a board or an investment vehicle, rather than a person “…owning, holding or trading securities or other assets and who offers or sells, or has offered or sold, securities to a board.” The proposed amendments would define a “placement agent,” in part, as a person engaged by or on behalf of an external manager, or of an investment fund managed by an external manager, and who acts or has acted for compensation as a finder, solicitor, etc. or other intermediary in connection with the offer or sale to the board or an investment vehicle of an ownership interest in an investment fund managed by the external manager, rather than the offer or sale of securities or assets to a board or an investment vehicle.[4] Thus, the proposed amendments would clarify that the registration requirements for placement agents apply to the solicitation of sales of interests in investment funds managed by external managers, rather than to securities in general, and that a brokerage firm can engage in normal trading with or on behalf of a state pension plan without its representatives engaged in the transaction registering as lobbyists.

The proposed amendments would retain the exception to the definition of “placement agent” for an individual who is an employee, officer, director, equity-holder, partner, member, or trustee of an external manager and who spends one-third or more of his or her time, during a calendar year, managing the securities or assets owned, controlled, invested, or held by the external manager.

Competitive Bidding Exception

Existing law requires that, for a solicitor of state pension plans on behalf of an external manager to be exempted from the definition of “placement agent,” the external manager had to have been selected through a competitive bidding process and to have agreed to the standard of care set forth in the California constitution. ldquo;Competitive bidding” is not defined, and the past tense is used in the exception, which has raised questions about when the exception applies.

The proposed amendments would make clear that the exception applies when the external manager is participating in a competitive bidding process, such as a Request For Proposals ("RFP"), or has been selected through that process and is providing services pursuant to a contract executed as a result of that process, and if selected through the process, has agreed to the applicable standard of care. Thus, employees, officers and directors of external managers or their affiliates that participate in the process but are not ultimately selected would be excluded from the definition of "placement agent" as would those of external managers that are or have been selected through the process.

The proposed amendments would add the following language to the competitive bidding exception from the definition of "placement agent"; in effect an individual is not a placement agent "…with respect to an offer or sale of investment management services described in [the definition of placement agent] if all of the following apply… [the three conditions, registration, competitive bid and fiduciary standard of care]." We understand that the additional language is intended to make clear that the exception applies on a transaction-by-transaction basis with respect to each engagement or investment and not on a permanent basis.

The proposed amendments would retain the requirement to this exception that the external manager be registered with the Securities and Exchange Commission ("SEC") as an investment adviser or broker-dealer, or if exempt from SEC registration or not required to register, with any appropriate state securities regulatory authority. The proposed amendments would not address pre-RFP communications of or on behalf of external managers who participate in the RFP process subsequent to such communications.

The FPPC recently has taken the position in an advisory letter dated April 7, 2011 ("advisory letter") that, under existing law, the exception applies to the entire RFP process and that pre-RFP communications are not within the exception. The FPPC position is that communications before an RFP is issued are not within the exception and may result in an individual qualifying as a placement agent. Thus, the individual(s), the external manager, and affiliates of the external manager that employ the individuals may have to register as lobbyists, lobbyist employers or lobbying firms, as applicable, for pre-RFP communications unless the nature of the communications does not cause the individual to fall within the definition of placement agent or another exception applies.

The advisory letter does not, however, address the applicability of the exception or the consequences if a firm engages in pre-RFP communications relating to an investment mandate prior to issuance of an RFP and then participates in an RFP process to obtain that investment mandate. It is not clear whether failure to register for pre-RFP communications, if registration is required, would be cured if the external manager then participates in the process or is selected. Additional open questions are, assuming individuals and firms register for pre-RFP communications and then participate in, and are selected pursuant to, a competitive bidding process, whether the exception also applies to the prohibition on contingent compensation, because lobbyists are prohibited from accepting contingent compensation, and whether the registered persons may withdraw their registration once the RFP is issued.

Neither the current draft of SB 398 nor the FPPC advisory letter addresses the effect of the competitive bidding exception for a person who is registered as a lobbyist to solicit engagements or investments that are not subject to the exception but who also participates in the offer or sale of an investment pursuant to the competitive bidding process. The Political Reform Act prohibits lobbyists from accepting compensation contingent on an engagement or investment by a state pension plan. If a person who is registered as a lobbyist solicits a new engagement or investment that falls within the competitive bidding exception there is a question of whether the competitive

bidding exception would apply to that person for the new engagement or investment, particularly with respect to contingent compensation.

The FPPC also takes the position in the advisory letter that efforts to extend a contract issued to an external manager pursuant to a competitive bidding process are within the exception but efforts to obtain contracts for that external manager for other types of services are not within the exception.

Local Requirements

The proposed amendments would retain the requirement that a person (including entities and individuals) acting as a placement agent in connection with a potential investment by a local public retirement system (1) file reports (with a local agency that requires lobbyists to register and file reports) and (2) comply with applicable requirements of the local government agency with respect to local plans. The proposed amendments would retain the placement agent exception from the local requirements for certain individuals who spend at least one-third of their time annually in portfolio management for the external manager. SB 398 also would make the local requirements for local plans inapplicable to persons who meet the conditions of the competitive bidding exception.

Local government requirements do not necessarily use the term “placement agent” or define it in the same way as in AB 1743. This section appears to require that a person acting as a placement agent (as defined under the California Government Code, and who does not meet the conditions of either of the two exceptions in AB 1743 as proposed to be amended in SB 398) comply with local law that is applicable to that activity. The language could also be interpreted as requiring that a person acting as a placement agent (as defined in AB 1743 and not subject to the exceptions) would have to file reports with the local agency if the agency requires lobbyists to register and report, whether or not the local law otherwise covers the activity of the placement agent. Concerns were raised about the meaning of the language prior to the submission of the bill, but the proposed amendments do not address this issue.

We hope that the remaining open issues eventually will be addressed by the FPPC.

Notes:

[1] AB 1743 amended the Political Reform Act and other provisions of the California Government Code (“Pension Law”). The definitions of “external manager” and of “placement agent” in the Pension Law refer to a “board,” which is defined as the board of a public pension or retirement system (which includes state and local public retirement systems). The Political Reform Act, however, limits its applicability to only state public retirement systems. References to “board” throughout this alert (including the proposed amended definitions) are deemed to include this distinction.

[2] AB 1743 defined “placement agents” under the Political Reform Act as individuals, but as both individuals and entities under the Pension Law. The Pension Law defined “lobbyist” as a “placement agent,” as defined in the Political Reform Act. The Pension Law prohibits entities or individuals, with certain exceptions, from acting as placement agents in connection with any potential investment by a state public pension system unless the entity or individual is registered with the California Fair Political Practices Commission (“FPPC”) as a lobbyist and complies with the Political Reform Act. The FPPC in a Fact Sheet published in December 2010 and updated in January 2011 provides that, for purposes of the Fact Sheet, “placement agent” means an individual who must register as a Lobbyist. The FPPC appears to be taking the position that individuals should register as Lobbyists

and that entities (and certain sole proprietorships) should register as Lobbyist Employers or Lobbying Firms. While this position may make sense (in spite of the statutory language), it raises a question whether entities that are placement agents under the Pension Law but which register as Lobbying Firms under the Political Reform Act are actually prohibited from accepting contingent compensation. This issue arises because the prohibition with respect to state pension plan investments applies only to placement agents as defined under the Political Reform Act, and that definition applies only to individuals. The proposed legislation does not address this issue.

[3] The legislative commentary on SB 398 shows that such interpretation was not intended.

[4] Under the proposed amendments, "external manager" means either of the following:

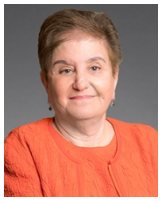
> (1) A person who is seeking to be, or is, retained by a board or an investment vehicle to manage a portfolio of securities or other assets for compensation. (2) A person who manages an investment fund and who offers or sells, or has offered or sold, an ownership interest in the investment fund to a board or an investment vehicle.

Under the proposed amendments, "investment fund" means a private equity fund, public equity fund, venture capital fund, hedge fund, fixed income fund, real estate fund, infrastructure fund, or similar pooled investment entity that is, or holds itself out as being, engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, owning, holding, or trading securities or other assets. Notwithstanding the foregoing, an investment company that is registered with the Securities and Exchange Commission pursuant to the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.) and that makes a public offering of its securities is not an "investment fund."

Under the proposed amendments, "placement agent" means any person (including entities but only individuals in the Political Reform Act) directly or indirectly hired, engaged, or retained by, or serving for the benefit of or on behalf of, an external manager, or an investment fund managed by an external manager, and who acts or has acted for compensation as a finder, solicitor, marketer, consultant, broker, or other intermediary in connection with the offer or sale to a board or an investment vehicle, either of the following:

> (A) In the case of an external manager within the meaning of paragraph (1) above, the investment management services of the external manager. (B) In the case of an external manager within the meaning of paragraph (2) above, an ownership interest in an investment fund managed by the external manager.

KEY CONTACTS



CARY J. MEER
OF COUNSEL

WASHINGTON DC
+1.202.778.9107
CARY.MEER@KLGATES.COM

SONIA R. GIOSEFFI
PARTNER

SAN FRANCISCO, PALO ALTO
+1.415.882.8006
SONIA.GIOSEFFI@KLGATES.COM