Proskauer

California Restricts Use of Placement Agents

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On September 30, 2010, California Governor Arnold Schwarzenegger signed into law Assembly Bill No. 1743 ("AB 1743"), which will impose significant restrictions on the use of placement agents to solicit investments from the nation's largest public pension plans. AB 1743 requires placement agents that solicit investments from California state public retirement systems (currently the California Public Employees' Retirement System (CalPERS) and California State Teachers Retirement System (CalSTRS)) to register as lobbyists with the state. By requiring lobbyist registration, AB 1743 effectively prohibits such placement agents from receiving compensation contingent upon a CalPERS' or CalSTRS' investment. AB 1743 further requires that placement agents seeking to solicit local public pension or retirement systems in California register as lobbyists if required by applicable local government agencies.

AB 1743 was enacted largely in response to revelations that a former CalPERS' board member, Alfred Villalobos, had received more than $47 million in commissions from CalPERS' investment managers. CalPERS and CalSTRS have a combined $274 billion (as of July 31, 2010) in assets under management.

"Placement Agents" May Include Employees

AB 1743 defines "placement agent" as any individual or entity hired, engaged, or retained by an investment manager "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 investment manager to a California public retirement system. An investment manager's employees, officers, directors, partners and members who solicit California public retirement systems for compensation may be placement agents under the definition, unless (i) they spend one-third or more of their time during the calendar year managing securities or assets of the manager (the "One-Third Test"), or (ii) with respect to solicitation of CalPERS and CalSTRS only, the manager is registered with the Securities and Exchange Commission, selected through a competitive bidding process and agrees to act as a fiduciary with respect to CalPERS' and CalSTRS' investments (the "RIA Exception").

While a private equity or hedge fund principal whose job includes portfolio management as well as soliciting investments may be able to rely on the One-Third Test, how the One-Third Test will function in practice is not entirely clear. For example, it is unclear whether the One-Third Test would apply to principals of a start-up manager that is not as yet managing assets. Although the principals are expected to eventually pass the One-Third Test, they may not be managing assets within the calendar year, given current fund-raising periods. In this situation, the principals may be required to register as lobbyists until the One-Third Test is satisfied, then could withdraw registration. Also unclear is what duties constitute "managing securities or assets" for purposes of passing the One-Third Test.

However, in a September 13, 2010 staff memorandum to CalPERS' Investment Committee, the CalPERS' staff noted that the One-Third Test "was not intended to broaden the scope of who is a Placement Agent in the first instance," and that only employees who were hired, engaged, or retained by an investment manager in connection with the offer and sale of securities or services to CalPERS would be considered placement agents. In other words, private equity firm employees with "only limited and intermittent roles in fund-raising processes," such as a typical chief financial officer, likely would not be considered placement agents.[1]

Placement Agents Required to Register as Lobbyists; Prohibition on Contingent Fees

If an outside consultant or employee is considered a placement agent, the consequences vary depending on whether the placement agent solicits a state retirement system (CalPERS or CalSTRS) or a local retirement system. AB 1743 requires placement agents that do business with CalPERS or CalSTRS to register as lobbyists under the California Political Reform Act of 1974 (the "PRA") and comply with all reporting and ethics rules applicable to registered lobbyists under it. Placement agents that do business with local retirement systems must comply with any applicable requirements imposed by local governments, which may include registration as a lobbyist under the PRA.

Under the PRA (as amended by AB 1743), placement agents registered as lobbyists are not permitted to "accept or agree to accept any payment in any way contingent upon … the decision by any state agency to enter into a contract to invest state public retirement system assets on behalf of a state public retirement system." As a result, the traditional means of compensating a placement agent with a percentage of investor commitments is now prohibited with respect to a CalPERS or CalSTRS commitment. This prohibition on contingent compensation applies both to third-party marketers and to employees who fall within the placement agent definition.

The PRA imposes additional ethics and reporting requirements on registered lobbyists (including, under AB 1743, placement agents), such as –

- Annual registration, including recent photograph, contact information, $25 filing fee and certification that the lobbyist has reviewed the PRA sections on unlawful gifts and other unlawful actions. Registration typically is effective within a week of the date that the state receives the required registration materials.
- Completion of a mandatory state ethics course.
- Prohibition on campaign contributions to elected officers of governmental agencies that the lobbyist is registered to lobby (as well as candidates for such offices).
- Prohibition of gifts in excess of $10 per month to any officers of such government agencies (as well as candidates for such offices).
- Filing periodic reports listing all gifts, fees, honoraria or other benefits provided to state officials, as well as campaign contributions exceeding $100.

Penalties

Any willful violation of the PRA is a misdemeanor, punishable by a fine of up to the greater of $10,000 and three times any amount the lobbyist unlawfully contributed, paid or failed to report. In addition, a violator is prohibited from acting as a lobbyist in California for four years, unless otherwise determined by the court. Lobbyists who violate the PRA also may be civilly liable for up to three times the value of unlawful or unreported gifts, contributions or other expenditures.

Penalties for violation of the PRA are assessed against the lobbyist – in this case, the placement agent. There are no penalties for PRA violation against the manager who retains the placement agent (except to the extent that a manager or investment fund indemnify the placement agent). However, disclosure and other policies of individual California pension plans may impose penalties upon the manager for nondisclosure of placement agents.[2]

Effective Date

AB 1743 will take effect as of January 1, 2011, and California public retirement plans are amending their existing disclosure policies accordingly. For example, as of September 13, 2010, CalPERS' Investment Committee approved proposed amendments to its policy with respect to Disclosure of Placement Agent Fees, Gifts and Campaign Contributions[3] to incorporate the One-Third Test into the policy's definition of placement agent. If approved by the California Office of Administrative Law, CalPERS' proposed amendments are expected to take effect in January 2011.

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Please call any of the attorneys listed with any questions.

[1] Memorandum to Members of the Investment Committee, Subject: Regulation Relating to Disclosure of Placement Agent Fees, September 13, 2010, available at http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/201009/item03-00.pdf, pages 4-5 (response to National Venture Capital Association ("NVCA") Comment Letter).

[2] In the event of materially erroneous placement agent disclosure by an investment manager, CalPERS' policy with respect to Disclosure of Placement Agent Fees, Gifts and Campaign Contributions, as modified as of September 13, 2010 (Article 2, Chapter 2, Section 559 of the California Code of Regulations), permits CalPERS to seek reimbursement of two years' prior management fees, to terminate the investment advisory contract or to withdraw from the applicable private equity or hedge fund without penalty. CalPERS' staff are responsible for negotiating such contractual rights with respect to each new advisory contract (including fund partnership agreements) and amendments thereto.

[3] Article 2, Chapter 2, Section 559 of the California Code of Regulations. See also footnote 1 above.

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