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SEC Joins State and Local Governments in Considering Regulation of Investment Adviser Activities Related to Government Plans

In response to investigations into alleged corrupt practices involving the use of placement agents with respect to public pension funds, retirement systems and other government fund entities, both the Illinois legislature and the New York State Comptroller took action in April of this year to restrict the use of placement agents.[1] Over the last several months, state and local pension funds, retirement systems and other government fund entities (referred to herein as government funds) have followed suit by adopting various policies regulating the use of placement agents.

Recently, the US Securities and Exchange Commission (SEC) took its own action in this area by issuing Proposed Rule 206(4)-5 under the Investment Advisers Act of 1940 (Advisers Act).[2] The Proposed Rule is designed to curb pay-to-play abuses with respect to investment advisory services for such government funds. Comments on the Proposed Rule were due October 6, 2009. Now that the comment period has concluded, it is expected that the SEC will consider final action in this area.

As the SEC considers what final action to take, various government funds are adopting their own regulations, and others that are considering action in this area are likely to do so after the SEC's final determination. As a result, regulation in this area is expected to continue to evolve in the coming months.

The SEC Proposed Rule

The SEC Proposed Rule aims to curb pay-to-play abuses with respect to government funds by banning the use of third-party placement agents in soliciting government funds for advisory business and by imposing limitations on certain campaign contributions. The Proposed Rule would apply to any investment adviser registered (or required to be registered) with the SEC, or advisers that are unregistered in reliance on the exemption available for advisers with fewer than 15 clients, and would prohibit doing indirectly that which if done directly would violate the Proposed Rule.

The Proposed Rule is modeled after Rules G-37 and G-38 of the Municipal Securities Rulemaking Board (MSRB), which impose similar campaign and third-party placement agent restrictions on securities dealers working with municipal bond issuers. Additionally, in 1999, the SEC proposed a pay-to-play rule similar to the campaign contribution portions of the Proposed Rule. The 1999 Rulemaking was eventually terminated in 2001. The SEC Proposed Rule was subject to a minimum 60-day comment period, which ended on October 6, 2009.

SEC BAN ON USE OF PLACEMENT AGENTS

The SEC Proposed Rule would make it unlawful for any covered investment adviser, or any of the adviser's covered associates, to provide or agree to provide, directly or indirectly, payment to any unaffiliated third party (including "finders," "solicitors," "placement agents," or "pension consultants") to solicit a government fund for investment advisory services. Affiliates excluded from this provision include: (i) a "related person" of the investment adviser (defined as any person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser), or an employee of that related person; or (ii) any of the adviser's employees, general partners, LLC managing members and executive officers. Furthermore, a contribution to a government official by certain of these persons would trigger the two-year "time out" described below.

The SEC proposes to exclude payments to related persons from the ban such that advisers are able to compensate parent companies and other owners, subsidiaries, and sister companies for governmental fund solicitation, because the SEC recognizes that there may be efficiencies in allowing advisers to rely on these particular types of persons to assist them in seeking clients.

RESTRICTIONS ON CAMPAIGN CONTRIBUTIONS

The SEC Proposed Rule makes it unlawful for advisers to receive compensation for providing advisory services to a government fund for a two-year period (the two-year "time out") after the adviser or any of its covered associates makes a political contribution to a public official of a government fund that is in a position to influence the award of advisory business. The two-year "time out" would continue to apply to the adviser firm even after the covered associate who made the triggering contribution had ceased employment. Additionally, contributions made by a covered associate would be attributed to any other adviser that employs or engages the covered associate within two years after the date of the contribution, requiring an investment adviser to "look back" in time to determine whether it would be subject to any business restrictions under the Proposed Rule when employing or engaging a covered associate. Moreover, an investment adviser to certain pooled investment vehicles in which a government fund invests, or is solicited to invest, would be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government fund.

The two year "time out" is applicable only to contributions made by "covered associates" and would apply only to *compensated* advisory services such that an adviser could still provide uncompensated advisory services to a government fund after making an improper contribution. In fact, an adviser may be required to provide services free of charge for a reasonable period of time to ensure that the government fund can identify a sufficient replacement. "Covered associates" would include general partners, managing members, certain executive officers connected to investment advisory services and other individuals with a similar status or function, as well as any employee of the adviser who solicits government fund clients for the investment adviser.

Individuals would be allowed to make *de minimis* contributions in the aggregate amount of $250 or less, per election, to an elected official or a candidate for whom the person making the contribution is entitled to vote. Certain other inadvertent prohibited contributions may be exempted from the prohibition if the adviser takes the necessary remedial steps. Additionally, an adviser would be able to seek a specific exemption from the SEC for any prohibited contribution.

Under the Proposed Rule, an adviser also would be prohibited from soliciting or coordinating (i) contributions for an official that is in a position to influence the award of advisory business for a government fund to which the adviser is seeking to provide investment advisory services, or (ii) payments to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government fund. Such actions would not trigger the two-year "time out" described above, but rather, would be prohibited generally by the Proposed Rule.

RECORDKEEPING REQUIREMENTS

To facilitate compliance with the Proposed Rule, the SEC also proposed a corresponding amendment to Rule 204-2 of the Advisers Act that would require covered investment advisers doing business with or seeking to do business with government funds, keep certain records of contributions and payments made by the adviser and its covered associates.

The Proposed Rule would require an adviser to maintain the following records: (i) the names, titles and business and residential addresses of all covered associates of the investment adviser; (ii) all government funds for which the adviser or covered associates are providing or seeking to provide investment advisory services, or which are investors or are solicited to invest in any covered investment pool to which the adviser provides investment advisory services, as applicable; (iii) all government funds and related covered investment pool(s) in which a government fund has invested to which the investment adviser has provided investment advisory services, as applicable, within the past five years (but not prior to the effective date of the Proposed Rule); and (iv) all direct or indirect contributions or payments made by the investment adviser or any covered associate to a covered official, a political party of a state or political subdivision thereof, or a political action committee.

The records of contributions and payments would be required to be kept in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment and whether the contribution or payment was subject to the exception for certain returned contributions pursuant to the Proposed Rule. These records would be required to be maintained in the same manner, and for the same period of time, as other books and records under Rule 204-2(a). This requirement would not apply to Advisers exempt from SEC registration under Section 203(b)(3) of the Advisers Act.

REACTIONS TO SEC PROPOSED RULE

As noted above, the SEC Proposed Rule was subject to public comment through October 6, 2009. Various comments were submitted and are publicly available at the SEC's web site at http://www.sec.gov/comments/s7-18-09/s71809.shtml. Many of the comments oppose the SEC's proposed placement agent ban, including comments by various government funds. The comments generally express less opposition to the SEC's proposed restrictions on campaign contributions.

State and Local Placement Agent Bans

Prior to the SEC's recent announcements, several state and local funds followed the example of New York State Comptroller Thomas DiNapoli by banning the use of placement agents entirely. In May 2009, New York City Comptroller William C. Thompson, Jr., announced that all five New York City pension funds — the New York City Police Pension Fund, the New York City Employees' Retirement System, the New York City Teacher's Retirement System, the Fire Department Pension Fund and the Board of Education Retirement Systems — had banned the use of placement agents. The New York City pension funds altogether hold over $82 billion in assets.

Similarly, the New York State Teachers' Retirement System (NYSTRS) and the New Mexico State Investment Council (NMSIC) recently took action to ban the use of placement agents and increase disclosure requirements. At its May 26, 2009 meeting, the NMSIC board of trustees adopted its "Transparency and Disclosure Policy," which banned the use of all third-party marketing agents by firms trying to obtain investments. The NMSIC amended its policy on July 28, 2009,[3] effectively narrowing the scope of the policy by limiting the ban on placement agents only to those firms represented by a placement agent in connection with a specific investment before the NMSIC. The initial policy prevented the NMSIC from doing business with firms that used placement agents in any investment deal. The NMSIC policy also requires disclosure of all third-party fees, including fees paid to lawyers, accountants and other service providers, and disclosure of the firm's in-house marketing employees in order to prevent circumvention of the placement agent ban. The restrictions under NMSIC's new policy are in addition to legislation signed by the Governor earlier this year requiring disclosure of all third-party placement agents and any fees paid to them in relation to the NMSIC, the New Mexico Educational Retirement Board and the New Mexico Public Employees Retirement Association.[4]

In a similar move on May 21, 2009, NYSTRS officials announced a plan to implement certain principles of the New York Attorney General's Public Pension Fund Reform Code of Conduct (the "Cuomo Code of Conduct"), including imposing an immediate ban on investments in any new fund or the engagement of any investment manager in any new assignment where the fund or manager used a placement agent or other intermediary and requiring additional fee disclosure from new funds and managers.

The Cuomo Code of Conduct was developed by New York Attorney General Andrew Cuomo with respect to investigations involving pay-to-play abuses among the New York pension systems. Currently, the Cuomo Code of Conduct has been adopted by various private firms as part of settlement negotiations with the Attorney General's office. Under this code, companies agree to refrain from making certain campaign contributions and from using third party placement agents with respect to any business with government funds.

State and Local Qualification, Disclosure and Political Contribution Requirements

Various other US government funds have also imposed new restrictions on the use of placement agents short of imposing a complete ban. Most notably, on May 11, 2009, the California Public

Employees' Retirement System (CalPERS), which has more than $177 billion in investments, adopted a disclosure policy entitled California Public Employees' Retirement System Statement of Policy for Disclosure of Placement Agents.[5]

The policy requires CalPERS investment partners and external managers to disclose their retention of placement agents, the fees paid to the agents, the services performed by the agents, whether the placement agent is registered as a lobbyist and other information about the engagement and the placement agent. The policy also requires that placement agents be registered as broker-dealers with the SEC or the Financial Industry Regulatory Authority (FINRA). Similarly, on April 28, 2009, the $9 billion Los Angeles City Employees' Retirement System (LACERS) adopted a placement agent disclosure policy requiring that firms disclose any third-party marketers or referring individuals involved in the investment process and indicate those that would receive fees if a contract were awarded.[6]

Additionally, AB 1584 was signed into law by Governor Schwarzenegger on October 11, 2009. This new law imposes pay-to-play restrictions on all California public pension and retirement systems.[7] These restrictions include a requirement that each fund develop and implement a policy requiring the disclosure of fees paid to placement agents and campaign contributions and gifts made by placement agents to board members.

Other pension systems have adopted or are considering adopting similar qualification and disclosure policies. At a July 2009 meeting, the New Jersey State Investment Council (NJSIC) adopted additional criteria for placements agents, including that they be registered with the SEC or FINRA, that the placement agent firms' professionals hold securities licenses, that top managers at the firms have at least three years' experience in the securities industry and that the agents sign and disclose a "detailed contract" specifying the work the agent is expected to do for the fund managers they represent. These revisions are add-ons to NJSIC's prior policy, adopted in 2004, that prohibits campaign contributions from investment professionals and their placement agents to any candidate for Governor or the legislature or any state party or political action committee.

Connecticut Treasurer Denise Nappier also announced that all fund of funds mangers will be required to provide additional disclosure of third-party payments made in connection with investments on behalf of the Connecticut Retirement Plans and Trust Funds, and that such disclosure would be made publicly available. Additionally, officials from the California State Teachers' Retirement System, the Maryland State Retirement and Pension System and the North Carolina state retirement systems have reviewed or have stated that they are considering revisions to their policies on the use of placement agents.

The New York State Comptroller and the New York Attorney General also took additional action in this area recently. On September 23, 2009, Comptroller DiNapoli issued an executive order adopting the "Interim Policy Regarding Political Contributions by Investment Advisers" (Interim Policy), prohibiting the CRF from doing business with any investment adviser within two years after a political contribution has been made to the State Comptroller, any candidate for State Comptroller, or the successful candidate for State Comptroller.[8] The Interim Policy is closely modeled after the two-year "time out" in the SEC Proposed Rule.

Under the Interim Policy, any investment adviser seeking to do business with the CRF must submit prior to the closing of an investment transaction a letter setting forth a "Political Contribution Representation" to the effect that no contribution has been made after the effective date of the Interim Policy and within the two-year period immediately preceding the date of representation. The ban set forth in the Interim Policy is effective with respect to contributions made on and after November 7, 2009 (45 days after the order was signed), and will expire upon the effective date of a final rule issued by the SEC pertaining to political contributions.

Additionally, on October 8, 2009, New York Attorney General Andrew Cuomo and several state senators introduced draft legislation entitled "Taxpayers' Reform for Upholding Security and Transparency" (TRUST),[9] which, if adopted, would abolish the sole trustee governance structure of the CRF and effectively codify the Cuomo Code of Conduct. TRUST would replace the Comptroller as sole trustee of the CRF with the "Employees Retirement Fund Board" comprised of thirteen trustees. The Comptroller would serve as Chair of the Board and custodian of the CRF; six trustees would be appointed by the Governor, the majority and minority leaders of the Senate and Assembly and the Attorney General; and the remaining six would be selected by the membership of the various retirement systems.

Further, TRUST would impose a statutory ban on the use of placement agents and other third-party intermediaries with respect to all New York public pensions funds and prohibit investment firms doing business with a public pension fund for two years after the firm makes a campaign contribution to any board member. TRUST also would impose heightened conflict of interest, recordkeeping, transparency and standard of conduct requirements on firms doing business or seeking to do business with New York public funds.

Now that the comment period for the Proposed Rule has closed, the SEC is expected to consider additional action in the coming months. Many government funds are awaiting final action of the SEC before adopting further regulation in this area. Much of the continued development of regulation in this area will depend on whether the SEC takes final action and, if so, the breadth of their final action.

This summary is not intended to be a comprehensive review of all action taken by government funds in this area. This area continues to evolve constantly as the multiplicity of government funds across the United States, as well as state legislatures in each state, continue to consider adopting regulations in this area. Investment advisers and placement agents should review the current state of regulations with respect to any government fund with which they are considering doing business.

Endnotes

1 For more information on these restrictions, see our client alert dated April 28, 2009, “Sweeping Pension System Reforms Adopted in Illinois; Bans on Pension System Placement Agents and Lobbyists In New York”http://www.mayerbrown.com/publications/article.asp?id=6537&nid=6.

2 Available at http://www.sec.gov/rules/proposed/2009/ia-2910.pdf.

3 Available at http://www.sic.state.nm.us/PDF%20files/090729F-POL_TRANSPARENCY_AND_DISCLOSURE_POLICY.pdf.

4 Available at http://www.nmlegis.gov/lcs/_session.aspx?chamber=H&legtype=B&legno=%20876&year=09.

5 Available at http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200905/item04a-02.pdf.

6 Available at http://www.lacers.org/AboutLACERS/Board/BoardDocs/2009/2009%20Investment%20Committee/20090428/ITEM%20III%20%20CONSIDERATION%20OF%20THIRD%20PARTY%20MARKETING%20AND%20REFERRALS%20DISCLOSURE%20POLICY.pdf.

7 Available at http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_1551-1600/ab_1584_bill_20091011_chaptered.pdf.

8 Available at http://www.osc.state.ny.us/reform/politicalcontribution.pdf.

9 Available at http://www.oag.state.ny.us/media_center/2009/oct/DRAFT%20BILL_TRUST.pdf.

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