

California Imposes Lobbyist Registration Requirement and Contingency Compensation Prohibition on Certain Placement Agents

California Assembly Bill No. 1743 (AB 1743) was introduced in response to investigations into alleged corrupt practices involving the use of placement agents with respect to public retirement systems or pension funds.¹ On September 30, 2010, the bill was signed into law by California Governor Arnold Schwarzenegger.

Pursuant to AB 1743, effective January 1, 2011, persons or entities acting as placement agents in connection with the sale of securities, assets or services of an external manager to a California state public retirement system must register as lobbyists pursuant to the California Political Reform Act of 1974 (PRA). The California state public retirement systems currently consist of the California State Teachers' Retirement System (CalSTRS) and the California Public Employees' Retirement System (CalPERS). AB 1743 also requires persons or entities acting as placement agents in connection with the sale of securities, assets or services of an external manager to local public pension funds or retirement systems to register as lobbyists as required by applicable local government agencies.

AB 1743 broadly defines "placement agent" as an individual or entity 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

public retirement system or pension fund in California or an investment vehicle, either directly or indirectly. AB 1743 defines an "investment vehicle" as an entity constituting, or managed by, an external manager in which a public retirement system or pension fund is the majority investor, and that is organized in order to invest with, or retain the investment management services of, other external managers.

Most notably, AB 1743 provides that all such placement agents subject to the lobbyist registration requirement pursuant to the PRA as amended by AB 1743 will be prohibited from accepting or agreeing to accept any payment that is in any way contingent upon the decision to enter into a contract to invest state public retirement system assets on behalf of a state public retirement system. Such placement agents also will be subject to the following requirements, among others:

- Placement agents will be required to register annually as lobbyists with the California Secretary of State, and to pay a registration fee of up to \$25 per year for each lobbyist required to be listed on a registration statement;
- Placement agents will be required to file quarterly reports covering any fees or compensation paid or received, including gifts to certain public officials and campaign contributions of \$100 or more to state candidates or state elected officers;

- Placement agents will be prohibited from making gifts to certain public officials, including board members of CalSTRS and CalPERS, in an aggregate amount of more than \$10 in a calendar month; and
- Placement agents will be prohibited from making contributions to elected state officers or candidates for elected state office, if the placement agent is registered to lobby the governmental agency related to such candidacy or office.

AB 1743 also requires placement agents soliciting local public retirement system or pension fund investments to file any applicable reports with a local government agency that requires lobbyists to register and file reports, and to comply with any applicable requirements imposed by a local government agency on lobbyists, which may encompass a variety of restrictions, including limitations on contingent payments. External managers seeking to utilize placement agents to solicit local public retirement systems or pension funds will need to identify and review applicable local lobbyist requirements on a case-by-case basis to ensure compliance with any reporting, registration or other requirements.

AB 1743 provides two important exclusions from the generally broad definition of placement agent, which may limit the application of the lobbyist registration requirements, including prohibitions on contingency payments, described above:

- With respect to solicitation of state *and* local public retirement systems and pension funds, an individual who is an employee, officer, director, equityholder, partner, member, or trustee of an external manager 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 (the “One-Third Exclusion”); or
- *Solely* with respect to solicitation of state public retirement systems, an employee, officer, or director of an external manager, *or of an affiliate of an external manager*, where the external manager: (i) is registered as an investment-adviser or broker-dealer with the SEC or an appropriate state securities regulator; (ii) was selected through a competitive bidding process and is providing services pursuant to a contract executed as a result of that competitive bidding process; and (iii) has agreed to a fiduciary standard of care with respect to the state retirement system as set forth in the California Constitution (the “External Manager Exclusion”).

These exclusions raise several issues, including the following:

- While the One-Third Exclusion applies to both state and local public retirement systems or pension funds, the External Manager Exclusion applies solely with respect to the use of placement agents to solicit state retirement systems (i.e., CalPERS and CalSTRS). Therefore, anyone who qualifies under the One-Third Exclusion would not be required to comply with local public retirement system and pension fund lobbyist requirements that might otherwise be in effect, while anyone who qualifies solely for the External Manager Exclusion would be subject to any such local requirements.
- Given that the One-Third Exclusion excludes only certain employees meeting the one-third threshold from the state and local lobbyist registration requirements, AB 1743 appears to require employees and other members of certain external managers who do not meet the one-third threshold to register as lobbyists. Such employees would also be subject to the restrictions on lobbyists described above, including the prohibition on contingency payments.

CalPERS has stated that the nearly identical one-third exclusion language that is included in its proposed regulations regarding placement agent disclosure should not be read to imply that internal employees who have limited and intermittent roles in the fundraising process, such as an external manager's chief financial officer (CFO), would be treated as placement agents. CalPERS highlighted the limitation that only employees hired, engaged, retained by, or serving for the benefit of or on behalf of an external manager in connection with the offer or sale of the external manager's securities, assets or services would be considered placement agents, and would not cover CFOs and other similar employees.² The position articulated by CalPERS may provide some comfort in limiting the scope of the definition of placement agent. However, employees who meet the general definition of placement agent and have not yet met the one-third time requirement in a given calendar year may still be subject to the lobbyist registration requirements. This may be particularly problematic for new start-up companies and smaller fund managers who rely on employees to market their services. Further, it is not clear what weight the interpretation by CalPERS of its regulations adopted for disclosure purposes will have on the lobbyist registration requirement.

- Under AB 1743, the only exclusion that might apply to affiliates of an external manager is the External Manager Exclusion. As described above, the External Manager Exclusion applies solely to the solicitation of *state* retirement systems such that affiliates would be required to comply with any applicable local law lobbyist requirements.

Additionally, because the External Manager Exclusion applies only to external managers (and their affiliates) who are providing services pursuant to a contract executed as a result of

the applicable competitive bidding process, and who have agreed to the requisite fiduciary standard of care, it is unclear how the External Manager Exclusion would apply in practice. AB 1743 suggests that the exclusion is applicable only after contract award such that placement agents that do not otherwise qualify for the One-Third Exclusion would be required to register as lobbyists at least up until such contract is successfully awarded to the external manager.

Moreover, the External Manager Exclusion is particularly limited because the circumstances in which placement agents are often used would not be subject to this exclusion. For example, it is unlikely that this exclusion would ever apply to a state plan's investment in a private market fund because such securities generally are not offered through a competitive bidding process, and a fund manager typically could not agree to serve as a fiduciary to an investor given its duties to the fund as a whole.

Violations of the PRA could result in civil penalties, and a knowing or willful violation of the PRA is a misdemeanor with potential criminal penalties, including imposition of a fine up to the greater of \$10,000 or three times the amount the person failed to report properly or unlawfully contributed, expended, gave or received upon conviction for each violation. The Fair Political Practices Commission is charged with enforcing lobbyist registration provisions of the PRA.

AB 1743 also requires that CalPERS and CalSTRS each provide to the California Legislature, not later than August 1, 2012, a report on the use of placement agents in connection with investments made by those retirement systems.

Endnotes

¹ AB 1743 is available at http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_1701-1750/ab_1743_bill_20100930_chaptered.pdf.

² See pages 4-5 of 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>, wherein CalPERS responds to a comment letter from National Venture Capital Association voicing concern regarding the scope of CalPERS placement agent disclosure requirements.

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