



California Passes Legislation Requiring Placement Agents Who Solicit State Pension Systems to Register as Lobbyists

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INTRODUCTION

On September 30, 2010 Governor Arnold Schwarzenegger signed into law AB 1743 (the "Act"), a law that will require placement agents who solicit funds from the California Public Employees' Retirement System ("CalPERS") or the California State Teachers' Retirement System ("CalSTRS") to register as lobbyists. The Act also limits the types of compensation that placement agents can receive for soliciting investments from CalPERS or CalSTRS and imposes new disclosure requirements on placement agents who solicit local public pension systems in California. The Act will take effect on January 1, 2011.

DEFINITION OF "PLACEMENT AGENT"

The Act covers solicitations to sell securities (such as interests in private equity or hedge funds) as well as solicitations to sell services (such as investment advisory services) and includes both direct solicitations of public pension agencies and solicitations of third-party managers who control designated pools of capital on behalf of public pension agencies. The legislation broadly defines a "placement agent" as any individual who is "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 in California or an investment vehicle that is majority-owned by a public retirement system, either directly or indirectly. An "external manager" includes a person or entity who is seeking to be retained by a public retirement system to manage a portfolio of assets for compensation or who offers or sells securities to a public retirement system. The sponsor of a private investment fund, for example, will be an external manager for purposes of the Act.

Exception for Investment Personnel Who Also Solicit Investors

Importantly, the Act does not distinguish between third parties retained by an external manager to solicit investors and an external manager's own employees, officers or directors who perform similar functions. For example, employees of a fund sponsor whose duties include the marketing of the sponsor's investment funds may be subject to the requirements described in this memo. However, the Act does include certain limitations intended to avoid treating all personnel who may be involved with the marketing of securities or investment services as placement agents. The definition of "placement agent" expressly excludes employees, officers, directors and equityholders of an external manager who spend at least one-third of their time managing the securities or other assets owned, controlled, invested or held by the investment manager. Because this exception requires at least one-third of an individual's time to be dedicated to asset management activities, some members of an external manager's in-house

marketing or investor relations staff may be considered “placement agents” within the meaning of the Act (subject to the additional exception described below).

Exception for Certain Managers Who Solicit CalPERS or CalSTRS

The Act provides a further exception from the definition of “placement agent” for an external manager’s own personnel who solicit CalPERS or CalSTRS, though a similar exception is not available when soliciting local public retirement systems. Specifically, an employee, officer or director of an external manager (or its affiliates) who solicits CalPERS or CalSTRS will not be considered a placement agent if (i) the external manager is registered as an investment adviser or broker-dealer with the U.S. Securities and Exchange Commission or any appropriate state securities regulator,¹ (ii) the external manager is 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) the external manager agrees to a fiduciary standard of care as defined by the standards of conduct applicable to the board of a California public pension or retirement system.²

This exemption may be unavailable for most sponsors of private investment funds, as investments in such funds are not generally obtained through competitive bidding processes within the meaning of the Act. Moreover, even where an external manager secures an investment mandate through competitive bidding, it is unclear whether the standard of care requirement in the Act will be interpreted to require external managers to expressly agree to the same standards as the members of the CalPERS or CalSTRS boards or if other fiduciary standards of care (such as the duties of a general partner of a limited partnership) will be deemed to satisfy this condition. Similarly, modifications of duties commonly agreed to in investment agreements may preclude compliance with this requirement. If a sponsor is unable to satisfy either of the foregoing conditions, its marketing or other employees who solicit investors could be deemed “placement agents” and required to register as lobbyists before soliciting CalPERS or CalSTRS.

LOBBYIST REGISTRATION AND RELATED DISCLOSURE

The most significant provision of the Act will require any placement agent who solicits CalPERS or CalSTRS to register as a lobbyist with the California Secretary of State. While the registration requirement does not apply to placement agents who solicit only local public retirement systems in California (such as county, city or district retirement systems), those placement agents may be subject to laws and regulations applicable to lobbyists in the jurisdictions where such pension agencies are located. Placement agents who register as lobbyists will be subject to

¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law by President Obama on July 21, 2010, eliminated the “private investment adviser” exemption to the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”), for most private equity and hedge fund advisers. As a result, unregistered private equity and hedge fund advisers whose advisee funds and client accounts have at least \$150 million under management will be required to register under the Advisers Act by July 2011.

² Article XVI, Section 17(c) of the California Constitution establishes the standards of conduct applicable to the board of a public pension or retirement system in California, providing that “[t]he members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.”

the California Political Reform Act of 1974, as amended (the “PRA”), including its restrictions on gifts to public employees and its prohibition on contingent compensation arrangements.

An external manager who retains a placement agent (whether a third party or the manager’s own employee) to solicit CalPERS or CalSTRS may itself be required to register or file certain disclosure reports under the PRA. For example, external managers whose in-house personnel are required to register as lobbyists under the Act may be deemed “lobbyist employers” under the PRA and be required to register as such with the Secretary of State. As lobbyist employers they will be required to disclose publicly certain information about their relationships with placement agents, including the amount of compensation paid for their services. External managers whose employees are not deemed lobbyists under the Act would not be lobbyist employers, but may still be required to file public disclosure statements with the Secretary of State, such as lobbying activity authorizations and lobbyist payment reports, if they hire third-party placement agents to solicit CalPERS or CalSTRS.

PROHIBITION ON CONTINGENT FEES

Placement agents are typically compensated based on the actual amount of securities sold to solicited investors. However, the Act will subject placement agents to provisions of the PRA that prohibit lobbyists from accepting fees based on the outcome of their lobbying efforts. Any placement agent required by the Act to register as a lobbyist will become subject to this restriction with respect to investments secured from CalPERS or CalSTRS.

In light of growing objections from some public pension agencies to the payment of contingent placement fees by the private funds in which they invest, some third-party placement agents have revised their compensation arrangements to describe their fees as comprising both a fixed consulting fee and a contingent placement fee. A typical placement agreement in these cases would provide that compensation in respect of investors that are subject to restrictions on the payment of placement fees comes solely from the fixed fee component. While some of these compensation arrangements may satisfy the Act’s prohibition on the payment of contingent fees to placement agents, the details of a particular arrangement will be critical to determining compliance with the PRA. For example, an arrangement that allocates the fixed fee to the solicitation of certain investors but includes all investors’ capital commitments in calculating the contingent fee may violate the Act’s prohibition on contingent fees.

LOCAL PUBLIC RETIREMENT SYSTEMS

As described above, the requirement to register as a lobbyist applies only to placement agents who solicit CalPERS or CalSTRS. However, the Act extends its reach to placement agents who solicit local public retirement systems in California (such as county, city or district retirement systems) by requiring them to comply with local reporting requirements where local laws require lobbyists to register and file reports. In addition, placement agents would be required to comply with any applicable rules imposed by local jurisdictions, including any applicable lobbying rules. Fund sponsors that plan to solicit investments from local public pension systems in California will need to determine whether the particular agencies are subject to lobbying rules that may impose additional restrictions on placement agents or the investment managers who hire them, including reporting requirements or restrictions on the type or amount of fees that may be paid for their services. Given the potential for widely varying rules among local jurisdictions, sponsors that solicit local public retirement systems in California

should consider including provisions in their fund documents that require investors to identify any laws or regulations to which the sponsor, its employees or third-party placement agents may become subject as a result of the agency's investment, including lobbyist disclosure rules.³

In addition, while the Act exempts all employees, officers and directors of an external manager who solicit CalPERS or CalSTRS from registering as lobbyists if certain conditions are satisfied (as described above), no comparable exemption is provided for the requirement that placement agents who solicit local public pension systems comply with local lobbyist reporting requirements and other applicable local rules. The availability of a similar exception would need to be established by the relevant local government. As a result, an external manager's employees, officers or directors may in some cases be required to comply with local lobbyist disclosure rules when soliciting local pension systems even if those same individuals would not be required to register as lobbyists or comply with state-level lobbying rules to solicit CalPERS or CalSTRS.

CONCLUSION

The Act marks a fundamental shift in the regulation of placement agents under California law. While other states have adopted policies restricting the use of placement agents or the payment of placement fees in connection with the solicitation of public pension systems in the wake of recent "pay-to-play" investigations, none appears to have passed legislation or adopted rules requiring placement agents to be regulated as lobbyists. The most far-reaching effects of the Act are likely to be on professional placement agent firms. However, the Act will have implications for fund sponsors and other investment managers whose in-house marketing or other personnel qualify as "placement agents" under the Act or that use third-party agents or finders to solicit investments from CalPERS, CalSTRS and local public retirement systems in California. In particular, fund sponsors who solicit CalPERS or CalSTRS will need to ensure that the compensation arrangements they enter into with placement agents do not violate the PRA's prohibition on contingent fees and that their placement agents are registered and in full compliance with applicable lobbying rules. As businesses that employ or retain the services of lobbyists, sponsors may themselves be subject to public disclosure requirements under the PRA. In addition, sponsors may be subject to different rules and disclosure requirements when soliciting local public retirement systems than when soliciting CalPERS or CalSTRS, with their in-house marketing or other personnel treated as lobbyists and required to comply with local reporting requirements even where the same individuals would be exempt from registering as lobbyists at the state level. Sponsors and other investment managers should update their compliance procedures and consult with appropriate legal counsel before soliciting state or local public pension systems in California to ensure that they are familiar with the Act's requirements and any related local rules.

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³ External managers who solicit public retirement systems in California should bear in mind that even unsuccessful attempts to solicit investments may subject them to registration or disclosure requirements under the Act. While a contractual obligation for an investor to disclose applicable lobbying rules may be a useful method of confirming that regulations have not been overlooked, external managers will need to determine prior to soliciting CalPERS, CalSTRS or a local public retirement system whether their solicitation will trigger a disclosure obligation.

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