New California Lobbyist Legislation Regulates Private Fund Sponsors and Placement Agents

Recent California legislation dramatically expands the regulation of private fund sponsors and placement agents. Both outside placement agents and certain employees of investment managers who solicit investments from CalPERS and CalSTRS are now required to register as lobbyists in California. Registered lobbyists may not receive commissions on investments by California's state public pension and retirement systems ("State Plans"), even if the lobbyist is an associated person of a registered broker-dealer. In addition, registered lobbyists are subject to annual reporting of certain expenses and limitations on contributions and gifts. Similar limitations apply to companies that employ, engage or retain registered lobbyists. CalPERS will no longer approve new investment contracts or certain types of amendments to existing investment contracts unless it is provided with significant additional remedies for failure by fund sponsors and other investment managers to comply with its placement agent disclosure rules.

New Placement Agent Legislation

Assembly Bill 1743. On January 1, 2011, Assembly Bill No. 1743 ("AB 1743") became effective in California. AB 1743 amends California's lobbyist law, the *Political Reform Act of 1974* (the "PRA"), to require placement agents, and employees of private fund sponsors and other investment managers and advisory services who are deemed to be placement agents, to register under the PRA as a condition to soliciting State Plans. State Plans currently consist of the California Public Employees' Retirement System ("CalPERS") and the California State Teachers' Retirement System ("CalSTRS").

AB 1743 defines "placement agent" to include any person "hired, engaged or retained by, or serving for the benefit of or on behalf of" an "external manager" or another placement agent if that person "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 the external manager to a State Plan. An "external manager" includes both:

- A person who is seeking to be, or is, retained by the retirement board of a State Plan or other public pension or retirement system to manage a portfolio of securities or other assets for compensation; and
- A person who is engaged, or proposes to be engaged, in the business of investing, reinvesting, owning, holding or trading securities or other assets and who offers or sells, or has offered or sold, securities to such a retirement board.

This broad definition applies to traditional third-party placement agents and their employees, as well as entities that are affiliated or "captive" placement agents of external managers. It also covers external managers' employees that participate in soliciting State Plans, unless one of the following exemptions applies:

- One-third or more of the employee's time during the calendar year is spent "managing the securities or assets" controlled by the external manager (the "One-Third Exemption"); or

- The external manager (i) is registered with the SEC as an investment adviser, with FINRA as a broker, or with a state regulator if exempt from SEC registration, (ii) was selected through a competitive bidding process and is providing services pursuant to a contract resulting from that process, and (iii) agrees to be subject to a fiduciary standard of care.

Individual placement agents registered as lobbyists are prohibited from making more than token gifts to various public officials and campaign contributions, are required to make annual reports of certain expenses, contributions and gifts, and are required to attend an ethics course every two years. In addition, lobbyists may not "accept or agree to accept any payment in any way contingent upon the defeat, enactment, or outcome of any proposed legislative or administrative action,"[1] where administrative action is defined, with regard only to placement agents, as "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."[2] This prohibition on contingency payments also applies to third-party placement agent firms subject to the PRA and to employees of external managers who are required to register as lobbyists.

The PRA is administered by the California Fair Political Practices Commission (the "FPPC"). The FPPC recently published the "AB 1743 Fact Sheet—Placement Agents: Lobbying Requirements" (the "Fact Sheet")[3], which provides some additional background and examples of completed registration forms. Individuals must be registered as lobbyists prior to soliciting investments from State Plans despite guidance issued prior to the enactment of AB 1743 suggesting that lobbyists have 10 days in which to register after becoming required to do so. Firms that employ, engage or retain registered lobbyists are themselves normally required to register under the PRA, either as "lobbying firms" (in the case of firms such as third-party placement agents) or as "lobbyist employers" (in the case of external managers that employ registered lobbyists directly or retain or engage third-party lobbyists or lobbying firms). Both lobbying firms and lobbyist employers are subject to many of the same types of limitations on gifts and contributions, reporting requirements and prohibitions on receipt of contingent compensation as apply to individual lobbyists.

California Code of Regulations Section 559. California law also requires State Plans to adopt regulations mandating disclosure surrounding the use of placement agents.[4] CalPERS has proposed Section 559 as an amendment to the California Code of Regulations ("Section 559"). Section 559 generally will require external managers to disclose any campaign contributions or gifts to any CalPERS board member or person with authority to appoint a board member. Details of managers' relationships with placement agents that solicit CalPERS (including compensation arrangements relating to the solicitation of CalPERS) must also be disclosed. Section 559, as currently drafted, would prohibit CalPERS from bearing, directly or indirectly, any of the external manager's expenses relating to placement agents. It would also require that new fund agreements and certain amendments to existing fund agreements entered into after the effective date of the regulation include significant remedies exercisable by CalPERS for the external managers' failure to comply with the requirements of Section 559.

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[1] Cal. Gov't Code § 86205(f).

[2] Cal. Gov't Code § 82002(a)(2).

[3] The Fact Sheet is available at http://www.fppc.ca.gov/factsheets/009-122010PlacementAgentFS.pdf.

[4] CalSTRS already has adopted policies requiring investment managers to disclose placement agent arrangements and has stated that it will refine its policies consistent with AB 1584 (a predecessor to AB 1743). See CalSTRS Board Policy 600J, Attachment 3 to Comment Letter to SEC, "Political Contributions by Certain Investment Advisers File Number S7-18-09" (October 6, 2009), available at http://www.sec.gov/comments/s7-18-09/s71809-171.pdf, at 7.

Penalties. An individual placement agent that fails to register in violation of the PRA, as well as lobbyist employers and lobbying firms that fail to register or otherwise comply with the reporting, gifts, contributions and other provisions of the PRA, will be subject to criminal and civil penalties. These penalties may include fines of up to $10,000 or three times the amount the person failed to report properly or gave for each violation. A person convicted of violating the PRA is barred from acting as a lobbyist in California, and thus from soliciting State Plans for compensation, for up to four years following the date of conviction.

Issues for Sponsors

Staffing Solicitations of State Plans. Private fund sponsors and other external managers that anticipate soliciting a State Plan using internal personnel face uncertainty resulting from the lack of detail in the new legislation, although according to the Fact Sheet, "[t]he FPPC is considering regulations to clarify the new law's application."

To date there is limited official guidance interpreting the placement agent definition. In response to a comment letter from the National Venture Capital Association on an earlier draft of AB 1743, the CalPERS staff stated that it disagreed with the Association's concern that the draft's definition of a placement agent captured venture fund employees such as the CFO who had "limited and intermittent" roles in the fund raising process. Instead, the staff "believes that the typical CFO does not meet the definition of Placement Agent since he or she is not 'hired, engage[d], retained by, or serving for the benefit or on behalf of an external manager . . . in connection with the offer or sale of the securities, assets or services of an external manager to CalPERS or a [feeder fund in which CalPERS is the primary investor]'".[5] This guidance suggests that employees of external managers who occasionally participate in soliciting CalPERS do not necessarily fall within the definition of placement agent if they have substantial unrelated duties.

External managers whose employees have traditionally managed relationships with State Plans must determine whether any of them are placement agents as defined in the new legislation. This may be difficult as the definition focuses on the functions of these employees, rather than their titles or job descriptions, and thus the decision of whether an employee is a placement agent must focus on the facts and circumstances of the employee's actual duties. Employees dedicated solely to fundraising would seem to fall within the definition without exemption, but "investor relations" personnel may or may not be placement agents depending on factors such as the content of their communications with State Plans. Managing directors or similar executives (such as portfolio managers) with authority to participate in decisions to make and dispose of investments may fall within the One-Third Exemption. However, the application of the One-Third Exemption to employees with multiple responsibilities in these and other areas is less certain because its key requirement—that employees be involved in "managing the securities or assets" controlled by the external manager—is undefined. Further official guidance is needed to help resolve these issues.

Having determined which of their employees are required to register as lobbyists, external managers should review the compensation arrangements for those employees to ensure that they comply with the PRA's prohibitions on contingent compensation and establish compliance procedures to ensure that both the firm and the registered employees do not violate the gift, contribution, reporting and ethics training rules applicable to them.

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[5] Final Statement of Reasons, Adoption of CCR Section 559. Disclosure of Placement Agent Fees, Gifts and Campaign Contributions (December 17, 2010) available at http://www.calpers.ca.gov/eip-docs/about/leg-reg-statutes/regulatory/current/final-statement-reason.pdf ("Final Statement"), at 5.

An external manager that does not wish to have employees treated as placement agents under the new legislation may consider having senior executives eligible for the One-Third Exemption "lead the charge" in soliciting State Plans. These executives would have primary responsibility for the solicitation by, for example, meeting with the CalPERS investment staff, presenting the case for investment, and negotiating significant economic terms. External managers taking this approach must carefully monitor the executives' continued eligibility for the One-Third Exemption. In particular, the exemption applies on an annual basis and this may have unintended consequences. For example, investment professionals launching a new investment fund seeking to raise money from State Plans who have not managed any assets or securities during the calendar year would be required to register as lobbyists under a literal reading of AB 1743. In addition, retiring or retired members of an external manager who no longer participate in investment decisions but remain engaged in State Plan marketing efforts would also appear to be required to register as lobbyists.

Further, a fund investment by a significant investor such as CalPERS typically involves discussing, negotiating and documenting a myriad of other issues that executives may delegate or at least require support from other employees to analyze and resolve. An external manager must determine the degree to which employees can support executives relying on the One-Third Exemption without crossing the line and becoming placement agents. There is no clear answer to this question. Following the CalPERS response to the NVCA comments discussed above, employees falling within the literal language of AB 1743 arguably would be considered placement agents and other employees would not, regardless of their actual involvement in the solicitation. If, on the other hand, the new legislation aims as a policy matter to reduce the opportunity for placement agents to improperly influence State Plan investment decisions, then perhaps only employees who have direct contact with CalPERS on substantive matters during the solicitation process should be considered placement agents. From a practical perspective it seems reasonable to suggest that employees directly involved in presenting, discussing or negotiating the principal economic terms of the external manager's investment contract with State Plans are within the scope and intent of the placement agent definition, while employees dealing with non-economic or immaterial terms or providing administrative assistance in the solicitation process are not. This would be consistent with the regulatory approach taken in a number of other instances, such as FINRA Rule 1060, which indicates that clerical and ministerial personnel are not required to register with FINRA notwithstanding their involvement in securities transactions. However, none of these approaches to analyzing the issue has yet received any formal approval.

Mandatory Fund Terms. As a condition to entering into new fund agreements or certain amendments to existing fund agreements, Section 559 requires the agreement or amendment to also include several terms discussed below. The amendments to which this requirement applies include: (i) continuing, terminating or extending the term of a fund agreement or a fund's investment period, (ii) increasing the commitment of funds by CalPERS, or (iii) increasing or accelerating the "fees or compensation" payable to a fund manager.

Remedies for Section 559 Violations. Any new agreement or amendment subject to Section 559 must provide for the following remedies, exercisable by CalPERS, if the fund manager knew or should have known of any material omission or inaccuracy in the disclosures required under Section 559 or in the event of any other violation of Section 559:

- reimbursement of management or advisory fees for the prior two years or the amount to be paid to the placement agent for obtaining CalPERS' investment, whichever amount is greater (although the term "management or advisory fees" is not defined in Section 559, it appears to refer to fixed fees and not to carried interest or other contingent compensation);

- termination of the investment management contract without penalty (presumably the intent of this provision in the context of a collective investment vehicle is to authorize CalPERS to cancel its own subscription, and not to terminate the manager's investment management contract with the fund, although Section 559 is not clear in this regard);
- withdrawal from the fund without penalty;
- cessation without penalty of CalPERS' obligation to make further capital contributions to the fund; and
- up to a five-year ban on future investments with the fund manager.

Private fund investors should note that these remedies may increase the risk of instability in funds where State Plans have significant investments.

Management Fee Offset. Section 559 requires new fund agreements to provide that CalPERS will not bear, directly or indirectly, any fees, compensation or expenses for any Placement Agent. In particular, Section 559 prohibits an external manager from calling capital "from CalPERS to pay placement agents even where there is a corresponding reduction to the management fee paid by CalPERS."[6] Management fee offset, fund expense and capital contribution provisions in typical private fund documents may need to be revised to comply with this requirement.

Indemnification Provisions. Sponsors should review the indemnification provisions of their fund and placement agent agreements. While external managers are not directly liable for third-party placement agent violations of AB 1743, they may have secondary liability if they have agreed to indemnify a placement agent in terms broad enough to encompass any such violation.

Private Placement Exemption. The new legislation potentially increases private investment funds' risk of becoming ineligible for the most commonly used private placement exemption. Section 926 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank") requires the Securities and Exchange Commission to adopt "bad boy" rules that, among other things, "disqualify any offering or sale of securities [under Rule 506 of Regulation D] by a person that . . . has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security." Conviction of a private equity sponsor or other external manager for a knowing and willful violation of the PRA could trigger this disqualification (although conviction of the external manager's employees or third-party placement agents it retains should not). While the chances that such a violation of the PRA would result in a misdemeanor conviction are unknown at present, the potentially severe consequences should prompt external managers to monitor developments in this area.

Investment Advisers Act Disclosure. Sponsors registered under the *Investment Advisers Act of 1940* (the "Advisers Act") may also be required to disclose violations of AB 1743 and Section 559 to their investors. This is significant because Dodd-Frank will effectively require investment advisers of typical private equity funds to register under the Advisers Act no later than June 2011.[7] Registered investment advisers have historically been required to file a brief, publicly available disclosure statement on Form ADV, Part 1 with the SEC and to provide more detailed disclosure about their operations and background, including past legal

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[6] Final Statement at 9.

[7] For more information, see the Ropes & Gray LLP Client Alert "The Impact of Financial Reform: Private Fund Investment Adviser Registration" (http://www.ropesgray.com/files/Publication/93d1fa4b-2872-45ef-855d-933ec152b1de/Presentation/PublicationAttachment/92b3fa84-9d61-45a3-9f8e-950e586cdf8e/PIF_FRM.pdf).

violations, on Part 2 of Form ADV only to their clients (and, in the case of advisers to collective investment vehicles, investors in the vehicles). Recent amendments to Form ADV continue to require disclosure of legal violations on Form ADV Part 2 but also require Part 2 to be filed with the SEC as a publicly available document.

Issues for Placement Agents

Ban on Commissions. The legislation effectively bans traditional "success fee" compensation of individual placement agents and outside placement agent firms (i.e., lobbying firms) for commitments from State Plans. Accordingly, placement agent firms that continue to solicit State Plans will need to review the terms of their compensation arrangements with clients and employees.

Disclosure of Placement Agent Information. Section 559 requires external managers to disclose a significant amount of information about the placement agents (third party and internal) they use in connection with solicitations of CalPERS.[8] Since information and documents provided in response to these requirements by external managers relating to their placement agents will, with few exceptions, become publicly available, placement agents may wish to enter into separate agreements with their external managers specifically for solicitations of State Plans.

Effective Date

AB 1743 became effective January 1, 2011. Section 559 remains a proposed regulation, but could become effective shortly following CalPERS' request in the Final Statement for an early effective date.

Conclusion

Fund sponsors, investment managers, placement agents and to some degree all private fund investors should pay close attention as State Plans finalize and begin to apply regulations to complement AB 1743 in order to gain a complete understanding of the intended application of new placement agent legislation. In addition, external managers should review their standard fund documents to determine whether they need to be revised to address any of these new requirements.

If you would like to discuss the Placement Agent Regulations and their potential impact on your business, please contact any member of Ropes & Gray's Private Investment Funds Group or your usual Ropes & Gray advisor.

[8] For the current CalPERS disclosure form, see http://www.calpers.ca.gov/index.jsp?bc=/about/leg-reg-statutes/regulatory/current/placement-agent-disclosure.xml.