Law360

Death Knell Of Placement Agent Outcome-Based Pay

Law360, New York (December 14, 2010, 12:48 PM ET) -- A recent bill from the California Legislature radically changes the status of intermediaries known as “placement agents” who work to help private investment managers secure investments from statewide retirement systems and pension funds. California is home to two of the largest retirement systems in the country — the California Public Employees Retirement System (CalPERS) and the California State Teachers Retirement System (CalSTRS).

As of July 2010, these systems had a combined $274 billion in assets under management. Competition to manage assets of these funds is both stiff and plentiful. Consequently, some managers hire placement agents to enhance their chances of being selected.

Placement agents often have familiarity and experience with a particular fund or group of funds. By virtue of this experience, placement agents are frequently in a position to introduce investment managers to a particular fund’s fiduciaries and decision makers, and also to help the managers present their case in the most favorable light.

In exchange, placement agents have historically received compensation tied to the success of their efforts — often a one-time payment of 1 to 2 percent of funds allocated for management. This is in direct contrast to lobbyists, who perform similar intermediary functions but are prohibited from receiving outcome-based compensation, instead receiving a flat fee.

The difference in treatment is due to the fact that lobbyist compensation is regulated by the state, while placement agents’ compensation is not. Placement agents have thus been free to garner what some consider excessive compensation from successful placements.

Such compensation levels prompted concern regarding the historical lack of regulation of placement agents. At the same time, high-profile investigations in New York and New Mexico regarding certain practices of placement agents led to criminal and civil charges, as well as widespread calls for a regulatory crackdown.

Following these revelations, reports surfaced that a California placement agent — and former CalPERS board member — received nearly $50 million in outcome-based compensation from investment managers selected by one of California’s state pension funds. These reports, in part, led to federal and state inquiries into the activities of placement agents operating within California.

Not long after, the legislature introduced Assembly Bill 1743, which takes effect on Jan. 1, 2011. AB 1743 comes on the heels of prior California legislation aimed at registering placement agents — Assembly Bill 1584. AB 1584 required all California statewide and local public pension plans to adopt detailed disclosure policies by June 30, 2010.

At its heart, AB 1743 requires placement agents doing or seeking to do business with state public retirement systems to register as lobbyists under the California Political Reform Act of 1974 (the PRA). This means that placement agents acting as financial intermediaries with respect to CalPERS and CalSTRS must follow a detailed stricture of immediate and future regulation.

Interestingly, the bill’s prohibition on outcome-based compensation applies only to placement agents registered as lobbyists under the PRA who lobby CalPERS and CalSTRS. While the bill also authorizes local retirement boards in California — such as the Los Angeles County Employees Retirement System — to require placement agents doing or seeking to do business with such boards to register as lobbyists under the PRA, it does not expressly prohibit outcome-based compensation at the local level.

However, a local board could independently adopt a policy prohibiting such compensation.

For both statewide and local registration, the first step in coping with the ramifications of the bill is identification. The amended Government Code will provide that a placement agent is “any person hired, engaged, or retained by, or serving for ... or on behalf of an external manager . . . who acts or has acted for compensation . . . in connection with the offer or sale of the securities, assets, or services of an external manager to a state public retirement system in California.”

Not every placement agent is covered. Accordingly, not all will have to register as a lobbyist. The bill provides two statusbased exceptions, unofficially termed the “One-Third Test” and the “External Managers Exception.”

The one-third test exempts any employee or officer of an external manager who spends one-third or more of his/her time managing securities or assets “owned, controlled, invested, or held” by the external manager. The external managers exception exempts from registration any employee or officer of an external manager who meets three requirements: 1) is registered with the SEC, 2) is selected through a competitive bidding process and 3) agrees to follow the fiduciary standards set by the particular pension fund or system being served.

The external managers exception appears straightforward, although it is doubtful that many private equity investment managers will be selected through a competitive bidding process (or will relish being subject to additional fiduciary duties). However, application of the one-third test is less clear — especially for new advisory businesses, where employees’ allocation of work is less defined.

Specifically, it may be difficult to determine whether a certain individual works one-third — as opposed to say, one-quarter — of his/her time managing securities. Because of the difficulty in determining the precise allocation of one’s time, it is imperative that all businesses establish clear and comprehensive procedures for documenting activities under the one-third test. This is especially so given that violations of the Political Reform Act are subject to criminal penalties.

Plan disclosure policies may also entail significant penalties if the member fails to disclose placement agents. CalPERS’ policy, for example, requires investment managers that manage CalPERS’ assets to agree to rebate two years of advisory fees to CalPERS and permit CalPERS to withdraw from the investment fund without penalty if the manager fails to disclose use of a placement agent.

It is also important to understand the distinctions between the three categories of actors covered by the bill. Though the term “lobbyist” may suggest application only to individuals, it is not. Because some businesses retain one or more placement agents who will now qualify as lobbyists, the bill regulates the firm as well.

These businesses are called “lobbying firms” — defined as any business (including individual contract lobbyists) entitled to receive compensation for influencing legislative/administrative action, where at least one employee or officer is a lobbyist.

The bill also regulates entities who hire lobbyists or lobbying firms. These entities are called “lobbyist employers.” The distinction between a lobbying firm and a lobbying employer lies in which way the revenue flows. A lobbying firm receives revenue from providing placement agent/lobbying services to others, while a lobbyist employer pays to receive such services.

The bill requires lobbyists and lobbying firms to register with the secretary of state within 10 days of qualifying as a lobbyist or lobbying firm. Lobbyist employers hiring outside lobbyists or lobbying firms must register before any lobbying activity on their behalf actually occurs.

The second step is compliance. This is perhaps where the bill will have its greatest impact on placement agents. Once registered, a placement agent/lobbyist must attend a biennial ethics course, accept limitations on gifts and honoraria, and is banned from making certain political contributions.

The effect is that many formerly common activities for placement agents — taking an official to lunch or contributing to a committee (or possibly even a charity) headed by an agency official — will be substantially limited or eliminated altogether.

For example, as lobbyists, placement agents may not “mail, deliver, or otherwise transmit a campaign contribution, including a nonmonetary contribution,” to any elected state official or candidate (or their controlled committees), or any other official associated with any agency related to the placement agent’s lobbying activities (e.g., CalPERS and CalSTRS board members). Lobbying firms and lobbyist employers, however, are prohibited only to the extent they are owned by a lobbyist participating in the decision to make the contribution.

In contrast, lobbyists, lobbying firms and lobbyist employers are all prohibited from making or arranging gifts in excess of $10 to state and relevant agency officials. Understanding the distinction between prohibitions on contributions versus prohibitions on gifts, and how each affects lobbyists, lobbying firms and lobbyist employers, is vital to proper post-bill compliance.

As the saying goes, the devil is in the details.

The most significant post-registration requirement, however, involves mandatory quarterly reporting of “activity expenses” (e.g., gifts). This requirement is meant to facilitate transparency. And in this sense, the quarterly reports act as a mechanism to ensure that placement agents do not “accept or agree to accept any payment in any way contingent upon the defeat, enactment, or outcome of any proposed legislation or administrative action.”

In other words, mandatory reporting ensures placement agents do not accept outcome-based compensation.

The bottom line is that the bill creates a new landscape for placement agents — one where the current potential for a big payday from a favorable outcome no longer drives a placement agent’s efforts. As California Treasurer Bill Lockyer iterated in his April 2010 testimony in support of the bill, “[w]ith hundreds of billions of retiree and taxpayer dollars on the line, this is no time to protect the status quo.”

Thus, the bill is not a subtle erosion of outcome-based compensation, but the complete elimination of it. For those qualifying as a lobbyist under the new law, registration is inevitable and imminent. So, too, is ongoing record-keeping and formal quarterly disclosure. Accordingly, it is critical not only to be aware of the accompanying requirements, but to be prepared for them as the new year ushers in a new regime.

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