

# FS Regulatory Briefs\*

## SEC and State Attorneys General Focus on Pay-to-Play

The recent probe into "pay to play" practices associated with state and local pension plan investments continues to expand in scope. The nearly two-year probe by the New York Attorney General (NYAG) and the SEC led to March indictments against a top political adviser to the former New York State Controller and the Controller's Chief Investment Officer on charges that they allegedly participated in a fraudulent multi-million dollar scheme involving kickbacks from investment management firms seeking to manage the assets of the New York State Common Retirement Fund. Since then the probe has continued to expand as cases have been brought against another New York state political leader and the founder of a \$7 billion hedge fund. The NYAG has also issued subpoenas to approximately 100 investment managers regarding their use of placement agents. It appears now that the probe is spreading into other states and the NYAG has established a task force to share investigative information with 36 other states probing potential abuses related to government pension funds.

The focus of the "pay-to-play" investigations is on the use of, and payments to and through, placement agents by investment managers to solicit investment contracts from state pension funds. In a classic "pay-to-play" scheme, an investment manager or its employees will make payments, directly or indirectly through a placement agent, to a government official in order to obtain or retain an investment contract with a government entity. While the use of placement agents or other intermediaries is not *per se* illegal (and is indeed common among buy-side managers seeking to do business with state and local governments), the probe is focusing on illegal payments made to placement agents and government officials and the use of unlicensed placement agents by government pension funds.

As the breadth of the probe into these activities by the SEC and the State Attorneys General continues to widen, investment management firms that manage assets for government entities should be aware of the key issues involved and should review their

policies and procedures related to the use of placement agents as well as their policies related to political contributions and other similar payments.

### Background of Pay-to-Play Scheme

The initial NYAG indictment alleges that the former Deputy Comptroller and Chief Investment Officer for the State of New York, caused the New York State pension fund to invest billions of dollars with investment management firms which paid sham finder or placement agent fees to a consultant and former political adviser to the State of New York's Comptroller. The Deputy Comptroller allegedly served as a gatekeeper and would not approve an investment manager unless the consultant received payment from the firm. The indictment alleges that the process of selecting investments was skewed and corrupted to favor political associates, family and friends of the defendants, and other officials in the Office of the State Comptroller.

### Implications of Pay-to-Play Scheme

Through their actions and failure to disclose the kickbacks, the defendants allegedly defrauded the pension fund investors and precluded the pension fund's investment advisory committee from its duty to act in the best interest of the fund in selecting suitable investment management firms. The complaint also alleges the investment management firms involved either knew of the scheme, or were "reckless in not knowing", although it is unclear at this point

whether some or all of the investment managers are themselves targets of the investigation. The NYAG has expressed concern about the possibility that participating investment firms could have charged higher advisory fees to the pension plan in order to recoup their payments to Morris and others.

Although the SEC has taken the position that Rule 206(4)-3 of the Investment Advisers Act (known as the cash solicitation rule) does not apply to situations with cash payments to persons soliciting investors for hedge funds managed by registered investment advisers, Section 206 of the Investment Advisers Act applies a broad fiduciary duty which would require client disclosures of any material conflicts. In addition, NY and other state laws generally require vendors to disclose payments made to intermediaries.

### Role of Placement Agents

A placement agent is responsible for raising capital and acts as an intermediary between the investment adviser and potential investors. Typically retained by the investment adviser, they perform services including making introductions and developing marketing material. Their compensation is generally a flat fee or a percentage of the investments they help secure. Investment advisers should beware of indirect methods of making illegal payments, e.g., paying for travel and personal expenses, making charitable and political contributions, etc. Placement agents stress that they play an important role in introducing investors who need to invest money to money managers looking for clients.

A separate element of the NYAG probe is whether the individual placement agents used by the pension fund were appropriately licensed with a registered broker-dealer. Apparently, 40 to 50% of the placement agents used by New York pension funds were not affiliated with a broker-dealer. New York has now banned the use of placement agents in connection with state pension funds.

### Investigation Likely to Spread

Investigations of illicit payments made through third parties are sometimes referred to as triangle investigations because three parties are involved in the payments - investment adviser, consultant/placement agent and pension fund. Investigations commonly expand well beyond their initial scope as the investigators probe each vertex of the triangle.

## Triangle Investigations: Questions to Consider:

### Investment Adviser

- With what other government and private pension funds did the investment adviser conduct business?
- What payments did the investment adviser make to consultants and placement agents?

### Consultant/Placement Agent

- What other investment advisers did the consultant/placement agent represent?
- What is the flow of funds from the consultant/placement agent?

### Public or Private Pension Fund

- Who else served as an investment adviser to the pension fund?
- Did government officials or private pension employees have dealings with other consultants and placement agents?

Triangle investigations tend to spread in various directions as the vertices, hoping to obtain leniency, agree to "cooperate" and provide information about others, e.g., an indicted placement agent might name other investment advisers for whom they made illegal payments. Rewards for cooperating are so high that, sometimes, there is a "race to the courthouse" to cooperate early.

## Applicable Laws & Regulations

While a description of the legal framework associated with "pay to play" schemes is beyond the scope of this Brief, the following are some of the key legal and regulatory requirements.

### Criminal Law

Public and commercial bribery violates both federal and state law. The laws of "aiding and

abetting" and "conspiracy" make it a criminal violation to make payments indirectly. The law treats an investment adviser who knowingly makes payments through a third party the same as if they made the payment directly.

### Cash Solicitation Rule

Rule 206(4)-3 under the Investment Advisers Act of 1940 (Advisers Act) governs the solicitation arrangements between investment advisers and placement agents. The cash solicitation rule prohibits an investment adviser from paying a cash fee, directly or indirectly, to a solicitor for solicitation activities unless certain disclosure and contractual requirements are met. The rule is intended to address certain conflicts of interest inherent in solicitation arrangements.

In 2008, the SEC issued an interpretative letter indicating that it would no longer cite registered investment advisers for failure to comply with certain provisions of the rule for cash payments to persons soliciting investors for private funds managed by registered investment advisers. However, the SEC stated that the anti-fraud provisions of the Advisers Act would continue to apply to all advisers, and that compliance with the terms of the cash solicitation rule may be a way to demonstrate that proper disclosure of the fees to solicitors has been made to investors.

### Response of Regulators

It is likely that the SEC, in light of the New York case and the growing investigation, will revisit the applicability of the cash solicitation rule for the solicitation of investments in private funds. SEC Chairman Mary Schapiro has announced that the agency is considering rules to prohibit investment management firms from paying to win business. In addition to reviewing the cash solicitation rule for private funds, the SEC may also revisit a proposal from 1999 which would have banned political contributions by investment advisers.<sup>1</sup>

As noted above, New York State announced a ban on the use of placement agents for its pension funds. The Attorney General's office is also investigating if the pension fund was "intentionally misled or deceived" by the advisers' failure to disclose payment of placement agent fees. Other states are paying attention and have taken or are considering taking action.

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<sup>1</sup> See Proposed SEC Rule 206(4)-5, "Political Contributions by Certain Investment Advisers (1999)

A similar recent pay-to-play case involving the Teachers' Retirement System of the State of Illinois resulted in the State of Illinois issuing a new law that requires a working group to evaluate investment managers and consultants for each of the state's pension funds. The case charged that former Governor Blagojevich and several aides asked investment management firms, wanting to do business with state pension fund, for campaign contributions.

### Points to Consider

There are several actions that investment managers can take as they consider their potential exposure to the "pay to play" scandal and implement controls to ensure that their interactions with placement agents and government entities are legal and appropriate.

### "Look Back" Reviews

Because the investigation is spreading, investment advisers may want to consider a "look back" review to assess their control environment and the risk of becoming a subject to a similar investigation. The review should focus on investments received from government pension funds and on payments made to consultants, including, but not limited to, placement agents. In conducting such a review, investment advisers should:

- Identify all interactions between the adviser and third party placement agents and pension funds.
- Review placement agent disclosure documentation and contractual agreement.
- Identify methods of remuneration that require closer monitoring by the adviser
  - Vendor Bills
  - Travel & Entertainment
  - Charitable Contributions
  - Campaign Donations

- Focus on whether the placement agent provided a legitimate service and proper disclosures were made and to whom.
- Review cash disbursement journals and research any unknown vendor or recipient names.
- Consider creating a list of pension funds and placement agents with whom they have conducted business. Such a list would enable easy monitoring as additional pension funds, consultants, and placement agents surface in the expanded investigation.

#### Review or Enhance Policies and Procedures

As firms evaluate their existing compliance program or contemplate implementing a new program, they may want to consider the following procedures or controls:

- Create a cash solicitation policy pursuant to Rule 206(4)-3, which must contain several provisions including:
  - The placement agent is not subject to court order or administrative sanction;
  - The fee is paid pursuant to a written agreement to which the adviser is a party; and
  - Receipt of client acknowledgement that the solicitor has disclosed all material aspects of the agreement to the client pension plan.
- Evaluate periodically the design and operating effectiveness of controls implemented to guard against pay-to-play arrangements.
- Document any alleged instance of inappropriate payments and the adviser's follow up investigation. If inappropriate payments are discovered, document steps taken to:
  - Determine whether additional inappropriate payments were made by the same individuals or others employed by or associated with the investment adviser;
  - Determine whether appropriate authorities should be contacted;
  - Conduct a root cause analysis and enhance controls to prevent recurrence; and
  - Monitor new controls.
- Define process and sanctions and/or remedies for violations of the adviser's pay-to-play policies.
- Consider a prohibition on exchanges or other considerations made for the purpose of obtaining or retaining the firm's engagement as an investment adviser by the government entity.
- Maintain a record of all pre-clearances of political contributions or other remunerative exchanges.
- Review political contributions and other remunerative exchanges in light of the firm's government clients looking for patterns of contributions or exchanges by employee or group of employees that may indicate an effort to exert direct or indirect influence on behalf of the firm obtaining or retaining the firm's engagement as an investment adviser by a government entity (e.g., contributions to state or local candidates for whom the employees were ineligible to vote).
- Consider a prohibition on all or selected employees from making political contributions above a certain *de minimis* amount to any person who may directly or indirectly influence the selection or retention of the investment adviser by a government entity or any candidate for whom the employee is not eligible to vote.
- Require pre-clearance of *de minimis* political contribution with compliance or legal personnel. An employee seeking pre-clearance should certify that the contribution is not made for the purpose of obtaining or retaining the firm's engagement as an investment adviser by a government entity.

- Require pre-clearance with compliance or legal personnel of *de minimis* exchanges or other considerations with certain outside parties which may be able to exert direct or indirect influence on behalf of the firm obtaining or retaining the firm's engagement as an investment adviser by the government entity.
- Establish standards for hiring and promotion and background investigations for all positions of trust in the organization including placement agents.

### Leverage FCPA Experience

Vigorous enforcement of the Foreign Corrupt Practices Act has led to numerous policies, programs and controls to guard against illicit payments. Investment advisers can leverage this knowledge to develop and implement a pay-to-play control framework.

- Reinforce the culture and "tone at the top" that senior management opposes and will not tolerate illicit payments.
- Create or, if necessary, amend the codes of ethics and conduct to define prohibited topics, offers and exchanges between certain adviser staff and certain outside parties.
- Require annual certification of codes of ethics, including certification by employees and outside consultants that they have not made any political contributions or engaged in any of the prohibited remunerative exchanges for the purpose of obtaining or retaining engagement as an investment adviser to a government entity.

- Ensure new covered employees are aware of, and disclose, any political contributions from the time they enter into employment negotiations with the adviser.
- Create a hotline or other mechanism for employees and third parties to submit concerns on an anonymous basis.

## Additional Information

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