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Pay to Play

Marketing to Public Pension Plans: Honest Services Fraud, Use of Placement Agents and Lobbyist Registration Issues (Part Two of Two)

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A recent Regulatory Compliance Association (RCA) seminar offered a comprehensive overview of the rules pertaining to marketing to public pension plans relevant to investment advisers. The seminar featured David Y. Dickstein, partner at Katten and an RCA Senior Fellow from Practice. This article, the second in a two-part series, examines honest services fraud; use of solicitors and placement agents; lobbyist registration; and disclosure, recordkeeping and other requirements applicable to doing business with public plans. The first article discussed municipal advisor registration; political contributions; and gifts and entertainment.

For more from the RCA, see "Risks With Investment Allocation, Trade Execution, Soft Dollars, Client Solicitation and Valuation" (Apr. 14, 2016); and "Issues Pertaining to the Custody Rule, ERISA, Client Agreements, Fees, Codes of Ethics and Confidentiality" (Apr. 7, 2016).

On May 8, 2019, the RCA will host its Enforcement, Compliance & Operations Symposium in New York City. For additional information or to register for the symposium, click here.

Honest Services Fraud

Honest services fraud falls within the mail and wire fraud provisions of federal law, Dickstein explained. It includes activity that deprives the public of honest decision making by public officials. For purposes of those laws, 18 U.S.C. § 1346 states that a "scheme or artifice to defraud" includes "a scheme or artifice to deprive another of the intangible right of honest services."

In 2010, in *U.S. v. Skilling*, the Supreme Court ruled that the statute was too broad to cover misconduct other than kickbacks and bribery, he continued. In 2013, the D.C. Circuit ruled that there does not have to be an explicit quid pro quo between the donor and the recipient to trigger liability; an expectation that something will be given in exchange for a gift is sufficient. The donor can be held liable even if the government employee does not accept the gift. The statute covers gifts of any amount, however small, as well as intangible items.

An offer of an internship to the child of a pension official in order to induce the official to invest pension money with the adviser would not be covered by Rule 206(4)-5 under the Advisers Act – the so-called "pay to play rule" (Rule) – but it could constitute honest services fraud. Another critical distinction between the Rule and the honest services fraud statute is that the Rule provides for strict liability, whereas honest services fraud requires intent to influence an official.

See "ACA Program Reviews State and Local Pay to Play Rules; Traps for the Unwary; and Compliance (Part Two of Two)" (Feb. 21, 2019); and "Implications of the *Rajaratnam* Verdict for the 'Mosaic Theory,' the 'Knowing Possession' Standard of Insider Trading and Criminal Wire Fraud Liability in the Absence of a Trade" (Jun. 1, 2011).

Use of Placement Agents

The Rule prohibits an adviser from paying a third-party placement agent to solicit business from government entities unless the third party is a regulated person or entity, Dickstein said. This portion of the Rule does not cover an adviser's internal marketing staff. The agent must be registered as an investment adviser, broker-dealer or municipal advisor because, in each case, the agent will be subject to either the Rule or one of the two parallel pay to play rules: Municipal Securities Rulemaking Board Rule G-37 or FINRA Rule 2030.

Some state and local placement agent rules prohibit payment of a success fee or contingent fee to a solicitor of a public pension, Dickstein explained. The prohibitions may apply not only to third parties, but also to the adviser's own employees. Some jurisdictions are even more restrictive and prohibit any use of a placement agent to solicit public plans. For example, in 2014, New York City banned the use of placement agents in connection with its retirement plans. Similarly, in 2018, New York State banned the use of placement agents to solicit the State's Common Retirement Fund. Even when solicitors or placement agents are not prohibited, an adviser may be subject to ongoing disclosure requirements pertaining to their use, he added.

See "How Can Hedge Fund Managers Structure the Compensation of Third-Party Marketers in Light of the Ban On 'Contingent Compensation' Under New York City and California Lobbying Laws? (Part Two of Three)" (Apr. 21, 2011).

Recordkeeping Requirements

An adviser that holds public pension money must keep track of its covered associates, the contributions made by its employees, the plans to which it provides services and the solicitors and placement agents it uses, Dickstein advised. Prior to an inspection, the SEC may check public databases of political contributions and cross-check the adviser's records. Advisers should have a system in place to monitor and record relevant employee activity. Compliance personnel should periodically check public databases to make sure that employees are reporting all of their contributions.

See our two-part series "A Roadmap to Maintaining Books and Records": Compliance With Applicable Regulations (Nov. 2, 2017); and Document Retention and SEC Expectations (Nov. 9, 2017); as well as "SEC No-Action Letter Outlines Alternative Recordkeeping Regime for Compliance With the Pay to Play Rule" (Sep. 22, 2011).

Lobbyist Registration

There are lobbying rules at the state, county and local levels, Dickstein explained. The definition of lobbying varies from jurisdiction to jurisdiction, but it generally entails direct or indirect communication with government employees for the purpose of influencing legislative, administrative or executive government action, including, in some jurisdictions, procurement of investment management contracts.

A person who meets the definition of lobbyist and does not have an available exemption must usually register with the relevant jurisdiction. In addition, the person's employer may have to register as a "lobbyist principal," "lobbyist firm" or "lobbyist employer." Some states use different terminology. For example, New Jersey refers to lobbyists as "government affairs agents."

Some states apply lobbying rules only to third parties hired by advisers. Others cover not only activities by third parties, but also activities by an adviser's own personnel.

See "Getting to Know the Gatekeepers: How Hedge Fund Managers Can Interface with Investment Consultants to Access Institutional Capital (Part Two of Two)" (Jul. 18, 2013); and "Third Party Marketers Association 2011 Annual Conference Focuses on Hedge Fund Capital Raising Strategies, Manager Due Diligence, Structuring Hedge Fund Marketer Compensation and Marketing Regulation" (Dec. 1, 2011).

Two Common Exceptions

There are two common exceptions to the definition of lobbying that may be available to investment advisers, Dickstein continued. First, the definition often excludes responses to a request for proposal issued by a plan or bids in a competitive bidding process initiated by the plan (as distinct from approaching a plan directly to solicit business).

Second, some states permit firms to spend up to a specified de minimis amount on salaries and associated expenses without having to register, he said. For example, in New York, a person can receive up to $5,000 per year in the aggregate from all represented principals without having to register as a lobbyist. A New York adviser must therefore calculate the hourly pay rate of marketing personnel working on a pitch, along with the associated marketing expenses, to determine how many hours those persons may spend on the pitch without triggering a registration requirement. Covered work typically encompasses preparing for meetings, putting together pitch materials, attending meetings and similar activities.

Registration and Other Requirements

Lobbyists must usually complete an initial and annual registration form. Some requirements apply both to the individual lobbyist and his or her employer. There are also periodic reporting requirements on lobbying and fundraising activities, some as frequent as bimonthly, Dickstein said.

Advisers should also be mindful of the following:

- Restrictions on gift giving by lobbyists may be more onerous than other state and local gift and entertainment (G&E) restrictions.
- Even if there is no prohibition on receiving a success fee for general marketing, there may be a restriction applicable to lobbying.
- Some jurisdictions require local ethics training, which must often be done in person.
- Many jurisdictions have recordkeeping requirements.
- Failure to register when required can result in daily fines. Violation of rules may be a misdemeanor.

See "How Much Are In-House Hedge Fund Marketers Paid, and How Will Recent Developments in New York City and California Lobbying Laws Impact the Compensation Levels and Structures of In-House Hedge Fund Marketers (Part Three of Three)" (Jun. 17, 2011).

Pre- and Post-Contractual Requirements

Some states require advisers to public pensions to make certain disclosures prior to taking a plan investment or to make ongoing disclosures, Dickstein explained. For example, an adviser must tell Pennsylvania, in advance, which of the adviser's employees will be servicing the account. South Carolina requires a quarterly summary of the adviser's compliance with its investment guidelines and strategy; the rationale for its decisions; and a discussion of performance. Some states go even further, while some have no requirements at all. Some require periodic certification of compliance with laws and other matters.

Effective January 31, 2017, California's Assembly Bill 2833 imposed a broad disclosure regime on public plans that enter into new alternative investment contracts or that make follow-on investments with existing managers, Dickstein said. Plans must now disclose:

- fees and expenses paid directly to the fund, its manager or related parties;
- the plan's pro rata share of other fees and expenses;
- its pro rata share of the manager's carried interest allocation;
- its pro rata share of fees and expenses paid by a portfolio company to the manager or related persons, such as a director fee paid to a manager employee who sits on the company's board; and
- the gross and net return of each vehicle in which the plan invests.

See "How Developments With California's Pension Plan Disclosure Law, the SEC's Rules and FINRA's CAB License May Impact Hedge Fund Managers and Third-Party Marketers" (Oct. 13, 2016).

In addition, under Section 6254.26(b) of the California Public Records Act, certain records of alternative investment vehicles in which a public plan invests must be open to public inspection on request, Dickstein added. These include, with respect to each vehicle:

- name, address and fund vintage;
- the aggregate amounts committed, and actually contributed, by the plan;
- annual cash distributions and the remaining value of the plan's investment;
- its internal rate of return and investment multiple since inception;
- the annual management fees and expenses paid by the plan; and
- the annual profit received from the vehicle.

See "K&L Gates Program Warns of Public Disclosure Risks Associated With Accepting State Public Pensions As Investors and Advises on How to Mitigate Them (Part Two of Two)" (Mar. 30, 2017).

Seven Ways to Ensure Compliance When Marketing to Public Pension Plans

An adviser that wants to market advisory services to public pension plans should:

1. if not registered with the SEC, ask the right questions in its subscription and account-opening documents to make sure that registration as a municipal advisor is not required;
2. before marketing to a public plan, check whether there are any applicable lobbyist registration requirements because "the clock starts to tick" right away and there may be very low de minimis exemptions;
3. check for restrictions on the use of placement agents;
4. check whether any prior contributions or activities by employees would be covered by the Rule or the pay to play or G&E rules of the relevant locality;
5. adopt a policy requiring preclearance of all political contributions and G&E;
6. screen incoming employees for past activities that might implicate one of the rules; and
7. train employees regularly on the policies.

See also "Four Pay to Play Traps for Hedge Fund Managers, and How to Avoid Them" (Feb. 5, 2015); and "Five Best Practices for Avoidance of Pay to Play Violations by Hedge Fund Managers or Their Covered Associates" (Dec. 8, 2011).

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