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Marketing Investment Management Services to Public Retirement Systems: Complying with Applicable Laws and Regulations

It is well-known that high-profile jurisdictions such as California and New York City have in certain instances placed lobbyist registration requirements on investment managers that solicit investment advisory business from state and local entities that manage retirement funds for government employees ("Public Pension Systems"). To ensure their compliance with the laws, however, investment managers must become familiar with developments in many other jurisdictions that have placed significant restrictions and obligations on investment managers that solicit Public Pension Systems. States such as Florida, Illinois, Indiana, Kentucky, Louisiana, Massachusetts and New Jersey, as well as various cities and counties including Philadelphia, Los Angeles, San Diego and San Francisco, are but a few examples.

Unfortunately, these state and local laws are far from uniform, and investment managers must assess the applicable restrictions with respect to each Public Pension System whose funds they seek to manage. An investment manager may be subject to state and local laws that require its marketing staff and third-party marketers to register as lobbyists or placement agents; that restrict or prohibit the payment of contingent compensation to such marketing personnel; that require the investment manager to disclose in detail its marketing arrangements; and that restrict or prohibit the making of political contributions and the offering of gifts and entertainment. These laws are in addition to, and in many cases more burdensome than, Rule 206(4)-5 (the "SEC Pay-to-Play Rule"), which was adopted in 2010 by the US Securities and Exchange Commission (the SEC) under the Investment Advisers Act of 1940, as amended, to govern political contributions by advisers.

As these requirements continue to evolve, investment managers face significant challenges in ensuring that their solicitation of Public Pension Systems complies with applicable law. As an introduction to this complex regulatory regime, this Advisory identifies the key issues facing investment managers seeking to do business with Public Pension Systems.

Pay-to-Play Laws

SEC Pay-to-Play Rule

Pay-to-play or similar laws ("Pay-to-Play Laws") restrict investment managers' ability to make campaign or other contributions to elected officials and candidates in order to obtain investment advisory business from state or local government entities. The SEC Pay-to-Play Rule prohibits an investment manager from providing investment advisory services to a government entity within two years after the manager makes a contribution to an official of the government entity ("two-year look-back period"). Among other minimal exceptions, the SEC Pay-to-Play Rule provides for a de minimis exception for contributions of $350 or less to one official per election when made by an employee, executive officer, managing member or general partner of the manager, if the contributor is a natural person and was entitled to vote in the election when he or she made the contribution. If the contributing person was not so entitled, the SEC Pay-to-Play Rule excepts contributions of $150 or less.

State Pay-to-Play Laws

At the state and local levels, Pay-to-Play Laws not only diverge from the SEC Pay-to-Play Rule but also vary substantially across jurisdictions. This variance may manifest itself in lower contribution thresholds, longer look-back periods and the absence of exceptions. For example, one state imposes a two-year look-back period on investment management firms identical to the SEC Pay-to-Play Rule but only provides for a $250 de minimis exception. Other jurisdictions can be even more restrictive and prohibit

any professional corporation, partnership or limited liability company formed or doing business under their laws from making any campaign contributions.

In addition to variations in their severity, state and local Pay-to-Play Laws also differ with respect to the contributors and recipients to which they apply. As an example, the SEC Pay-to-Play Rule applies to, among other persons, the investment manager's internal marketing personnel, supervisors of internal marketing personnel and executive officers, as well as its general partners or managing members, as applicable. However, state and local Pay-to-Play Laws may extend to all employees of the investment manager and third-party marketers and solicitors hired by the manager.

Further, the coverage of the SEC Pay-to-Play Rule is limited to contributions made to an incumbent, candidate or successful candidate for an elective office, if such office is directly or indirectly responsible for, or has influence over, the hiring of an investment manager or possesses the authority to appoint a person with such responsibility or influence. In contrast, the Pay-to-Play Laws of a particular state or locality may cover a broader range of contributions, which might include, for example, contributions to a state or local committee controlled by a state official or a ban on all campaign contributions by business entities.

Gifts and Entertainment

While the SEC Pay-to-Play Rule prohibits investment managers from making certain political contributions, its definition of "contribution" is limited to gifts, loans and anything else of value when contributed either for the purpose of influencing any election or for the payment of any election expenses or any transition or inauguration expenses of a successful candidate for state or local office. Although the SEC also recommends that investment managers include in their codes of ethics limitations on gifts, the only bright-line prohibition on gifts is that contained in the SEC Pay-to-Play Rule. In contrast, many state and local laws impose significantly more stringent restrictions on the solicitation, offering and acceptance of gifts, and such restrictions often apply regardless of the purpose for which a gift is given.

General Prohibitions

Numerous states prohibit the acceptance of gifts where the recipient has a reasonable basis for believing that the donor is doing business, or is seeking to do business, with the state. Alternatively, other jurisdictions impose blanket prohibitions on gifts whether or not tied to the existing or potential relationship of the donor with the governmental entity with which the recipient is affiliated. In some jurisdictions, there are exceptions to such general prohibitions for gifts of de minimis or "nominal" value.

Food and Beverages

Investment managers must keep in mind that most gift prohibitions encompass food, drinks and other refreshments and, even where an exception for such items exist, that the exception is likely to be de minimis. One state, for example, allows an employee of the state's retirement system to consume food and beverage as a guest of the donor, provided that the value of such food and beverage does not exceed $54. Investment managers should also be aware that Public Pension Systems typically adopt internal standards of conduct or codes of ethics that provide for similar or heightened restrictions.

Regulation of Lobbying

What Constitutes Lobbying?

The solicitation activities of an investment manager may also trigger the application of state and local lobbying laws, which may require investment managers, their employees and their third-party solicitors and placement agents to register as lobbyists. States and municipalities maintain widely variant laws with respect to the regulation of lobbying. However, the term "lobbying" may, in a general sense, be considered direct or indirect communication with a government official or employee for the purpose of influencing government action, which may encompass administrative, legislative or executive action depending on the jurisdiction.

For example, one jurisdiction defines "lobbyist" as any person that engages in "lobbying" on behalf of a principal for economic consideration. In turn, the jurisdiction considers "lobbying" to include, among other things, any communication or gift-giving to influence an administrative action for the purpose of advancing the interest of the principal. Thus, the marketing and sales employees of an investment manager that meet with the members of that jurisdiction's board of pensions and retirement would be lobbyists subject to registration and reporting requirements. Alternatively, certain jurisdictions place lobbying registration and reporting requirements on third-party solicitors, but not on an investment manager's internal marketing staff.

Lobbyist Registration and Reporting Requirements

Under lobbying laws, a person that engages (or will engage) in lobbying must register with a government office as a lobbyist. In certain states, an employer of a lobbyist, or the person or entity on whose behalf the lobbyist engages in lobbying, may also be required to register with the state or municipality as a lobbyist employer or lobbyist principal, as applicable. Variations to this standard registration structure are possible. One state, for example, considers a person that communicates with a Public Pension System to be a "governmental affairs agent," and the entity or person engaging such agent is deemed a "lobbyist."

A registered lobbyist is typically required to disclose the persons whom the lobbyist represents, to report any reimbursement or compensation in excess of a certain threshold, often through quarterly reports, and to file an annual registration statement. A registered lobbyist employer or principal is subject to similar obligations with respect to the person that engages in lobbying on its behalf.

Limited Exemptions

In some cases, state and local lobbying laws provide for limited exemptions from lobbyist registration and/or reporting, which in some jurisdictions may be characterized as exclusions from the lobbyist or lobbying definition. These provisions frequently take the form of de minimis exemptions that exempt a person (or an employer or a principal thereof) from the lobbying laws if such person is not compensated, or does not incur expenses, above a certain threshold with respect to activities that would otherwise constitute lobbying.

As with all of the laws discussed in this Advisory, these exemptive provisions vary greatly in their leniency. In one state, for example, a person must register as a lobbyist if such person expends more than $500 in a calendar quarter for lobbying purposes. In contrast, another state exempts a person from lobbyist registration and reporting if the economic consideration such person receives for his or her lobbying activities, from all represented principals, does not exceed $2,500 in a calendar quarter.

Use of Solicitors

In addition to registration and reporting obligations that may arise under the lobbying laws, investment managers may also be subject to restrictions on how (and whether) they may use third-party placement agents. In some jurisdictions the restriction on the use of placement agents may take the form of a prohibition on contingent fees, which bars a person from retaining a placement agent to lobby with respect to any legislative, executive or administrative action for compensation in any way contingent upon the outcome of such action. Contingent fee prohibitions frequently apply not only to third-party placement agents but also to employees of the investment manager. Further, in many jurisdictions, contingent fee prohibitions apply irrespective of whether the placement agent or employee must register with the jurisdiction as a lobbyist.

Other jurisdictions may take a more stringent stance, barring the use of placement agents entirely regardless of the manner of compensation. Finally, to the extent that investment managers may use placement agents at all, an investment manager may be required to make detailed disclosures about such agents. Investment managers must thus take care to ensure that neither their retention nor their compensation of placement agents violates any applicable prohibitions or limitations.

Pre- and Post-Contractual Disclosure Requirements

In addition to the foregoing, investment managers may also be subject to an additional layer of regulation that requires them to make disclosures prior to and subsequent to entering into a contract with a Public Pension System. For instance, one state requires contractors to disclose the names of all individuals who will be providing professional services to a municipal pension system prior to entering into a professional services contract with the system. However, required disclosures may extend beyond basic information about the investment manager and may cover previously made gifts and campaign contributions. As an example, one state demands that each investment management firm make a disclosure of, among other things, certain political contributions over $250 in addition to the disclosure of investment management professionals in its employ.

Further, in many jurisdictions, an investment manager must submit periodic certifications that its conduct has conformed to applicable law once it has acquired investment advisory business from a Public Pension System. For example, a contractor may be required to submit an annual certification that, among other things, it did not give any gifts to any employee of the state agency who participates substantially in the preparation of bids, requests for proposals or the negotiation or award of state contracts. Applicable law may also require that such submissions be made available for public inspection.

Ensuring Compliance

An investment manager may undertake the following steps to ensure that it is in compliance with the laws applicable to its solicitation of Public Pension Systems:

1. Prior to targeting any of its marketing activities toward a Public Pension System, an investment manager should determine whether it must register as a lobbyist employer and/or whether its employees or third-party solicitors must register as lobbyists.
2. An investment manager should confirm that applicable laws and internal policies permit the use of placement agents, and the compensation of such agents, before engaging an agent to contact a Public Pension System on the manager's behalf.
3. Prior to targeting any of its marketing activities toward a Public Pension System, an investment manager should determine whether any prior activities, such as previous campaign contributions or gifts, would preclude its acceptance of an engagement from the Public Pension System.
4. If it has not done so already, an investment manager should require preclearance of all gifts and political contributions and should, as required by applicable law, prohibit such gifts or contributions entirely or prohibit those that exceed an appropriate de minimis threshold.
5. An investment manager should implement policies requiring each prospective employee to disclose all political contributions and gifts he or she has made and should review such disclosures prior to hiring such person as a new employee.

Finding the Requirements of Particular Jurisdictions

The prohibitions and requirements applicable to investment managers are found in a variety of sources, including state statutes, agency regulations, municipal ordinances and internal policies and procedures, which often contain codes of ethics and, in some cases, sample investment management contracts. Additional guidance may be found in advisory opinions or memoranda issued by the state or local ethics commission with jurisdiction over the solicited Public Pension System.

An investment manager seeking to solicit a Public Pension System should be aware that the applicability of these potential sources of law will vary depending on the specific Public Pension System that it intends to solicit. In certain cases, direct contact with the Public Pension System may be required to confirm the applicability of state statutes and/or local ordinances. Finally, investment managers should be mindful that all of these sources of potential regulation are subject to revision and repeal.

Attorneys at Katten Muchin Rosenman LLP are available to assist investment managers in their efforts to comply with applicable law. To request additional information regarding specific state or local laws concerning pay-to-play, contributions, lobbying or any of the other issues identified above, please contact your regular Katten Muchin Rosenman LLP contact.

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