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The State and Municipal Lobbying and Pay-to-Play Regulation of Pension Fund Management Participants

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Over the last several years, there has been a trend toward the enactment of general pay-to-play laws and tighter lobbying, campaign finance and ethics laws by many states and localities. More recently, this trend has included the very specific application of lobbying laws and pay-to-play laws to investment managers. These laws regulate the government interactions and political contributions of investment advisers, placement agents and other participants in the pension fund management business. Perhaps the most widely publicized of these laws is the Securities and Exchange Commission's (SEC) Rule 206(4)-5 under the Investment Advisers Act of 1940. Generally, this rule is aimed at curtailing "pay-to-play" activity, *i.e.*, preventing advisers from making political contributions or other payments to influence their selection by government officials to provide advisory services for public programs, such as public pension plans and 529 Plans. Parts of the SEC's rule became effective March 14, 2011 and other parts will be effective Sept. 13, 2012.[1]

This bulletin focuses attention on the development of the state and local laws. These laws impact certain pension fund management business participants as lobbyists, who are subject to specific registration, reporting and other requirements, and/or prohibit or limit campaign contributions from these participants through pay-to-play laws. The growing implementation of these types of laws at the state and municipal level require participants in the pension fund management business to carefully track, understand and comply with these new requirements. This bulletin discusses, *as a sampling*, such laws in New York City, California, the City of Los Angeles and Pennsylvania. This bulletin should not be considered exhaustive in the discussion of such laws or requirements. Some jurisdictions are approving even more specific restrictions, whether by statute, regulation or guidance. For example, the Texas Teachers Retirement System has implemented its own policies, which are not codified. In addition, it should be noted that this bulletin does not cover the impact of more general lobbying and campaign finance law in the United States on participants in the pension fund management business.

I. Examples of Lobbying Laws Impacting Pension Fund Management Participants

New York City Law Department Opinion

The New York City Law Department issued an opinion to the New York City Clerk in 2010 that clarifies the application of the New York City lobbying laws to placement agents and other persons who attempt to influence decisions made by the New York City Comptroller, Comptroller's staff, boards of trustees of the City's pension funds and retirement systems or members of their staff, about the investment of pension funds.[2] Effective Jan. 1, 2011, placement agents and other persons conducting such activity and who have (or reasonably expect to have) more than $2,000 in annual compensation and expenses for lobbying must register and report as lobbyists.

New York City Lobbying Law Generally

The Lobbying Bureau of the New York City Clerk administers and enforces the City's lobbying law, which imposes certain obligations on lobbyists and their clients as discussed below. The term "lobbyist" includes every person or organization retained, employed or designated by a client to engage in lobbying. The term "lobbying" means any attempt to influence certain activities in New York City including, but not limited to: (1) a determination made by an elected City official or an officer or employee of the City concerning (a) the procurement of goods, services or construction, including the preparation of contract specifications, (b) the solicitation, award or administration of a contract, or (c) the solicitation, award or administration of a grant, loan or agreement involving the disbursement of public monies; and (2) any determination of a City board or commission.

New York City Lobbying Law as Applied to Investment Managers

Under the City of New York Law Department's opinion of March 31, 2010, parties who seek to influence the investment decisions made by the New York City Comptroller, Comptroller's staff, boards of trustees of the City's five pension systems, or members of their staff about the investment of pension funds, and who have (or reasonably expect to have) more than $2,000 in annual compensation and expenses for lobbying are deemed lobbyists.[3]

If an entity qualifies as a lobbyist and/or a client, it will be subject to certain filing requirements under the lobbying law. In certain situations, an investment management firm will be considered a client, such as when it retains a placement agent or other third party to lobby the pension systems on its behalf. If an investment management firm has employees that lobby pension systems on its own behalf, the firm would be considered both a lobbyist and client.

Registration Requirements

Statement of Registration: A Statement of Registration must be filed by a lobbyist each calendar year for each client on the City's e-Lobbyist website,[4] except that no such filing is required for any year in which the lobbyist does not incur, receive or expend more than $2,000 in total compensation and expenses for lobbying with respect to all of its clients. In the Statement of Registration, the lobbyist must include certain information about itself, its lobbying activities and its employees who engage in lobbying activities. Along with this filing, the lobbyist must file the written retainer agreement, or written summary if the agreement is oral, between the lobbyist and client. A client that is not also a lobbyist does not need to register,[5] but it must file reports, as discussed below.

Timing of Registration: The Statement of Registration must be filed by January 1 each year by lobbyists that reasonably expect to exceed the $2,000 threshold for such year and who were retained as lobbyists by December 15 of the prior year. In all other cases, a lobbyist must file a Statement of Registration within 15 days of being retained, but no later than 10 days from actually incurring or receiving reportable compensation and expenses of more than $2,000. A Statement of Registration must be accompanied by filing fees of $150 for the first client and $50 for each additional client registered by a lobbyist.

Reporting Requirements

Lobbyists' Reports: A lobbyist must file up to six bi-monthly periodic reports each calendar year. The initial report must be filed by the 15th day following the end of the bi-monthly reporting period in which the lobbyist filed the Statement of Registration.[6] Following that, subsequent reports must be filed by the 15th day following the end of each bi-monthly reporting period in which the lobbyist expends, receives or incurs combined compensation and expenses of more than $500 for the purpose of lobbying. The sixth report, known as the Lobbyist Annual Report, for a calendar year must be filed by January 15 of the following year. Any lobbyist who engages in fundraising or political consulting activities in any calendar year in which the lobbyist is registered, or in the six months preceding any such calendar year, must file fundraising and political consulting reports with the City Clerk on the same filing schedule as the bi-monthly reports. (See below for more information regarding political giving restrictions.)

Clients' Reports: A client who incurs, receives or expends more than $2,000 in total compensation and expenses for lobbying in a calendar year must file a client Annual Report by January 15 of the following year, unless the client lobbies on its own behalf, expends more than $2,000 annually in reportable compensation and expenses for lobbying, and files the applicable lobbyist reports. Thus, if an investment management firm is only a client, its first reporting obligation under this new interpretation will be January 2012.

Additional Requirements and Restrictions Imposed by the New York City Lobbying Law

In addition to the lobbyist registration and reporting requirements discussed, placement agents and other persons who register as lobbyists must also comply with the various other requirements and restrictions imposed on lobbyists. For instance, they:

- Must maintain certain information and documentation of their expenses, contributions and related payments for five years;
- May not accept any arrangement wherein their compensation is contingent on the outcome of the City's actions, including actions related to the pension systems;
- May not make political contributions exceeding the following limits per calendar year: Mayor/Public Advocate/Comptroller[7]: $400; Borough President: $320; and City Council: $250;
- May not give or offer to give gifts to any public servant. This prohibition applies to: lobbyists; spouses or domestic partners of lobbyists; the unemancipated children of lobbyists; if the lobbyist is an organization, the officers or employees of such lobbyist who engage in any lobbying or who are employed in such lobbyist's division that engages in lobbying activities, and the spouse or domestic partner and unemancipated children of such officers or employees;

- May not have their contributions to candidates who participate in the City's optional public financing process to be matched by the City; and
- Must comply with numerous additional ethics requirements included explicitly in the lobbying law.

Penalties

Any person or organization who fails to file a Statement of Registration or any report required by the lobbying law within 14 business days after being notified by the City Clerk of such failure shall be guilty of a Class A misdemeanor, and subject to a civil penalty of up to $20,000 to be assessed by the City Clerk. Any person or organization violating any other provision of the lobbying law is subject to various penalties, including being found guilty of a Class A misdemeanor, liable for a civil penalty of up to $30,000, and/or being subject to an order to cease all lobbying activities for up to 60 days. In addition, any person or organization who fails to file in a timely manner a Statement of Registration or any report required by the lobbying law is subject to late penalties.

State of California Assembly Bill 1743

With the enactment of the State of California's Assembly Bill 1743 ("AB 1743"), effective Jan. 1, 2011, persons serving as placement agents before the State's retirement systems – including the California Public Employees' Retirement System and the California State Teachers' Retirement System – must register as lobbyists with the State. Persons acting as placement agents in connection with potential investments by local public retirement systems in California must comply with the applicable local lobbying requirements.

Defining "Placement Agent"

AB 1743 defines a placement agent as "any person hired, engaged, or retained by, or serving for the benefit of or on behalf of, an external manager, or on behalf of another placement agent, who 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 an external manager to a board or an investment vehicle, either directly or indirectly." An external manager is either: a person who is seeking to be or is retained by a California retirement system board to manage a portfolio or securities or other assets for compensation; or a person engaged or who 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 board.

There are, however, two exceptions to the definition of placement agent. The first is that a person who is an employee, officer, director, equityholder, partner, member or trustee of an external manager and spends one-third or more of his/her time a calendar year managing the securities or assets owned, controlled, invested or held by the external manager is *not* a placement agent (the "One-Third Exception"). Additionally, an employee, officer or director of an external manager or its affiliate is not a placement agent if the external manager: is registered as an investment adviser or broker-dealer with the SEC or any appropriate state securities regulator; was selected through a competitive bidding process; and has agreed to a fiduciary standard of care as to the state public retirement system's investments (the "Competitive Bid Exception").

State Registration Requirements

A placement agent must register as a lobbyist with the State *before* acting in connection with any state public retirement system investment. An individual who qualifies as a placement agent must complete and submit Form 604, "Lobbyist Certification Statement", submit a $50 registration fee and recent photograph, and attend a Lobbyist Ethics Orientation Course in California within 12 months of registering as a lobbyist.

An investment management firm with employees who will act as placement agents for the firm must file Form 603, "Lobbyist Employer/Lobbying Coalition Registration Statement" along with a Form 604, $50 registration fee and photograph for each lobbyist it employs.

If an investment firm retains a third party as a placement agent, it must file Form 602, "Lobbying Firm Activity Authorization."

A business organization that is retained by an investment manager as a placement agent must register using Form 601, "Lobbying Firm Registration Statement," in addition to a Form 604, $50 registration fee and photograph for each of its employees who will act as a lobbyist.

Registrations must be renewed annually and each lobbyist must take an ethics course in California every two years.

State Reporting Requirements

Lobbyists must submit quarterly reports on Form 615, "Lobbyist Report," to their employers within two weeks after each calendar quarter. The reports must include descriptions of matters actively lobbied, an itemization of activity expense incurred or arranged during the quarter and a description of contributions of $100 or more to state candidates, elected state officials and certain committees.

An investment management firm with employees who will act as placement agents for the firm must file Form 635, "Report of Lobbyist Employer/Lobbying Coalition," along with the Form 615 of each of its lobbyist employees' by the end of the month following each calendar quarter. These reports must disclose information including salaries paid to lobbyist employees, lobbyist activity expenses and other payments made in connection with lobbying.

A business organization that is retained by an investment manager as a placement agent must file Form 625, "Report of Lobbying Firm," along with the Form 615 of each of its lobbyist employees' by the end of the month following each calendar quarter.

Applicability to Local Pension Fund Placement Agents

AB 1743 also deems "placement agents," as newly defined, to local pension funds in California as lobbyists with respect to the respective local jurisdictions, and requires that they comply with applicable local lobbying laws. The One-Third Exception discussed above applies to local pension fund placement agents, but the Competitive Bid Exception does not. Not all local government agencies in California have lobbying requirements, but those that do can vary significantly from jurisdiction to jurisdiction. Thus, it is important that "placement agents" (as defined by AB 1743) for local pension funds in California understand and comply with the lobbying laws of the pertinent local jurisdictions.[8]

Additional Requirements and Restrictions Imposed by AB 1743

In addition to the lobbyist registration and reporting requirements discussed above, placement agents must also comply with the various other requirements and restrictions imposed on lobbyists. For instance, they:

- Must maintain documentation of their expenses, contributions and related payments for five years;
- May not accept or agree to accept any fees that are contingent on the outcome of a sought-after engagement;
- May not make political contributions to an elected state officer or candidate for that office if the lobbyist is registered to lobby the officer's/candidate's government agency;
- May not give gifts aggregating more than $10 a calendar month (or act as agents or intermediaries in the making of a gift or arrange the making of a gift) to a state candidate, elected state officer, legislative official or agency official employed by an agency that the lobbyist lobbies; and
- Must comply with numerous additional ethics requirements explicitly included in the lobbying law.

Penalties

The California Fair Political Practices Commission and Attorney General have enforcement authority over the lobbying laws. Failure to provide information required by the lobbying laws is subject to various penalties including: an administrative enforcement proceeding before the Commission; a criminal misdemeanor proceeding; a civil action; liability for late penalties; liability for monetary penalties of up to $5,000 per violation of the lobbying laws; and liability for monetary penalties of up to the greater of $10,000 or three times the amount a person failed to report properly or unlawfully contributed, expended, gave or received may be imposed upon conviction for each violation.

II. Examples of Pay-to-Play Laws Impacting Pension Fund Management Participants

City of Los Angeles Charter Amendment H

On March 8, 2011, voters in the City of Los Angeles voted to amend the City Charter by approving, among other amendments, Charter Amendment H. Generally, Charter Amendment H implements pay-to-play restrictions applicable to most City contractors, increases the City's existing pay-to-play restrictions on underwriting firms, and removes the cap on the City's public matching funds program for City candidates.[9] For purposes of this bulletin, only the provisions applicable to underwriting firms are discussed. Charter Amendment H applies to City contract solicitations issued on or after May 8, 2011.

Restrictions on Prospective Underwriting Contractors

Even before enactment of Charter Amendment H, the City Charter prohibited the City from awarding a non-competitively bid contract to an underwriting firm that gave gifts of $50 or more or political contributions of $100 or more to certain City officials within the 12 months prior to the award date. Charter Amendment H now prohibits underwriting

firms, their principals, subcontractors and subcontractors' principals from making any contributions to or fundraising for elected City officials, candidates or their committees within the 12 months prior to the award date. Underwriting firms must certify under oath that they will comply with and notify their principals and subcontractors of the prohibitions and disclose the names of their principals, subcontractors who are expected to receive at least $100,000 from their contract and those subcontractors' principals.

Any gift or contribution is considered having been made by the underwriting firm if it was made by the firm itself; any other business entity related as a parent, subsidiary or other relation; or any political action committee controlled or primarily financed by the firm or a related business entity. "Principals" of an underwriting firm are the firm's president, chairperson of the board, chief executive officer, and chief operating officer; any vice president, assistant vice president or managing director employed in the firm's public finance unit; any other individual who communicates with the City for purposes of influencing the City's selection of an underwriter for a participate bond issue; or any person owning 20 percent or more of the firm. "Principals" of a subcontractor are the firm's board chair, president, chief executive officer, chief operating officer or functional equivalent of those positions; any individuals having 20 percent or more ownership interest in the subcontracting firm; and any individual who communicates with the City to influence the City's selection of an underwriter for a particular bond issue.

Restrictions on Underwriting Contractors

Charter Amendment H amends the City Charter's existing laws that limit contributions by current underwriting contractors. Specifically, the City Charter had prohibited each underwriting firm for the noncompetitive sale of revenue bonds from giving gifts of $50 or more, or contributions of $100 or more, to City elected officials in the 12 months after the contract is signed. Charter Amendment H now extends this prohibition: to the firm's principals, subcontractors and subcontractors' principals; to gifts valued at an amount lower than $50 if set by ordinance;[10] to contributions to not only City elected officials, but also to candidates for City elective office; to eliminate the $100 political contribution threshold (so that all contributions are prohibited); and to include not only contributions, but also fundraising.

Penalties

A person who violates the provisions of Charter Amendment H may be subject to numerous penalties, including being deemed guilty of a misdemeanor, being held liable in a civil action for an amount up to $2,000 for each violation, and contract termination and debarment. In addition, any person who intentionally or negligently makes or receives a contribution or makes an expenditure in violation of any provision of Charter Amendment H will be liable in a civil action for an amount up to three times the amount of the unlawful contribution or expenditure.

Commonwealth of Pennsylvania Act 44

On Sept. 18, 2009, then-Gov. Edward G. Rendell signed Pennsylvania Act 44 into law. Among other provisions, Act 44 imposed pay-to-play and other restrictions on municipal pension system contractors and prospective contractors, which went into effect on Dec. 17, 2009.[11]

Pay-to-Play Restrictions

Under Pennsylvania's Act 44, no entity may enter into a professional services contract [12] with a municipal pension system if the entity made, within the past two years, a contribution to a Pennsylvania municipal official or candidate in the municipality which controls that municipal pension system.[13] Likewise, once it holds a contract, no professional services contractor or prospective contractor to a municipal pension system, and agents, officers, directors and employees of the contractor/prospective contractor may make or solicit a contribution to any municipal official or candidate where the pension system is organized, or their political party or political action committee.[14]

Gifts Prohibited

Professional services contractors to municipal pension systems may not offer or make any gift having more than a nominal value to any official, employee or fiduciary of a municipal pension system. This prohibition extends to the entity's affiliated entities, but not to its officers, directors, employees or owners.

Contribution Disclosure Requirements

Act 44 also requires contractors to disclose certain information to the municipal pension system with which it contracts. This information includes the following:

- Certain campaign contributions made to any elected official or candidate in the Commonwealth, or their committees, from the contractors or their affiliated persons[15] in the last five years;
- Information about the individuals who made the above contributions;
- Gifts made by the contractor or affiliated entity to an official or employee of the municipal pension system or the municipality which controls the municipal pension system;
- Employment or retention of third-party intermediaries, agents or lobbyists; and
- Any financial relationships between the contractor or affiliated entities and any official of the municipal pension system or the municipality which controls the municipal pension system.

Penalties

If a contractor knowingly makes a material misstatement or omission in a disclosure form required by Act 44, the municipal pension system must void the contract and bar the contractor from entering into a contract with the system for a period of up to three years. If a person submits a bid or proposal in violation of this debarment more than twice in a 36-month period, all contracts between that contractor and municipal pension system will be void and the contractor will be debarred for a period of at least three years from the date of the last violation.

Increasingly, state and municipal government agencies are regulating the government interactions and political contributions of investment advisers, placement agents and other participants in the multi-trillion dollar pension fund management business. As noted in the introduction, some pension systems, like Texas' Teacher Retirement System, have enacted their own specific policies. As a result of these laws and policies, those in

the pension management business may have new registration and reporting requirements, may be prohibited or limited in their political giving and the political giving of their key employees, and may be subject to a number of new ethics requirements. Therefore, it is critically important that persons and entities in the pension fund management business track, understand and comply with the campaign finance and lobbying laws and policies applicable to the pension funds with which they do business and seek to do business.

[1] For additional information regarding the SEC's pay-to-play rule, please see Drinker Biddle's publication, "SEC Adopts New Rule to Curb 'Pay-to-Play' Activity" at: http://www.drinkerbiddle.com/paytoplay/.

[2] For additional information regarding this opinion, please see Drinker Biddle's publication, "Investment Manager and Placement Agent Solicitation of New York City Pension Systems Now Regulated by Lobbying Law" at: http://www.drinkerbiddle.com/nycpensionsystem/.

[3] Parties that merely manage funds in which one or more City pension funds are currently invested and that do not seek to influence investment decisions of the pension system are not deemed lobbyists and do not need to register.

[4] The City of New York's e-Lobbyist website is: https://www.nyc.gov/portal/site/eLobbyist.

[5] A lobbyist-client is a party that lobbies on its own behalf and expends more than $2,000 annually in reportable compensation and expenses for such lobbying. A lobbyist-client must comply with the lobbyist filing requirements described above. In its Statement of Registration and other required filings, the lobbyist-client would include itself as both the lobbyist and the client. The lobbyist-client would not be required to file a Client Annual Report with respect to its lobbying activities; however, it would be required to file such a report concerning lobbying activities conducted on its behalf by a third-party lobbyist.

[6] The bi-monthly reporting periods are: 1) January 1 - last day of February; 2) March 1 - April 30; 3) May 1 - June 30; 4) July 1 - August 31; 5) September 1 - October 31; and 6) November 1 - December 31.

[7] Some City officials may voluntarily decide not to accept any campaign contributions from investment managers and their agents doing business with, or seeking to do business with, the New York City pension systems.

[8] For example, large local jurisdictions in California that regulate lobbying include, but are not limited to: City of Los Angeles, Los Angeles County, City of San Diego, San Diego County, City and County of San Francisco, City of Sacramento, and City of San Jose.

[9] As already noted, the City of Los Angeles also has lobbying laws affecting investment managers.

[10] According to guidance from the Los Angeles City Ethics Commission, the City Attorney's office is in the process of drafting an implementing ordinance to complement Charter Amendment H and such ordinance will be published on the Commission's website. This ordinance has not been published on the Commission's website as of July 14, 2011.

[11] Please note that the Commonwealth of Pennsylvania also has a disclosure-only pay-to-play law, at 25 P.S. 3260a, wherein certain contractors must disclose certain political contributions made by them and their affiliated persons.

[12] A "professional services contract" is a contract to which a municipal pension system is a party and is: 1) for the purchase of provision of professional services, including investment services, legal services, real estate services and other consulting services; and 2) not subject to a requirement that the lowest bid be accepted.

[13] Contributors covered by the Act are the entity itself and the entity's affiliates. The entity's "affiliates" are any of the following: subsidiary or holding company of lobbying firm or other business entity owned in whole or in part by a lobbying firm; or an organization under section 501(c) of the Internal Revenue Code of 1986 established by a lobbyist or lobbying firm or affiliated entity. Because of the effective date of the Act, the prohibition does not apply to contributions made before Dec. 17, 2009.

[14] A "prospective contractor" includes an entity that has applied for, submitted an offer or bid for, responded to a request for proposal on or otherwise solicited a professional services contract with a municipal pension system.

[15] An affiliated person is any officer, director, executive-level employee or owner of at least 5 percent of the person or affiliated entity. An executive-level employee is an employee who can affect or influence the outcome of the employing entity's actions, policies or decisions relating to pensions and the conduct of business with a municipality or municipal pension system or is directly involved in the implementation or development of policies relating to pensions, investments, contracts or procurement or to the conduct of business with a municipality or municipal pension system.

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