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Unveiling Pay-to-Play Arrangements

BUSINESS

By Keith Bishop

Recent news stories have focused on the existence of so-called "pay-to-play" arrangements at public employee pension funds. A pay-to-play arrangement exists when a fund official responsible for hiring fund advisers or making fund investments receives directly or indirectly some benefit from those seeking the fund's business. Because a direct bribe can be easily discovered, these benefits are often disguised and may flow from intermediaries known as "placement agents." Investment advisers and others seeking fund contracts or investments hire placement agents to help secure those deals. Pay-to-play arrangements raise serious questions about whether fund officials are making decisions in the public interest or in their own self-interest. Recently, the national and local press has featured front-page stories of allegations of pay-to-play arrangements at the California Public Employees Retirement System, known as CalPERS.

This month, Governor Arnold Schwarzenegger signed into law a bill, AB 1584, which imposes new disclosure and prohibitions with respect to placement agents. Because the bill was enacted as an emergency statute, it takes effect immediately.

A key new requirement is that the boards of all public employees pension or retirement systems in California will be required to develop and implement a policy requiring the disclosure of payments to placement agents in connection with system investments in or through asset management firms. Among other things, these policies must include a five-year solicitation ban on external asset managers and placement agents who violate a board's disclosure policy. The five-year ban may be reduced, however, by a majority vote of the board in open session. Boards must adopt and implement a policy before June 30 of next year.

Anticipating the gathering storm of concern, CalPERS adopted a statement of policy for disclosure of placement agent fees last May. CalPERS, however, failed to comply with the rulemaking provisions of California's Administrative Procedure Act when it adopted its policy. In September, I asked the California Office of Administrative Law for a determination that CalPERS' statement of policy was an "underground regulation." Under the Administrative Procedure Act, underground regulations cannot be enforced. I challenged CalPERS' statement of policy because I believed that the policy involves an issue of significant public interest (as evidenced by the substantial press attention to pay-to-play allegations at CalPERS and other public employee funds). Given the obvious public importance, CalPERS should not have gone underground and bypassed the Administrative Procedure Act's public notice and comment requirements. By doing so, CalPERS violated the principles of transparency and accountability that it preaches to corporations. AB 1584 does not absolve state boards, including CalPERS, from compliance with the Administrative Procedure Act when adopting disclosure policy statements. CalPERS should now come out of the shadows and give the public notice and an opportunity to comment on its disclosure policy statement.

AB 1584 also requires that before acting as a placement agent in connection with a potential system investment, intermediaries must disclose to the board all campaign contributions made to any elected member of the board as well as all gifts given to any board member in the preceding 24 months. Disclosure of any subsequent contributions or gifts is also required.

In addition to imposing disclosure requirements, the law prohibits any board member or board employee from, directly or indirectly, selling or providing any investment product that would be considered an asset of the fund to any public retirement system.

The Securities and Exchange Commission has also proposed regulations that are intended to address pay-to-play arrangements. Unlike CalPERS, the SEC acted openly by publishing these proposed regulations for public comment. If adopted as proposed, these regulations would apply to federally registered investment advisers and to certain unregistered investment advisers. State registered advisers would not be subject to the regulations as proposed. The regulations would prohibit investment advisers from providing advisory services to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. The regulations would also ban the use of third parties to solicit government business. The SEC is also proposing to prohibit advisers from soliciting from others, or coordinating, contributions to elected officials or candidates or payments to political parties when the adviser is seeking government business. Finally, the SEC has proposed record-keeping requirements with respect to political contributions made by the adviser or certain of its executives or employees.

The SEC justifies its proposals by citing numerous enforcement actions that it has already brought. It also cites criminal cases brought in several states involving pay-to-play allegations. Rather than support an argument for additional regulation, however, these facts suggest that no additional regulation is needed. If the both federal and state authorities are able to use existing laws to successfully prosecute pay-to-play, why is additional regulation required? Thus, it appears that the SEC's proposals represent nothing more than a desire to be seen as doing something in light of recent press attention to pay-to-play scandals.

The SEC's proposed regulations also violate the spirit of federalism. Ironically, the SEC's proposal cites examples of state laws, state regulations, county ordinances, and even city codes addressing pay-to-play. The SEC also cites successful state enforcement of existing law. By proposing to regulate these matters at the federal level, the SEC's proposal removes from state and local governments the ability to apply to themselves rules and principles that reflect their own particular circumstances and values.

Advisers and others seeking state public employee fund business will need to take immediate steps to ensure that they comply with the requirements of AB 1584. Public employee retirement system boards will also need to ensure that they meet the statutory deadline for adopting disclosure policies. Boards, moreover, must comply with the Administrative Procedure Act's rulemaking requirements when they adopt these policies. In doing so, they will not only be complying with the law, but they will be promoting transparency and good government.

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