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Marketing of Investment Advisers to Public Pension Plans: Achieving Transparency Through Lobbying Regulations?

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MARKETING OF INVESTMENT ADVISERS TO PUBLIC PENSION PLANS: ACHIEVING TRANSPARENCY THROUGH LOBBYING REGULATIONS?

Abstract

In the past decade, public pension plans and their outside investment advisers have been at the center of scandals involving bribery, blatant asset mismanagement, and widespread corruption. In response to this corruption, the U.S. Securities and Exchange Commission and many state legislatures have adopted laws addressing "pay-to-play," the custom of making political contributions or other payments to state or local officials in return for an opportunity to "play"—invest the public pension fund money. This Note examines certain pay-to-play legislation enacted by state and local governments seeking to regulate investment advisers and public pension plans through the promulgation of lobbying regulations. As such, the Note will provide an in-depth analysis of the laws arising from the original governmental bodies to create this type of pay-to-play: New York City and the State of California. The Note will examine this trend in other states and look at another layer of regulations, coming not from states, but from public pension plans themselves. Finally, this Note will discuss the transaction costs associated with this trend and propose a compliance protocol for investment advisers, laying out the most efficient method by which investment advisers can attempt to comply with the multitude of pay-to-play regulations.

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INTRODUCTION

In the past decade, public pension plans and their outside investment advisers have been at the center of scandals involving bribery, blatant asset mismanagement, and widespread corruption.[1] Public pension plans are among the largest investors[2] and, in the aggregate, control over $4.8 trillion in assets.[3] Given their size, importance, and "tens of millions of people who rely" on public pension plans, any corruption within or affecting public pension plans is a serious issue that must be addressed.[4]

In response to corruption, the U.S. Securities and Exchange Commission (SEC) and many states' legislatures have adopted laws addressing "pay-to-play," the practice of exchanging political contributions or other payments to state or local officials for an opportunity to "play"—manage and invest the public pension fund money.[5] More specifically, pay-to-play refers to various arrangements by which investment advisers may seek to influence the award of advisory business by making or soliciting political contributions to government officials charged with awarding such business.[6] The SEC's pay-to-play rule, SEC Rule 206(4)-5,[7] regulates SEC-registered investment advisers' political contributions to candidates, elected politicians, commissions, and

[1] *See, e.g.*, Imogen Rose-Smith & Ed Leefeldt, *Shadow Lands*, INSTITUTIONAL INVESTOR, Oct. 2009, at 44 (describing a six-month investigation into the "dark underworld" of public pension funds by way of backroom deals mixing political patronage, vast amounts of assets, and the lack of effective regulation that creates a corrupt situation); *Calpers Disclosure of Placement Fees Paid to Ex-board Member*, BLOOMBERG (Oct. 15, 2009), http://www.bloomberg.com/apps/news?pid=21070001&sid=a2MI8a3PJ.jk (describing *Institutional Investor*'s findings about the public pension plan allocation process as "everyone must pay-to-play .... This sinister game enriches those who play—the hedge fund and private equity managers, consultants, placement agents, pension officials and politicians—at the cost of taxpayers and pension beneficiaries."). *See generally Public Employee Retirement Systems*, AFSCME, http://www.afscme.org/union/retirees/resources/retiree-tools-and-information/public-employee-retirement-systems (last visited Jan. 12, 2014) (listing all public employee retirement systems).

[2] *Table: The 2012 largest retirement plans at a glance*, PENSIONS & INVESTMENTS (Feb. 6, 2012, 1:57 PM), http://www.pionline.com/article/20120206/INTERACTIVE/120209913/table-the-2012-largest-retirement-plans-at-a-glance.

[3] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS AND OUTSTANDINGS, FOURTH QUARTER 2013 82 tbl.L.118 (Dec. 9, 2013).

[4] *See, e.g.*, Rose-Smith & Leefeldt, *supra* note 1, at 42.

[5] *See, e.g.*, CAL. GOV'T CODE § 82047.3(c)(3) (West 2013); N.Y.C., N.Y., ADMIN. CODE § 3-211(c)(1) (2014); OHIO REV. CODE ANN. § 101.90 (West 2013); 17 C.F.R. § 275.206(4)-5 (2013) [hereinafter SEC RULE 206(4)-5].

[6] SEC RULE 206(4)-5.

[7] *Id.*

government committees. Importantly, SEC Rule 206(4)-5 does not preempt existing state and local pay-to-play rules.[8]

As SEC Rule 206(4)-5 does not preempt state and local rules, investment advisers marketing to public pension plans across states are left with the task of complying with an assortment of varying and inconsistent regulations.[9] This Note focuses on jurisdictions that have developed laws requiring investment advisers to register as lobbyists if they interact in certain ways with public pension plans. For instance, New York City and California require investment advisers to register as lobbyists and comply with the reporting requirements of relevant lobbying laws if they solicit investments from government pension plans.[10] Lobbying is defined by section 3-211(c)(1) of New York City's Administrative Code as an attempt to influence "any determination made by ... an officer or employee of the city with respect to the procurement of ... services ... including ... the solicitation, award, or administration of a contract ... involving the disbursement of public monies."[11] This lobbying definition has been interpreted to include the marketing of investment advisers to government pension plans.[12] Consequently, investment advisers may be subject to the registration requirements and regulations governing lobbyists.[13] This lobbyist definition does not comport with traditional conceptions of investment advisory firm employees and the role of legislative lobbyists.[14] The new lobbying laws also create additional compliance burdens for investment advisers, public pension plans, and

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[8] SEC Release No. IA-3043, File No. S7-18-09, *Political Contributions by Certain Investment Advisers* 146 (July 1, 2010), http://www.sec.gov/rules/final/2010/ia-3043.pdf [hereinafter SEC Release No. IA-3043].

[9] SEC RULE 206(4)-5.

[10] *See, e.g.*, CAL. GOV'T CODE § 82047.3(c)(3); N.Y.C, N.Y., ADMIN. CODE § 3-211(c)(1).

[11] N.Y.C., N.Y., ADMIN. CODE § 3-211(c)(1)(iii).

[12] Letter from Patrick Synmoie, Counsel to the City Clerk, Office of the City Clerk of New York City (Dec. 28, 2010), http://www.cityclerk.nyc.gov/downloads/pdf/cc-lobbying lawletter.pdf (claiming that certain financial services firms doing business with New York City's pension funds may be required to register as lobbyists).

[13] *Id.*

[14] Andrew P. Thomas, *Easing the Pressure on Pressure Groups: Toward a Constitutional Right to Lobby*, 16 HARV. J.L. & PUB. POL'Y 149, 149 (1993).

> The very word 'lobbying' unfailingly evokes images of furtive influence peddlers lurking in the lobbies outside congressional meeting places, awaiting their opportunity to pounce on defenseless elected officials and 'buttonhole'—the catchword of the lobby critic—them until they agree, however reluctantly, to sacrifice the public welfare to appease whatever special interest the lobbyist happens to represent that day.

Id. See generally U.S. v. Harriss, 347 U.S. 612, 618–19 (1954) (discussing the Federal Regulation of Lobbying Act and that it applies to persons whose principal purpose is "[t]he passage or defeat of any legislation by the Congress of the United States.").

enforcement agencies by broadening lobbyist definitions and expanding reporting requirements to investment advisers. As a result, these new lobbying laws unnecessarily complicate methods of monitoring and compliance by trying to liken investment advisers to traditional lobbyists.[15]

Labeling investment advisers as lobbyists is counterintuitive and unduly burdensome on investment advisers, placement agents, and public pension plans; however, this legislation is unlikely to be amended or overturned. This Note examines certain pay-to-play legislation enacted by state and local governments that target the suspect arrangements by which investment advisers may seek to influence the award of public pension plan assets through political contributions. As necessary background, the Note will provide an in-depth analysis of the laws arising from the original governmental bodies to create pay-to-play legislation regulating investment advisers marketing to public pension plans: New York City and the State of California. Examination of New York City and California's lobbying laws focuses on their clarity, relevant exemptions, efficiency, reporting requirements, and penalties. Through this review, each jurisdiction's strengths and weaknesses become readily apparent. Further, this analysis demonstrates the provisions that best achieve the purpose of regulating investment advisers, who seek investments from public pension plans.

Following the comparison of the New York City and California prototypes, the Note will provide a sampling of recent state statutes that attempt to regulate pay-to-play issues in their own way. After addressing these state laws, the Note will examine another layer of regulations, coming not from states, but from public pension plans themselves, illustrating the ever-growing complexity in this area. These self-imposed regulations govern the interaction between investment advisers and public pension plan officials. These many levels of regulations—federal, state, local, and pension plan—create a landscape so wrought with mandates that compliance becomes increasingly complex.

The multiple sources of regulation create uncertainty, resulting in high transaction costs and inefficient disclosures. First, it has become difficult for investment advisers to fully understand and keep up with the regulatory environment. This uncertainty in the law results in increased legal and compliance fees, and therefore increases transaction costs.[16] Second, the enhanced

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[15] Thomas, *supra* note 14, at 154–55 (describing the reporting requirements of the Lobbying Act, which require traditional lobbyists to "divulg[e] the minutiae of contributions and expenditures....").

[16] *See generally* Gary Slater & David A. Spencer, *The Uncertain Foundations of Transaction Cost Economics*, 34 J. ECON. ISSUES 61, 61 (Mar. 2000) ("Uncertainty is a core assumption in transaction cost theory.").

reporting requirements require information specific to traditional lobbyists and not that of investment advisers, thus creating increased reporting requirements that are not as applicable to investment advisers marketing to public pension plans. Third, the increased reporting requirements necessitate an increase in expenditures and resources by public pension plans to monitor the influx of lobbyist reports and other immaterial information. Thus, these laws create uncertainty and increase reporting requirements, while still failing to enhance transparency in the public pension plan allocation process.

Due to these resulting transaction costs, regulating investment advisers under the umbrella of lobbyists is not the most efficient solution to increase transparency in investment adviser and pension plan interactions. Rather, these regulations dilute the flow of meaningful information and increase transaction costs to the detriment of public employees: the intended beneficiaries of public pension plans. While the current regulatory system is inefficient, it is unlikely to change. Therefore, after analyzing the transaction costs associated with these regulations, this Note will propose a compliance protocol for investment advisers, laying out the most efficient method by which investment advisers can attempt to comply with the multitude of pay-to-play regulations.

I. PENSION PLAN CORRUPTION AND THE ORIGINS OF PAY-TO-PLAY LEGISLATION

A. Overview

Pay-to-play legislation concerning investment advisers and public pension plans, and the promulgation of similar laws across the country, is the result of highly publicized scandals showcasing high-stake bribes, disregard for rules, inefficient regulatory oversight, and blatant abuse of government power. Due to their significant amount of assets,[17] managing public pension plans assets is highly coveted and sought after among investment advisers.[18] These conditions inevitably create an environment prone to corruption.

Investment advisers marketing to public pension plans have become subject to government pay-to-play regulations. The public pension plans' employees, who are charged with managing pension plan assets, are considered government officials under certain lobbying laws.[19] These government employees often have the sole discretion to select investment advisers, who then make investment decisions for government public plans.[20] As governmental

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[17] *See supra* note 3 and accompanying text.

[18] SEC Release No. IA-1812; File No. S7-19-99, *Political Contributions by Certain Investment Advisers* (Aug. 5, 1999), http://www.sec.gov/rules/proposed/ia-1812.htm#foot36.

[19] *See, e.g.*, Letter from Michael A. Cardozo, N.Y. Corporation Counsel, to Michael McSweeney, N.Y. City Clerk 1 (Mar. 31, 2010), http://www.cityclerk.nyc.gov/downloads/pdf/placmentagents.pdf.

[20] *Id.* at 1–2 (discussing the governance structure of New York City's five pension plans).

officials are authorized to allocate a certain amount of public pension plan assets to alternative investment advisers, such as hedge funds and private equity funds, this allocation of government money qualifies as government activity. Therefore, marketing by investment advisers to public pension plans, in some jurisdictions, qualifies as an activity that is subject to lobbying regulations because such marketing necessarily includes engaging with government officials with respect to government activity.[21]

Pension plan governance structure has been ineffective in mitigating scandals stemming from bribery.[22] In New York City, only one elected official is responsible for managing the pension plans,[23] whereas some states, such as California,[24] have a board of trustees who are appointed, and thus are considered elected officials.[25] Pension plans in both jurisdictions, however, have been the subject of scandals.[26] This dynamic is problematic because it reveals that governance structure is not effective, and rather, elected officials allow outside factors to influence their selection process and reward contributors with access to public pension plan assets.[27] Scandals surrounding misallocation and corruption of pension plan assets highlighted the need for accountability and transparency in the government pension plan allocation process and triggered the onset of the regulations analyzed in this Note.[28] While regulations are necessary to enhance accountability in the government pension fund allocation process, these regulations should be scrutinized and analyzed for their effectiveness because the management of these assets affects taxpayers and beneficiaries of the retirement systems, as well as publicly held companies[29] and the securities markets.[30]

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[21] Dealbook, *Hevesi Is Expected to Plead Guilty in Pension Case*, N.Y. TIMES (Sept. 29, 2010), http://dealbook.nytimes.com/2010/09/29/hevesi-is-expected-to-plead-guilty-in-pension-case-2/ [hereinafter Dealbook].

[22] *See infra* Part I.B.

[23] Op-Ed., *It's Time to End Pay For Play*, NEWSDAY, Mar. 22, 2009, at A32.

[24] *Id.*

[25] *See generally id.* "Whether New York should change its sole trustee arrangement needs to be examined. What doesn't need to wait is campaign financing. Not needing millions of dollars to run reduces the temptation to abuse the office." *Id.*

[26] *Id.*

[27] *See, e.g.*, Rose-Smith & Leefeldt, *supra* note 1.

[28] For instance, Alan Hevesi, former New York state comptroller, pled guilty to a felony count for taking $1 million in gifts, including foreign travel arrangements and campaign contributions, from a California money manager. Hevesi, as sole trustee of the pension fund, granted $250 million of New York pension assets to the California money manager. *See* Dealbook, *supra* note 21.

[29] SEC Release No. IA-3043, *supra* note 8, at 5–13 (citing Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 317 (2008)).

[30] SEC Release No. IA-3043, *supra* note 8, at 5–13 (citing BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES,

B. Scandals Illustrate Need for Transparency

Public pension funds have certain key elements that render them susceptible to corruption: they control a significant amount of assets, they are a highly coveted investment resource for investment advisers, and the officials and regulatory entities charged with their oversight lack sufficient resources. Corruption across the country involving government pension plans and investment advisers demonstrated the need for increased regulations, oversight, and transparency.[31] New York State Common Retirement Fund (NYSCRF), a state government pension plan, became mired with controversy and served as the catalyst to create pay-to-play regulations that require investment advisers to register as lobbyists.[32] Alan Hevesi, former New York State Comptroller, sought investments from other public funds for a private equity fund based in California run by his friend and political campaign supporter, Elliott Broidy.[33] Through his wife, Elliot Broidy made thousands of dollars in political contributions to officials with oversight authority of public funds, including Hevesi.[34] Hevesi, as sole trustee of the pension fund, granted $250 million of New York pension assets to the California money manager.[35] Ultimately, Hevesi pled guilty to a felony count for taking $1 million in gifts, including foreign travel arrangements and campaign contributions.[36] Further, other investment firms have agreed with New York Attorney General Andrew Cuomo to pay fines in connection to fees paid to third parties, who acted as conduits and solicited business with NYSCRF.[37]

As a result of the scandal, when the succeeding New York State Comptroller took office, increasing transparency and heightening anti-corruption efforts became a top priority.[38] NYSCRF, under the control of Comptroller

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FLOWS AND OUTSTANDINGS, FOURTH QUARTER 2009, 78 tbl.L.119 (Mar. 11, 2010)). One and a half trillion U.S. dollars is invested in corporate equities. *Id.*

[31] *Lobbyist Regulations' Impact on Investment Managers—California, New York and Beyond*, SIDLEY AUSTIN LLP 1 (Feb. 1, 2011), http://www.sidley.com/files/News/a6105e8a-8770-44ec-9341-87cdaab80ac4/Presentation/NewsAttachment/7fa3c04a-6373-41d4-5ef-d272250eaa53/Investment%20Funds_02.01.11_Lobbyist%20Regulations%20Impact.pdf [hereinafter SIDLEY AUSTIN].

[32] *Id.*

[33] Dealbook, *sup*ra note 21.

[34] Rose-Smith & Leefeldt, *supra* note 1.

[35] Dealbook, *supra* note 21.

[36] *Id.*

[37] *SEC Looked to Muni Rules in Writing Placement Ban*, PE MANAGER (Aug. 8, 2009), *available at* http://www.privateequitymanager.com/Article.aspx?aID=0&article=4 4800.

[38] Press Release, Thomas P. DiNapoli, Comptroller, Office of the N.Y. State Comptroller, Statement on Hevesi Sentencing (Apr. 15, 2011), *available at* http://www.osc.state.ny.us/press/releases/apr11/041511.htm ("Since taking office, I have changed the

Thomas DiNapoli, adopted very conservative pay-to-play rules. These rules are not state regulated, but rules adopted by the NYSCRF.[39] First, NYSCRF banned pay-to-play practices, which prohibits NYSCRF from doing business with any investment adviser who has made a political contribution to the State Comptroller or a candidate for State Comptroller.[40] The ban parallels SEC Rule 206(4)-5 and its subsequent regulations. This ban lasts for two years from the date of the contribution.[41] Second, NYSCRF bans the use of placement agents, registered lobbyists, and other paid intermediaries soliciting investments.[42] A placement agent or a paid intermediary is a firm or person hired by investment advisers to connect investment advisers with potential investors. A placement agent or paid intermediary's pay is usually contingent upon the successful matching of investors with investment advisers. The ban also includes entities compensated on a flat fee, a contingent fee, or any other basis.[43]

A scandal similar to NYSCRF and subsequent enactment of pay-to-play legislation occurred in California. A former top official of California Public Employees' Retirement System (CalPERS), Frederico Buenrostro, was charged by the SEC with defrauding the pension plan into paying $20 million to a private equity firm represented by his friend.[44] In this case, CalPERS, was "victimized by its own board member in a clever pay-to-play scheme,"[45] in which Buenrostro conspired to scam "the pension fund into paying millions of dollars in fees for a $3 billion investment" deal.[46] The SEC successfully argued that Buenrostro created documents to make Apollo Global Management, a private equity firm, believe that CalPERS had approved the payments to Buenrostro's friend.[47] The scheme revealed inadequacies

way the pension fund does business so history cannot repeat itself. I have banned placement agents and pay-to-play practices, and I have increased transparency in pension fund transactions. But there is more that can be done.").

[39] *Pension Reforms*, OFFICE OF THE N.Y. STATE COMPTROLLER, https://www.osc.state.ny.us/pension/reform.htm# (last visited Jan. 12, 2014).

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] These rules will be discussed in depth in Part III.B.1.

[44] Peter Lattman, *S.E.C. Charges Former Calpers Chief with Fraud*, N.Y. TIMES (Apr. 23, 2012, 5:50 PM), http://dealbook.nytimes.com/2012/04/23/s-e-c-files-fraud-charges-against-former-calpers-chief/.

[45] *Today's Calpers Scandal Only Latest Chapter in Story of Corruption in the Public Fund Industry; Magazine Calls Lawmakers to Action to Eliminate Pay-to-Play*, BLOOMBERG (Oct. 15, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5xSGl3ZJBuQ.

[46] Karen Gullo & Michael B. Marois, *Ex-Calpers CEO Buenrostro Indicted Over Apollo Investment*, BLOOMBERG (Mar. 19, 2013, 12:01 AM), http://www.bloomberg.com/news/2013-03-18/ex-calpers-ceo-buenrostro-indicted-over-apollo-investment.html.

[47] *Id.*

in the pension plan's asset allocation process. As a result of the scandal, CalPERS co-sponsored a bill that increased disclosure requirements and bans on payments to intermediaries and lobbyists.[48]

Pay-to-play scandals across the country reveal that corruption and bribery are national and systemic problems. In Ohio, the Chief Financial Officer of the Ohio Bureau of Workers' Compensation misallocated $19 billion due to bribes and "gifts" from placement agents.[49] Some of these "gifts" came in the form of payments towards his child's college "tuition and use of a luxury condominium in Florida."[50] This scheme illustrates the craftiness and extent to which placement agents and money managers will go to attain investment management positions from public pension plans.[51] As "pay-to-play casts its shadow nationwide"[52] and similar scandals occurring in Texas and New Mexico further demonstrate, the investment adviser and government pension plan relationship is conducive to corruption.[53]

C. Overview of Pay-to-Play: SEC Rule 206(4)-5

In July 2010, in response to the scandals discussed above, the SEC adopted Rule 206(4)-5, pay-to-play regulation that bans political contributions by SEC-registered investment advisers to candidates running for positions that could influence the allocation of public pension funds.[54] These regulations were adopted to regulate how investment advisers interact with government personnel.[55] Pay-to-play rules apply to government pension plans because certain pension plan personnel are considered government officials.[56] Thus, the SEC pay-to-play rule sought to regulate the ways in which investment advisers, or any other person, doing business with public pension plans may operate with respect to solicitation of investment opportunities.

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48 *Cuomo's Pay-To-Play Saga Comes Full Circle*, PE MANAGER (May 2, 2011), *available at* http://www.privateequitymanager.com/Article.aspx?aID=0&article=60825.

49 Rose-Smith & Leefeldt, *supra* note 1, at 41.

50 *Id.* at 42.

51 *Id.* at 42.

52 Rose-Smith & Leefeldt, *supra* note 1, at 41.

53 *See, e.g.*, James Drew, *State Veils Peddling of Pension Investments*, DALL. MORNING NEWS, July 22, 2012, *available at* 2012 WLNR 15347567 (discussing a scandal in Texas); Rose-Smith & Leefeldt, *supra* note 1, at 77 (discussing a civil suit filed in New Mexico, in which "the former CIO of the $8.5 billion New Mexico Educational Retirement Board … has risen from obscurity by filing two 'whistle blower' lawsuits, both alleging that allies of New Mexico Governor Bill Richardson had pressured the ERB into making investment decisions 'tainted by political considerations and contributions.'").

54 SEC Release No. IA-3043, *supra* note 8, at 26–29, 202.

55 *Id.* at 11–19.

56 *Id.* at 6. *See also supra* Part I.A (explaining why the marketing of investment advisers to government pension plans is considered government official activity).

The SEC Rule 206(4)-5 contains three significant prohibitions: (i) a two-year prohibition on any adviser providing compensated services to a government entity following a political contribution to certain officials of that entity;[57] (ii) a prohibition on using third-party solicitors;[58] and (iii) a prohibition on bundling, coordination, or other organizational efforts by advisers to solicit political contributions for certain officials of a government entity to which the adviser is seeking to provide services.[59]

SEC Rule 206(4)-5 contains certain exceptions that make the pay-to-play regulations more appropriate for investment advisers,[60] particularly the de minimis exception and the exception for new employees.[61] Nonetheless, if an investment advisor falls under one of these exceptions, SEC Rule 206(4)-5 contains a requirement to report these exceptions by amending the annual ADV.[62] The de minimis exception creates an exception for contributions under $350.[63] This exception applies to officials that the covered associates[64] are entitled to vote for at the time of contribution at each election. A separate $150 de minimis exception applies to officials that the covered associates are not entitled to vote for at the time of the contribution.[65] The exception for certain new employees excludes employee contributions more than six months prior to becoming a covered associate.[66] If investment

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57 SEC Rule 206(4)-5(a)(1).

58 SEC Rule 206(4)-5(a)(2)(i). Third-party solicitors are not regulated persons and therefore not subject to pay-to-play restrictions on political contributions.

59 SEC Rule 206(4)-5(a)(2)(ii).

60 SEC Release No. IA-3043, *supra* note 8, at 195–96.

61 SEC Rule 206(4)-5(b)(1), (b)(2).

62 SEC Rule 206(4)-5(b)(3)(ii). *See generally Form ADV*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/formadv.htm (last visited Jan. 12, 2014) ("Form ADV is the uniform form used by investment advisers to register with both the Securities and Exchange Commission (SEC) and state securities authorities. The form consists of two parts. Part 1 requires information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees.... Beginning in 2011, Part 2 requires investment advisers to prepare narrative brochures written in plain English that contain information such as the types of advisory services offered, the adviser's fee schedule, disciplinary information, conflicts of interest, and the educational and business background of management and key advisory personnel of the adviser.").

63 SEC Rule 206(4)-5(b)(1).

64 SEC Rule 206(4)-5(f)(2) (defining "covered associate" as: "(i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any of its covered associates").

65 SEC Rule 206(4)-5(b)(1).

66 SEC Rule 206(4)-5(b)(2). This exception is narrowly construed and states that it does not apply to employees, who after becoming a covered associate, solicit clients on behalf of the investment adviser.

advisers choose to rely upon the above exceptions, they must disclose the contributions that fall under the exceptions by amending the Form ADV.[67] The reporting requirement through the Form ADV implements additional restrictions that limit reliance on this exception for many investment advisers and adds another layer of transactional costs.[68]

SEC Rule 206(4)-5 does not preempt existing state and local pay-to-play rules and does not impose additional reporting requirements. In fact, the only SEC reporting requirement with regard to pay-to-play rules is a requirement to update the Form ADV amendments.[69] SEC Rule 206(4)-5 is silent regarding the requirement for investment advisers to report or register with localities and states disclosing campaign contributions. Because the rule does not preempt state and local pay-to-play rules, advisers not only must comply with general pay-to-play rules, but also with state and local regulations applying to investment advisers soliciting plans from public pension plans. The enactment of state and local lobbyist regulations fills the void of disclosure, as discussed below, but the variation and lack of guidance creates increased transaction costs, and skews market efficiency. Furthermore, these regulations will lead to a flood of information and materials that will more than likely overburden the regulatory agencies and public pension plans tasked with their review.[70] As a result, the regulations achieve an opposite effect, in which the regulatory agencies and pension plans are clogged with inapplicable information that will likely hinder their review of truly material issues.

II. ORIGINS OF LOBBYING DEFINITIONS TO INCLUDE INVESTMENT ADVISERS MARKETING TO PUBLIC PENSION PLANS

As discussed above, scandals involving public pension plans and investment advisers revealed the rampant abuse of power and the innovative

[67] *Form ADV*, *supra* note 62.

[68] SEC Rule 206(4)-5(b)(3)(ii). ("In any calendar year, an investment adviser that has reported on its annual updating amendment to Form ADV (17 CFR 279.1) that it has more than 50 employees is entitled to no more than three exceptions pursuant to paragraph (b)(3)(i) of this section, and an investment adviser that has reported on its annual updating amendment to Form ADV that it has 50 or fewer employees is entitled to no more than two exceptions pursuant to paragraph (b)(3)(i) of this section.").

[69] *Form ADV*, *supra* note 62.

[70] *See* SEC Release No. IA-3043, *supra* note 8, at 162 (discussing the recordkeeping requirements of the SEC's pay-to-play rule and the resulting burden on investment advisers). While the SEC Release explicitly addresses whether the pay-to-play rule complies with the Paperwork Reduction Act, the state and local laws do not make reference to the Paperwork Reduction Act or any parallel state law. The SEC Release only addresses the burdens of the SEC pay-to-play rule. This Note looks beyond SEC Rule 206(4)-5 and addresses the multiple other levels of regulations imposed on investment advisers, illustrating that, taken as a whole, pay-to-play regulations on investment advisers are truly over-burdensome.

(yet illegal) methods used to win control of public pension plan assets. While SEC Rule 206(4)-5 bans certain pay-to-play practices, it does not impose enhanced reporting requirements to increase transparency. This section will analyze the laws of the first two jurisdictions to address pay-to-play through legislation, New York City and the State of California. New York City is particularly important because New York City is the center of global finance[71] and thus sets the tone for market norms. The State of California has one of the largest public pension funds,[72] and thus has a strong vested interest in its regulation. The starting point for regulations by both New York City and California is an enlarged definition of the term "lobbyist" so that certain investment adviser activities related to public pension plans fall within its scope.[73] This section will analyze each jurisdiction's definition of lobbyist, registration and reporting requirements, lobbyist prohibitions, and penalties for noncompliance. Through analysis of both jurisdictions, their differences in approach become apparent. After this introduction to each jurisdiction's definitions and regulations, a side-by-side comparison of select provisions of the New York City and California prototypes illustrates the problematic ambiguities and conflicts among the various laws.

A. New York City

1. Lobbyist Definition

New York City implemented regulations to increase oversight and transparency that ultimately require certain investment advisers to register as lobbyists. Investment advisers who market to New York City pension plans[74] now fall within the scope of New York City's enlarged definition of lobbyist. Section 3-211(c)(1) of New York City's Administrative Code defines lobbying as any attempt to influence "any determination made by ... an officer or employee of the city with respect to the procurement of ... services ... including ... the solicitation, award, or administration of a contract ... involving the disbursement of public monies."[75] The definition excludes

[71] Alison Fitzgerald, *New York Eclipses London as Financial Center in Bloomberg Poll*, BLOOMBERG (Oct. 29, 2009), http://www.bloomberg.com/apps/news?pid=21070001&sid=aEC0OYmvvcZM.

[72] SIDLEY AUSTIN, *supra* note 31, at 1.

[73] *Id.* at 7.

[74] New York City's pension plans are as follows: (i) the New York City Employees' Retirement System (NYCERS); (ii) the New York City Police Pension Fund (PPF); (iii) the New York Fire Department Pension Fund (FDPF); (iv) the New York City Teachers' Retirement System (TRS); and (v) the New York City Board of Education Retirement System (BERS). *See, e.g.*, *supra* note 19.

[75] N.Y.C., N.Y., ADMIN. CODE § 3-211(c)(1) (2014).

"prospective contractors who communicate with ... city contracting officers or employees in the regular course of ... the contractor selection process."[76] This exception is limited to personal communications or appearances by either an employee charged with the responsibilities related to contracts or persons who provide technical or professional services; it does not apply to those in the regular course of business.[77] The law also strictly forbids exempt individuals from making contact with "elected officials or their deputies" during the selection processes.[78]

New York City's definition of lobbyist leaves many ambiguities, particularly with respect to whether it includes investment adviser firm personnel. Although the provisions of the New York City law could be interpreted to exclude investment sales activities directed at pension funds, certain relevant governmental authorities, including the Office of the City Clerk and the Corporation Counsel, stated even normal investment adviser activities that involve any communication with public pensions funds could require registration under the City's lobbying law.[79] Further, the lobbying law applies to third-party placement agents and to employees of investment firms when they attempt to influence government investment decisions.[80] There is a lack of clarity and guidance regarding what is meant by "attempt to influence."[81] Other ambiguities arise from Advisory Opinions issued by New York City's Lobbying Bureau,[82] which also suggest "normal sales activities could ... require[] registration under the City's law."[83] As described below, among other regulatory burdens placed on investment adviser personnel, lobbyist regulations create additional registration and reporting burdens. These reporting burdens coupled with ambiguities in New York City law result in increased transaction costs.

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[76] § 3-211(c)(3)(vi)(A).

[77] *See id.*

[78] Jake Simpson, *Pension IAs Face Lobbyist Label, Burden*, COMPLIANCE REPORTER 1, 11 (April 25, 2011), http://www.iinews.com/site/rss/CR042511.pdf ("'In some cases the deputy officials or the officials themselves may appear at a final presentation even if the negotiations were conducted by their staff, and it's unclear if that would negate the exemption,' said Edward Pittman, partner with Dechert.").

[79] Applies to "persons who attempt to influence determinations of the boards of trustees of the City's five pension funds about investments of the pension funds." *See* Letter from Patrick Synmoie, *supra* note 12.

[80] *Id.*

[81] N.Y.C., N.Y., ADMIN. CODE § 3-211(c)(1). *See also* Letter from Patrick Synmoie, *supra* note 12.

[82] *See* N.Y.C. Office of the City Clerk Op. 2011-2, http://cityclerk.nyc.gov/html/lobbying/2011-2.shtml (last visited Jan. 12, 2014); N.Y.C. Office of the City Clerk Op. 2011-3, http://cityclerk.nyc.gov/html/lobbying/2011-3.shtml (last visited Jan. 12, 2014).

[83] SIDLEY AUSTIN, *supra* note 31, at 7.

2. *Registration and Reporting Requirements*

Pursuant to section 3-213 of the New York City Administrative Code, lobbyists must file statements of registration annually.[84] The statement of registration has an income and expenditure threshold.[85] Specifically, the regulation does not require "any lobbyist who in any year does not expend, incur or receive an amount in excess of five thousand dollars of reportable compensation and expenses ... for the purposes of lobbying."[86] As the $5,000 threshold is to be applied cumulatively to expenditures and compensation related to all an investment adviser's clients, the threshold is quite low given the expenses and compensation associated with marketing to any of New York City's five pension plans.[87] For example, throughout the course of fundraising and marketing to investors, including pension plans, investment adviser employees will undoubtedly encounter expenses, including travel costs to and from meetings, lodging requirements, meals, etc.

Individuals who reasonably anticipate reaching the $5,000 compensation threshold by December 15th must register for the upcoming year and must comply with ongoing reporting requirements.[88] The term "reportable compensation" is not defined in the Administrative Code. While "reported compensation" is not defined, "compensation" is defined as "any salary, fee, gift, payment, subscription, loan, advance or anything of value paid, owed, given or promised by the client to the lobbyist for the purpose of lobbying."[89] Under section 3-216 lobbyists must file periodic reports including: (i) up to six bi-monthly Periodic Reports; (ii) Lobbyist Annual Report; (iii) up to six Fundraising/Political Consulting Reports; and (iv) Termination Report(s).[90] Therefore, once an investment adviser meets the relatively low $5,000 threshold, he is subject to a slew of burdensome reporting requirements.

3. *Lobbyist Prohibitions—Contingent Compensation, Gifts, and Payments*

New York City regulations prohibit contingent compensation—compensation that is dependent upon whether public pension plan assets are

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[84] N.Y.C., N.Y., ADMIN. CODE § 3-213(a)(1).

[85] *Id.*

[86] *Id.*

[87] N.Y.C., N.Y., ADMIN. CODE § 3-211(f).

[88] N.Y.C., N.Y., ADMIN. CODE § 3-213(a)(1). As of January 1, 2014, New York City Administrative Code has increased the threshold from $2,000 to $5,000.

[89] N.Y.C., N.Y., ADMIN. CODE § 3-211(e).

[90] N.Y.C., N.Y., ADMIN. CODE § 3-216(a)(1), (2)-(b)(3), (4).

awarded.[91] This prohibition directly bans placement agents[92] from taking contingency fees when doing business with New York City pension plans. The contingent compensation prohibition is clearly targeted at placement agents and does not apply to salaried investment adviser employees.[93] With respect to gifts and payments, New York City prohibits any person required to register as a lobbyist from giving or offering to give a gift to any public servant.[94] The terms "payment" and "gift" include anything that has "any value whatsoever, whether in the form of money, service, loan, travel, entertainment, hospitality, thing or promise, or in any other form."[95] As in most jurisdictions, even jurisdictions that have not enacted specific pay-to-play legislation, gifts to public officials are prohibited. The analysis of gift policy will not be a focus of this Note.

4. Penalties

Most investment advisers dealing with New York City pension plans will likely act conservatively and preemptively register, in order to ensure compliance with lobbyist disclosure reporting regulations. Even the threat of a legal proceeding or violation of regulatory laws creates reputational damage and hinders sales activities.[96] If an investment adviser or its personnel fail to comply with the lobbying laws, they are subject to penalties. A knowing or willful violation is considered a Class A misdemeanor and subject to civil penalty of up to $30,000 and/or subject to an order to cease all lobbying activities for up to sixty days.[97] Failure to file a Statement of Registration pursuant to section 3-213 is also a Class A misdemeanor and subject to a civil penalty of up to $20,000.[98] The monetary penalty is certainly consequential and serves as a deterrent; however, the cessation of lobbying activities and

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[91] *See* N.Y.C., N.Y., ADMIN. CODE § 3-218 ("No client shall retain or employ any lobbyist for compensation, the rate or amount of which compensation in whole or in part is contingent or dependent upon legislative, executive, or administrative action where efforts by a lobbyist to influence such action are subject to the jurisdiction of the city clerk, and no person shall accept such a retainer or employment.").

[92] *See* SIDLEY AUSTIN, *supra* note 31, at 7.

[93] Placement agents are paid when they successfully "place" investors with investment advisers. Placement agents are paid a "finder fee" that is contingent upon the successful matching of an investor and an investment adviser.

[94] *See, e.g.*, N.Y.C., N.Y., ADMIN. CODE § 3-225.

[95] N.Y.C., N.Y., Rules, 53 Tit. § 1-16(b)(5) (2012).

[96] *See* SIDLEY AUSTIN, *supra* note 31, at 7. "Because a proceeding against a firm for failing to register could hinder sales activities to the City's pension boards, registration may be advisable." *Id.*

[97] *See, e.g.*, N.Y.C., N.Y., ADMIN. CODE § 3-223(a).

[98] *Id.*

reputational damage likely to ensue are the more significant factors investment advisers will consider in complying with New York City's lobbying laws.[99] The prospect of reputational damage and a civil penalty, together, renders compliance with the reporting requirements a cost of doing business for these investment advisors.

B. California Law

1. Definition of Lobbyist

California amended its existing lobbying laws such that placement agents and investment advisers marketing to any of California's state public retirement plans[100] may fall under California's definition of lobbyist.[101] California expanded the definition of the term "placement agent" and treats such individuals or entities as lobbyists for certain purposes.[102] Individuals, including internal investment manager personnel, and entities that are involved in soliciting or finding investment management business, including fund investments, from California state public retirement systems are thus subject to California's state lobbying laws and regulations.[103] California's lobbyist definition includes two categories of covered persons: placement agents and investment manager personnel.[104] A placement agent is any person hired or engaged on behalf of an external manager or another placement agent, who earns compensation as a type of "finder, solicitor, marketer, consultant, broker or other intermediary" in connection with any type of sale of securities either, directly or indirectly.[105] With respect to investment manager personnel, its definition includes all employees "w*hose activities include soliciting or marketing* to California public retirement systems and to third party investment managers who manage certain investment funds of which

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[99] *See generally* Greg Wolski & Virginia Adams, *Anti-corruption Considerations for Private Equity Firms*, ERNST & YOUNG, *available at* https://www.yumpu.com/en/document/view/12410162/anti-corruption-considerations-for-private-equity-firms-ernst-young (last visited Jan. 12, 2014) (discussing reputational risks associated with corruption).

[100] State public retirement plans include CalPERS, CalSTRS, and the University of California pension system. *See* SIDLEY AUSTIN, *supra* note 31, at 2.

[101] CAL. GOV'T CODE § 82047.3(a) (West 2013).

[102] *Id.*

[103] *Lobbyist Laws May Significantly Impact Marketing of Funds and Advisory Services to California and New York City Plans in 2011*, SCHULTE ROTH & ZABEL LLP 1 (Feb. 3, 2011), http://www.srz.com/files/News/adc95517-90e6-4cc3-9201-36153ba4f951/Presentation/NewsAttachment/e8af7c80-49fb-47c0-b191-364d7f12c6a4/020311_Lobbyist_Laws_May_Significantly_Impact_Marketing_of_Funds_and_Advisory_Services.pdf.

[104] *See* SIDLEY AUSTIN, *supra* note 31, at 2. This varies from New York City's definition of lobbyist, which has a separate categorization for placement agents.

[105] *Id.* at 2 (quoting CAL. GOV'T CODE § 82047.3(a) (West 2013)).

public pension funds are majority owners."[106] On its face, the definition of lobbyist, by possibly expanding to include placement agents and investment manager personnel, includes any employee who participates in any soliciting or marketing activity directed at government.

Despite the explicit list of the types of personnel who may be "covered" by the lobbying laws, the law does not clarify which activities constitute solicitation or marketing. In turn, this lack of clarification creates ambiguity in determining who is a "covered" person. Materials published by the California Fair Political Practices Commission (FPPC) emphasize that business or investment contact between investment adviser employees and state public retirement system personnel is a key criterion for determining what activity is covered.[107] Yet the FPPC guidance still leaves ambiguities, and neither the statute nor legislative history provides clarification of the level or type of contact that would render an individual to be "soliciting" or "marketing."[108] Confusion arises in determining whether contact is merely official in nature, and whether contact that occurs to responses to due diligence inquiries qualifies as soliciting or marketing. As such, employees whose principal responsibilities involve sales, marketing, or investor relations most likely qualify as "covered," such that they qualify as lobbyists under the regulation as soon as they begin contacting state public retirement system personnel in any way that relates to potential business.[109] Organizations, whose employees are "covered" by the lobbying laws, are deemed a "Lobbyist Employer"[110] and must comply with regulations for "Lobbyist Employers."[111] This is yet another layer of compliance that further increases transaction costs.

2. Registration and Reporting Requirements

California's law contains reporting requirements that further complicate compliance with various pay-to-play regulations.[112] Individuals who are

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[106] *Id.* at 2 (emphasis added); CAL. GOV'T CODE § 82047.3(a) (West 2013).

[107] *See, e.g.*, The Lobbying Provisions of the Political Reform Act, Cal. Fair Political Practices Comm'n Asst. Gen. Counsel Op. 11-1031 4 (Apr. 20, 2011), http://www.fppc.ca.gov/index.php?id=545&zoom_query=lobbyists+contact+public+retirement+system+personnel&zoom_cat=21&zoom_per_page=10&zoom_and=0&zoom_sort=0 (click on document "11-031").

[108] *See* Placement Agents, 2010 Cal. Legis. Serv. Ch. 668 (A.B. 1743) (West), *available at* http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=200920100AB1743&search_keywords=; Cary J. Meer et al., *California Regulates Investment Managers' Placement Agents and Solicitors as Lobbyists*, K & L GATES 2 (Nov. 2010), http://m.klgates.com/files/Publication/fd5d02d6-dda1-4c15-bb4c-01181806bb70/Presentation/PublicationAttachment/7b06f446-2656-4eb6-a085-0af45ac5d8ef/IM_alert_111710.pdf.

[109] *See* SIDLEY AUSTIN, *supra* note 31, at 2.

[110] *See, e.g.*, CAL. GOV'T CODE § 82039.5(a)–(b) (West 2013).

[111] *See Form 635, Report of Lobbyist Employer and Report of Lobbying Coalition*, CAL. SEC'Y OF STATE, http://www.sos.ca.gov/prd/forms/form-635.pdf (last visited Jan. 12, 2014).

[112] *See* CAL. GOV'T CODE § 82039.5(a).

lobbyists must file quarterly reports—Form 615[113]—to their employers within two weeks after each calendar quarter ends.[114] The report includes disclosure of matters actively lobbied, itemization of activity expenses incurred or arranged during the quarter, and a description of political contributions of $100 or more.[115]

Lobbyist employers' reports focus on payments to and from lobbyist employees. Employers of lobbyists must file a report on Form 635 along with their Lobbyist employees' Forms 615 by the end of the month following each calendar quarter-end.[116] The Form 635 requires disclosure with respect to payments made in connection with lobbying activities, portion of salaries paid to employees who are lobbyists, and identification of lobbyist routine expenses and similar payments made to influence legislative or administrative action.[117] Lobbyist employers are responsible for having a recordkeeping system to ensure the accuracy and reliability of all information related to lobbying activity.[118] In addition to the reporting requirements, lobbyists must attend mandatory ethics training that is only offered in California and not offered online.[119] The mandatory ethics training is an extraordinary cost, in terms of both time and money, for investment advisers. The Forms 615 and 635 place a large disclosure burden on both lobbyists and their employers, creating unnecessarily high transaction costs as a result.

3. Lobbyist Prohibitions—Contingent Compensation, Gifts, and Payments

California law bars contingent compensation.[120] Specifically, lobbyists and their employers are prohibited from making "any payment in any way contingent upon the defeat, enactment, or outcome of any proposed legislative or administrative action."[121] Under the new regulations, this contingent

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[113] *See Lobbying Quarterly Disclosure Reports—Forms Required*, CAL. SEC'Y OF STATE, http://www.sos.ca.gov/prd/lobbying-info/filing-requirements/required-docs-lob-quarterly.htm (last visited Jan. 12, 2014) (providing a complete list of lobbying reports required by California).

[114] *See Form 615, Lobbyist Report*, CAL. SEC'Y OF STATE, www.sos.ca.gov/prd/forms/form-615.pdf (last visited Jan. 12, 2014).

[115] *Id.*

[116] *See Form 635, supra* note 111.

[117] *Id.*

[118] *Id.*

[119] *See AB 1743 Fact Sheet Placement Agents: Lobbying Registration Requirements*, CAL. FAIR POLITICAL PRACTICES COMM'N 1, 3 (Jan. 1, 2011), http://www.fppc.ca.gov/factsheets/009-122010PlacementAgentFS.pdf.

[120] *See, e.g.,* CAL. GOV'T CODE § 86205(f) (West 2013).

[121] *Id.*

compensation ban applies to both activities of placement agents and "covered" investment management personnel.[122] In this respect, the California ban is similar to the New York City prohibition on contingent compensation.[123]

California's regulation only allows nominal gifts and payments made by lobbyists. Lobbyists are prohibited from making political contributions to officers of the state agency with whom the lobbyist is registered to lobby.[124] For example, a lobbyist registered in California is prohibited from making political contributions to any California state candidate, such as a California State Senator or California Governor.[125] Specifically, the law bars the making of gifts over $10 per month to any such officials of any government agency to whom the lobbyist is registered to lobby.[126] Both the contingent compensation ban and the regulations regarding gifts and payments are fairly consistent across states;[127] therefore, while the inclusion of this information is helpful to provide a full picture of the lobbying laws, it is not of particular importance with respect to the analysis in this Note.

4. *Penalties*

Failure to comply with California's lobbyist regulations results in both a monetary fine and a ban from soliciting new business.[128] First, any knowing or willful violation of the provision is a misdemeanor.[129] Second, the monetary penalty is "[a] fine of up to the greater of $10,000 or three times the amount the person failed to report properly or unlawfully contributed, expended, gave, or received."[130] Third, the failure to comply with regulations results in a ban from soliciting new business from the retirement system, or any government agency, for five years.[131] The fine and the ban from soliciting new business, while significant statutory penalties, are probably less of a concern than the reputational damage an investment adviser might incur by facing a penalty or paying a settlement.[132]

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[122] *See* SIDLEY AUSTIN, *supra* note 31, at 2.
[123] *Id.* at 2, 5, 7.
[124] *See, e.g.*, CAL. GOV'T CODE § 85702 (West 2013).
[125] *Id.*
[126] *See* CAL. GOV'T CODE § 86203 (West 2013).
[127] *See supra* Part II.B.3, Part II.C.3.
[128] *See* CAL. GOV'T CODE § 91000(a)-(b) (West 2013); SIDLEY AUSTIN, *supra* note 31, at 6.
[129] *See, e.g.*, CAL. GOV'T CODE § 91000(a).
[130] CAL. GOV'T CODE § 91000(b).
[131] SIDLEY AUSTIN, *supra* note 31, at 6.
[132] *See, e.g.*, Nathan Koppel, *'Pay to Play' Pact Yields $24 Million for New Mexico*, WALL ST. J. (Feb. 22, 2013, 6:50 PM), http://online.wsj.com/article/SB1000142412788

C. New York versus California Prototypes

While previous sections of this Note set the background of New York City and California's lobbyist regulations for investment advisers, both laws contain exemptions that further confuse identifying which activity constitutes lobbying and which firm personnel are subject to regulation. Comparison of the relevant exemptions side-by-side helps demonstrate the significant differences in the two regulatory methods and the complexities investment advisers face while interpreting the regulations. Analysis reveals that both prototypes fail to achieve their purpose because their definitions of lobbying activity and purported exemptions are unclear. The resultant maze of definitions and exemptions to those in the industry increases the cost of doing business to a debilitating extent.

Pay-to-play regulations are constantly evolving. More and more states are adopting laws impacting marketing from investment advisers to pension plans. Industry professionals have suggested the regulatory situation in New York is complicated because city officials re-interpreted existing law rather than making new rules.[133] For example, New York City Administrative Code section 3-211(c)(vi)(A) provides an exception for "contractors or prospective contractors who communicate with or appear before city contracting officers or employees in the regular course of procurement planning ... [or] city contracting officers or employees in the regular course of the administration of a contract are not engaged in lobbying."[134] The problem arises from the fact that this exception does not clarify which activity qualifies as in the "regular course" of procurement planning or administration of a contract. The Office of the City Clerk has issued several advisory opinions that attempt to clarify the meaning of the exemptions. In an advisory opinion, the City Clerk determined that "communications between investment managers, who have been solicited through the procurement process,"[135] in the regular course of procurement planning fall within the exception. This exception is contingent

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732386430457832045371131 0538.html; Chad Bray, *Adviser, Lobbyist to Pay $1.5 Million in Pay-to-Play Settlement*, WALL ST. J. (Dec. 8, 2010, 5:47 PM), http://online.wsj.com/article/SB10001424052748703493504576007592042897326.html. *See also supra* Part II.A.4.

[133] *See, e.g.*, *supra* note 82 and accompanying text. New York City Lobbying Bureau regularly issues advisory opinions, which are available on their website. In 2011 the New York City Lobbying Bureau issued two advisory opinions discussing exceptions to the obligation to register as a lobbyist for marketing to pension funds.

[134] N.Y.C., N.Y., ADMIN. CODE § 3-211(c)(3)(vi)(A) (2014).

[135] N.Y.C. Office of the City Clerk Op. 2011-3, *supra* note 82 (explaining the proper procurement procedures for selecting investment advisers and issues of request for proposals (RFP)).

upon whether the communication is through the procurement process[136] or in response to requests for proposals.[137] Second, the City Clerk determined that communications between employees of investment managers that have an existing contract with a fund are not lobbying.[138] Despite the continued ambiguities seemingly acknowledged by the Office of City Clerk, New York City's regulatory agency remains steadfast in threatening to enhance scrutiny on the investment activities.[139]

California law contains two exemptions around onerous lobbying requirements that make its law more reasonable than New York City's Administrative Code. First, the one-third exemption covers internal adviser firm personnel who spend at least one-third of their time on portfolio management. Second, the competitive bidding exception covers internal personnel of registered advisers who will be selected through a competitive bidding process and has agreed to a fiduciary standard of care.[140] The one-third exemption states that the definition of "placement agents" does not include an investment manager's employees who spend at least one-third of their time during a calendar year "managing the securities or assets owned, controlled, invested or held by the [investment] manager."[141] With these exclusions, an investment adviser can skirt the lobbyist registration requirement by limiting involvement in solicitation of California public retirement system business to internal personnel who satisfy the one-third exemption.

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[136] *See* 4 THE RULES OF THE CITY OF NEW YORK 8 (N.Y. Legal Publ'n Corp. 2011), http://www.nyc.gov/html/mocs/ppb/downloads/pdf/April2010rulesmodifiedMar2011pdf (defining procurement as: "Buying, purchasing, renting, leasing, or otherwise acquiring any goods, services, or construction. It also includes all functions that pertain to the obtaining of any good, service, or construction, including planning, description of requirements, solicitation and selection of sources, preparation and award of contract, and all phases of contract administration, including receipt and acceptance, evaluation of performance, and final payment.").

[137] *See* N.Y.C. Office of the City Clerk Op. 2011-2, *supra* note 82 ("It is the determination of the City Clerk that persons who attempt to influence the Pension Funds' decisions to enter into limited partnership agreements or contracts for alternative investments such as real estate investment funds, private equity funds, and hedge funds are engaged in 'lobbying' or a 'lobbying activity' as defined in the Administrative Code. However, if those persons are responding to a request for information by the staff of the Comptroller's office or a Pension Fund they would not be engaged in 'lobbying' or a 'lobbying activity' because such communications are exempt under Administrative Code § 3-211(c)(3)(v).").

[138] N.Y.C. Office of the City Clerk Op. 2011-3, *supra* note 82.

[139] Letter from Patrick Synmoie, *supra* note 12 ("Beginning in January 2011, this office will be reviewing the activities of individuals, businesses, and organizations that, as of January 1, 2011, are attempting to influence investment decisions made by pension funds and retirement systems of New York City. Parties that fail to comply with the Lobbying Law will be subject to … penalties ....").

[140] CAL. GOV'T CODE § 82047.3(c) (West 2013).

[141] *Id.*

While the one-third exemption makes California's lobbying law more manageable for investment advisers, it still leaves several ambiguities. First, the exemption does not specify how to measure the "calendar year."[142] If the exclusion is interpreted literally, then the investment adviser must have spent at least a full calendar year managing assets for one-third of his or her time in order for the exclusion to apply. If so, then the exclusion is unavailable for employees at new firms or newly hired employees. Other situations, such as employees hired laterally who were working in investment advisory roles previously, reveal the complications that can arise from interpreting this exemption. However, a more flexible standard is readily available: make the calendar year requirement subject to a good faith projection of the investment professional's estimated allocation of yearly assigned duties and historical responsibilities.[143] Assembly Bill 1743 is the bill that amended existing California law to expand the definition of lobbyist and require reporting standards.[144] Neither AB 1743,[145] its legislative history,[146] nor the FPPC offer any guidance regarding how to interpret the calendar year requirement. Furthermore, in opinions distributed by law firms, it is suggested that "because the 'placement agent' definition applies so differently than the traditional 'lobbyist' definition, analogies drawn from FPPC's existing guidance may not be helpful" in interpreting the calendar year rule.[147] A second ambiguity is that the one-third exemption does not identify which particular activities fall under the description of managing assets. An individual whose position includes creating the investment fund's portfolio and deciding which securities to invest is a clear example of an employee whose responsibilities fall within the description of "managing assets."[148] In contrast, it is less clear whether "managing assets" includes the majority of individuals whose responsibilities are related to managing assets but are not responsible for the actual investment decision.

The competitive bidding exception under section 82047.3 of California Code provides that investment firm personnel are excluded from the "placement agent" definition, with respect to public retirement system contacts if the investment adviser:

> (i) is registered with the SEC or an appropriate state regulator as an investment adviser or broker-dealer; (ii) has been selected through a competitive bidding process subject to specified California laws and is

[142] SIDLEY AUSTIN, *supra* note 31, at 3.
[143] *Id.* at 3.
[144] 2010 Cal. Legis. Serv. Ch. 668 (A.B. 1743) (West).
[145] *Id.*
[146] *See supra* note 107 and accompanying text.
[147] SIDLEY AUSTIN, *supra* note 31, at 3.
[148] *Id.* at 3.

> providing services pursuant to a contract executed as a result of that competitive bidding process; and (iii) has agreed to a fiduciary standard of care as to the state public retirement system's investments.[149]

While California's exclusions from the lobbyist definition leave fewer ambiguities than New York City's exemptions, both jurisdictions' laws create confusion as to what particular activity constitutes lobbying under the statutes. California and New York City's regulations have paved the way for other states to police the interaction between pension funds and investment advisers.[150] As such, the analysis above involves only two jurisdictions and does not reflect a complete picture of the regulatory environment in which investment advisers market to public pension plans. The next Part provides a sampling of developments in other states' legislatures and of internal regulations by public pension plans to provide a more accurate picture of the many layers of lobbying laws challenging investment advisers. As the layers build on top of already ambiguous predecessors, the transactional costs for dealing in this environment continue to grow.

III. DEVELOPMENT OF LAW IN OTHER JURISDICTIONS & PENSION PLAN REGULATIONS

A. Development of Laws in Other States

In reviewing the development of lobbying laws in other states, it is interesting to note that many of the regulations do not follow the precedent established by the New York City or California prototypes, but rather, states are taking their own approaches to regulate the interaction between investment advisers and government pension plans. This variance in states' laws further complicates and confuses the regulatory environment.

1. Ohio

While New York City and California expanded their definitions of lobbyist to include certain investment adviser activities, Ohio created a separate category to define the interaction between investment advisers and public pension plans, labeled as "retirement system lobbying activity."[151] Ohio Code defines retirement system lobbying activity as:

> contacts made to promote, oppose, reward, or otherwise influence the outcome of a retirement system decision by direct communication with

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[149] *Id.* at 3 (discussing CAL. GOV'T CODE § 82047.3(c) (West 2013)).
[150] *See infra* Part III.A.
[151] OHIO REV. CODE ANN. §101.90(I) (West 2013).

> a member of a board of a state retirement system, a state retirement system investment official, or an employee of a state retirement system whose position involves substantial and material exercise of discretion in the investment of retirement system funds.[152]

The Ohio regulation sets forth clear parameters for which activity qualifies as lobbying the retirement system.[153] From the language in the statute, certain investment advisers marketing to the Ohio Retirement System are "influenc[ing] the outcome of a retirement ... decision" and are in direct communication with personnel whose "position involves ... material exercise of discretion in the investment of retirement system funds."[154]

The Ohio regulation differs from the New York City and California prototypes in that it creates a distinct category and definition for retirement system lobbying.[155] Whether the investment adviser's employee qualifies as a retirement system lobbyist depends upon whether the employee is in direct communication with a retirement system employee with "material exercise" over the system's assets.[156] In reality, most pension plan employees with whom investment firm employees communicate will likely fall under this qualification, permitting only communications between purely administrative personnel. The separate category of "retirement system lobbyists" allows for a tailored approach to reporting requirements, only requiring disclosures and information that pertain to public pension plans and investment advisers. But nonetheless, the determination hinges on whether the employee has "material exercise" over system assets, which inherently contains a level of ambiguity.

2. Texas

In Texas, investment advisers have discretion over whether to register as a lobbyist, even if they meet the spending threshold definition.[157] Unlike Ohio, the Texas Code does not create a new category for retirement system lobbying activity. As such, investment advisers marketing to public pension plans in Texas must interpret existing law to determine whether their activity falls within the legislature's interpretation of the term lobbyist.[158] The code

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[152] *Id.*
[153] *Id.*
[154] *Id.*
[155] *Compare id.*, *with* CAL. GOV'T CODE § 82047.3 (West 2013), *and* N.Y.C., N.Y., ADMIN. CODE § 3-211(c)(1) (2014).
[156] OHIO REV. CODE ANN. §101.90.
[157] *See* TEX. GOV'T CODE ANN. § 305.003 (West 2013).
[158] *Id.*

requires an investment adviser to register as a lobbyist if, "as part of his regular employment, [the employee] has communicated directly with a member of the legislative or executive branch to influence legislation or administrative action ... whether or not the person receives any compensation for the communication in addition to the salary for that regular employment."[159]

Texas uses a threshold approach and requires registration if an adviser exceeds the spending threshold of $200 in a calendar quarter.[160] The $200 threshold applies to an employee's total expenditure or if an employee receives, or is entitled to receive, compensation for activities to communicate with a member of the executive or legislative branch to influence legislative or administrative actions.[161] The threshold excludes the employee's own travel, food, or lodging expenses.[162] While the threshold approach provides certainty, the approach does not seek to regulate the underlying activity itself. The Texas Code only specifies that communication with the legislative or executive branch qualifies as lobbying—the lobbying definition in the Code is silent with respect to public pension plans and whether officials at public pension plans are subject to the lobbying registration requirements. Despite the lack of clarity in the law, investment advisers who spend greater than $200 in connection with marketing to public pension plans in Texas have not been categorized as lobbyists and, therefore, have discretion as to whether to register as lobbyists.[163]

3. New Jersey

Unlike the Texas and Ohio approach, New Jersey defines "lobbyist" broadly, encompassing a large spectrum of interaction with the government. Under New Jersey law, a lobbyist is "any person ... that employs, engages or otherwise uses the services of any governmental affairs agent to influence legislation, regulation or governmental processes."[164] The term "influence governmental process" is defined separately as:

> any attempt, whether successful or not, to assist a represented entity or group to engage in communication with, or to secure information from, an officer or staff member of the Executive Branch, or any authority, board, commission or other agency or instrumentality in or of a principal

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[159] *Id.*
[160] *Id.*
[161] *Id.*
[162] *Id.*
[163] This section only addresses whether investment advisers have to register as lobbyists in Texas. It does not discuss gift policy or other pay-to-play regulations.
[164] N.J. STAT. ANN. § 52:13C-20 (West 2013).

> department of the Executive Branch of State Government, empowered by law to administer a governmental process or perform other functions that relate to such processes.[165]

Thus, the New Jersey statute and accompanying definitions cast a very wide net as to what activity constitutes lobbying. Despite the broad definition, there is no evidence that investment advisers marketing to New Jersey state pension plans have faced any pressure to register as lobbyists.[166] While this situation could be attributed to fewer publicized scandals related to pay-to-play and New Jersey pension funds, it also could signal a trend that other jurisdictions are refusing to adopt the California and New York City prototypes.

B. Pension Plans Impose Regulations

In addition to the various state-imposed lobbying requirements, investment advisers also face regulations that are self-imposed by the public pension plans themselves. This additional layer of regulations further complicates the regulatory environment.

1. NYSCRF

After the pay-to-play scandal in New York, the new comptroller, Thomas P. DiNapoli, reformed the New York State Common Retirement Fund (NYSCRF) to make it "one of the most transparent and accountable public pension funds in the country."[167] First, DiNapoli changed the fund's policies, including banning pay-to-play practices, banning the use of placement agents, creating a pension fund task force, increasing internal vetting of investments, forming a special commission of outside experts, and creating

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[165] *Id.* (defining "government process" as the: "promulgation of executive orders; rate setting; development, negotiation, award, modification or cancellation of public contracts; issuance, denial, modification, renewal, revocation or suspension of permits, licenses or waivers; procedures for bidding; imposition or modification of fines and penalties; procedures for purchasing; rendition of administrative determinations; and award, denial, modification, renewal or termination of financial assistance, grants and loans.").

[166] SIDLEY AUSTIN, *supra* note 31, at 1 (noting that while New Jersey law does not cover investment advisers marketing to its pension plans, "the lobbying laws of many other states or local jurisdictions could cover procurement activities depending on the interpretations of the relevant government regulators").

[167] *DiNapoli's Pension Reforms*, NEW YORK STATE OFFICE OF THE STATE COMPTROLLER, http://www.osc.state.ny.us/pension/reform.htm (last visited Jan. 12, 2014) ("Like all New Yorkers, DiNapoli is outraged by the alleged wrongdoing of the former administration and has taken steps to strengthen oversight of the Fund and fix New York's weak campaign finance laws.").

mandatory ethics training.[168] Second, NYSCRF increased oversight.[169] The increased oversight included partnering with New York State Insurance Department, hiring an external law firm, creating an "inspector general" position, and hiring a special counsel on ethics.[170] Third, NYSCRF "increased transparency in fund transactions" by releasing monthly reporting on investment transactions, announcing pension fund performance quarterly, and creating a review of external investment consultants.[171] Finally, NYSCRF "[p]roposed Campaign Finance Reform" legislation.[172] The increased regulations and reporting requirements are more comprehensive than the lobbying registration requirements imposed by state and local governments.

2. CalPERS

Similar to NYSCRF, CalPERS self-imposed enhanced investment protocols and increased regulations. In reaction to the CalPERS' scandal discussed in Part I, CalPERS took "aggressive steps ... to strengthen the pension fund's accountability and ethics, and to ensure full transparency."[173] These steps included delegating investment decisions to the Chief Investment Officer, "lifting the veil on placement agents," setting policy for state legislation, special review of fees paid to external managers, and tightening its own board governance rules.[174] CalPERS' policies on placement agents led the way in placement agent disclosure rules and resulted in the co-sponsorship of the legislation discussed in Part II.C. In addition to enhancing governing policies, CalPERS increased transparency by putting key investment documents online and was the first public pension fund to disclose placement agent data, which included more than 600 placement agent disclosures obtained by the fund from its external managers.[175] As of August 1, 2012, CalPERS and CalSTERS require reporting placement agent information "to the respective chairpersons of the Assembly Committee on Public Employees, Retirement, and Social Security and the Senate Committee on Public Employment and Retirement."[176] CalPERS took action by ending the use of placement agents in new deals. Thus, CalPERS took measures by not only increasing

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[168] *Id.*
[169] *Id.*
[170] *Id.*
[171] *Id.*
[172] *Id.*
[173] *Fact Sheet: CalPERS Strengthens Accountability, Transparency and Ethics*, CalPERS 1, http://www.calpers.ca.gov/eip-docs/about/pubs/ethics-accountability.pdf (last visited Jan. 12, 2014).
[174] *Id.* at 1–3.
[175] *Id.* at 4–5.
[176] *See* SCHULTE ROTH & ZABEL, *supra* note 103, at 5 (citing 2010 Cal. Legis. Serv. Ch. 668 (A.B. 1743 § 9) (West)).

accountability and reporting requirements but also increasing transparency by forcing external managers to disclose information.

IV. Adequate Compliance Procedures & Economic Costs

A. *Economic Costs*

1. *Cost for Investment Advisers*

Pay-to-play laws have contributed to an increasingly complex regulatory environment for investment advisers. Investment advisers are therefore increasing their legal and compliance departments in order to deal with these regulations.[177] David Sobel, Chief Compliance Officer at Abel/Noser Corporation, has commented that "as the web of regulations has become more complex, his workload has expanded by about 25 percent."[178] Further, pension plans expect investment advisers to have a sophisticated compliance structure.[179] Industry professionals expect to see increased legal hiring by financial institutions to meet their compliance needs.[180] Thus, investment advisers must increase their budgets and head count to comply with the regulatory environment. "'In the last few years, compliance has become a new profession within financial services,' noted Zebrowski, an attorney and CPA who runs an alternative investment firm."[181] While a boon for lawyers and compliance professionals, increased costs in non-profit generating departments is a cost that reduces the overall profitability of investment advisers. Unfortunately, the increase in regulations and compliance costs do not necessarily offset enough corruption to justify the expense.

2. *Cost for SEC*

The SEC has increased its budget to enforce its own pay-to-play laws and respond to the increasingly complicated regulatory environment.[182] While the SEC is not responsible for specific jurisdictions' pay-to-play rules, it is

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[177] Christine Simmons, *New Rules Create Jobs for Attorneys at Hedge Funds*, 248 N.Y. L.J., no. 122, Dec. 26, 2012, at 1, *available at* http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202582718326&thepage=3slreturn=20130103210738 (subscription required).

[178] *Id.* at 3.

[179] *Id.* at 2 ("Asset allocators, such as pension funds, 'have become more sophisticated and expect more from the infrastructure of the firms they're investing in. They expect there to be some legal type or compliance type filling a role in the firm'").

[180] *See, e.g.*, *id.* at 3 (quoting Gary Watkins of the ACA Compliance group, "Increased regulation leads to more responsibilities and in turn firms may look to increase their resources by hiring additional compliance personnel[.]").

[181] *Id.*

[182] U.S. SEC. & EXCH. COMM'N, IN BRIEF FY 2012 CONGRESSIONAL JUSTIFICATION 1 (2011), http://www.sec.gov/about/secfy12congbudgjust.pdf.

necessary for the SEC to understand how the jurisdiction-specific rules relate to the federal rules. In its 2012 Budget Justification, the SEC requested funds to support its regulatory functions.[183] The SEC referenced its steps over the past two years to make it "more vigilant, agile, and responsive, and is moving on multiple fronts to enhance its effectiveness and provide robust oversight of the financial markets" as justification for its increased budget.[184] Further, the SEC created "new senior leadership in key positions" in order to create regulations regarding "equity market structure, credit rating agency conflicts and disclosure, investment adviser custody controls, money market fund resiliency, asset-backed securities, large trader reporting, *pay-to-play*, and municipal securities disclosure."[185] Pay-to-play laws present a new regulatory burden to which the SEC has to respond. The SEC has "stepped up its interest in pay-to-play cases," and even created a specialized unit that examines corruption in government bond offerings and bringing actions against financial institutions and public officials.[186] The SEC has increased its staffing levels and budget as a result of the new regulatory workload.[187]

3. Cost for Pension Plans

As previously addressed, public pension plans have imposed their own regulations regarding investment advisers and increased transparency. This Note only briefly addresses the associated additional costs incurred by pension funds, because it is self-evident that with increased regulations, increased filings, and increased reporting requirements come increased costs.[188] To comply with federal, state, and self-imposed regulations, pension funds must expend large sums increasing oversight employees or hiring outside legal counsel. For example, the NYSCRF hired outside compliance experts

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[183] *Id.*

[184] *Id.*

[185] *Id.* (emphasis added).

[186] Susanne Craig & Ben Protess, *Goldman to Pay $12 Million to Settle S.E.C. 'Pay to Play' Case*, N.Y. TIMES (Sept. 27, 2012, 11:14 AM), http://dealbook.nytimes.com/2012/09/27/goldman-to-pay-12-million-to-settle-s-e-c-pay-to-play-case/.

[187] U.S. SEC. & EXCH. COMM'N, IN BRIEF FY 2012 CONGRESSIONAL JUSTIFICATION, at 1–2:

> SEC staffing levels are just now returning to the level of FY 2005, despite the fact that the size and complexity of the securities markets have undergone tremendous growth since then. During the past decade, trading volume has more than doubled, the number of investment advisers grew by 50 percent, and the funds they manage have increased to $38 trillion.... In acknowledgement of this significant new workload, the [Dodd-Frank] Act authorized an increase in the agency's budget from the $1.11 billion appropriated in FY 2010 to $1.3 billion in FY 2011, $1.5 billion in FY 2012, and $2.25 billion by FY 2015.

Id.

[188] *See supra* Part III.B.

to conduct a compliance review of every single pension fund transaction.[189] Similarly, NYSCRF releases monthly reports detailing investment transactions and hiring of investment advisers.[190] Of course, the pension plans can decide not to incur these expenses and simply rely on their current employees to meet all of these additional burdens. These increased costs, while necessary to respond to the heightened regulatory requirements, do not directly result in higher profit returns.

4. Transaction Costs

The increased transaction costs for public pension funds, investment advisers, and the SEC correlate to a decrease in the returns for beneficiaries of public retirement systems. Ronald Coase developed the eponymously named Coase Theorem, which provides, assuming no transaction costs, that parties in repeat transactions will negotiate to the most cost effective outcome.[191]

> In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.[192]

The public pension plan and investment adviser relationship should be one in which transaction costs are low because as Coase described, there are repeat players, who are able to negotiate, and draw up bargains. Unfortunately, the many layers of regulations discussed in this Note create ambiguity in the public pension plan allocation process and increase transaction costs. Uncertainty creates increased transaction costs.[193] The increased transaction costs, partially the result of increased compliance needs for investment

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[189] *The New York State Common Retirement*, N.Y. OFFICE OF THE STATE COMPTROLLER, http://www.osc.state.ny.us/pension/ (last visited Jan. 12, 2014) ("Comptroller DiNapoli tasked the Mercer Group to conduct a compliance review of the 131 transactions approved during DiNapoli's tenure.").

[190] *Disclosure of Investments & Transactions*, N.Y. OFFICE OF THE STATE COMPTROLLER, http://www.osc.state.ny.us/pension/disclosure.htm (last visited Jan. 12, 2014).

[191] *See generally* Ronald Coase*, The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

[192] *Id.* at 15.

[193] *See* Slater & Spencer, *supra* note 16, at 61 (explaining that uncertainty "forms the basis of the explanation of transaction costs and also provides a vital link in the conceptual analysis of the transition from market coordination to internal organization.").

advisers, the SEC, and public pension plans, suggest investment returns become more and more inefficient.

The benefit of increased regulation is the benefit from diminished corruption in the public pension plan allocation process. For pension plans, the cost of corruption is the opportunity cost of the misallocation of funds—that is, investing with funds who pay-to-play rather than a more ethical investment adviser who refuse to pay-to-play. For investment advisers, the costs of corruption are reputational damages, regulatory fines, and an uneven playing field. The increased transaction costs are inefficient if they outweigh the benefit—the corruption they prevent.

Investment advisers are forced by these regulations to update existing compliance programs, which directly result in higher management fees or lower cost-to-profit ratios. Pension plans devote more effort to increasing transparency to comply with new regulatory requirements, which leads to higher costs and lower return for beneficiaries.[194] The SEC, as a result of increased regulation and oversight measures, has incurred, and will continue to incur, incredible costs to regulate the growing uncertain investment environment.[195] A possible result of the increased costs is an environment in which government pension plans diversify less with investment advisers because the risk of exposure to pay-to-play scandals is too costly.[196] In turn, all of these lobbying regulations may result in a lower return for beneficiaries of public retirement systems.

B. Compliance Procedures for Investment Advisers

Public pension plans have significant assets under management, and investment advisers associate a certain prestige with winning management of public pension plan assets. Therefore, it is likely that investment advisers will attempt to comply with the inefficient laws and increased transaction costs[197] to gain access to these coveted funds.[198] To help investment advisers comply with these developing laws, this Note proposes a set of compliance procedures that most efficiently and comprehensively addresses these

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194 *See, e.g.*, Mary W. Walsh, *The Burden of Pensions on States*, N.Y. TIMES (Mar. 10, 2011), http://www.nytimes.com/2011/03/11/business/11pension.html?pagewanted=all&_r=.

195 *See supra* note 187 and accompanying text.

196 *See generally* Rose-Smith & Leefeldt, *supra* note 1.

197 *See supra* Part IV.A.4.

198 *See, e.g.*, Simpson, *supra* note 78 ("CalPERS and CalSTERS have a combined $380 billion in assets under management while the New York City funds total roughly $45 billion—makes registering as lobbyists the lesser of two evils. No one wants to go to their bosses and say: 'We've gotta cut the retirement systems off,' said a chief compliance officer at a New York adviser with city pension fund investments.").

laws. This protocol consists of proactive planning by investment adviser personnel, especially with respect to the legal, compliance, and investor relations' departments.

First, legal and compliance departments must track meetings and contact with public pension plans. Therefore, investor relations and other personnel that have contact with public pension plans must immediately notify legal and compliance of any plans to contact or meet with public pension plans. To do so, the department that schedules meetings with potential investors, usually the investor relations department, must submit a schedule to the legal and compliance departments identifying any planned contact with, or marketing directed at public pension plans. For clarity, this schedule will be referred to as the "public pension plan schedule." The public pension plan schedule should specify the particular investment adviser personnel involved, the type of contact, the length of contact, and the public pension plan personnel involved. This first step will ensure that any registration, if necessary, will occur before any substantive contact commences.

Second, compliance departments must use the public pension plan schedule to review each pension plans current state, local, and pension specific lobbying laws. This review is similar to the analysis provided in this Note, in that compliance department must look at the many layers of regulations and determine if the investment adviser activity falls under the scope of the definition of lobbying. Compliance must also look to see if the relevant jurisdiction's laws contain exceptions. In this review, the same problems arise with interpreting the jurisdiction's definitions, exceptions and reporting requirements.

Third, after the relevant regulations are reviewed, compliance must keep track of time and expenses associated with firm personnel who have had contact with pension plans. Investment adviser personnel who will most readily fall into the lobbyist category are those in the investor relations, finance, and legal departments. The time and expenses must be organized to track whether any personnel pass the spending threshold of the particular jurisdiction's lobbyist regulations.[199] Keeping track of the investment advisers' marketing plans and employees' time and expenses is a large burden and cost, adding to the existing responsibilities of legal and compliance departments.[200] While

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[199] *See How States Define "Lobbying" and "Lobbyist"*, NATIONAL CONFERENCE OF STATE LEGISLATURES, http://www.ncsl.org/legislatures-elections/ethicshome/50-state-chart-lobby-definitions.aspx (last visited Jan. 12, 2014) (listing states lobbying definitions and illustrating different monetary reporting thresholds).

[200] *See* Troy A. Paredes, Commissioner, SEC, Remarks Before the 2011 Investment Adviser Compliance Conference (Mar. 10, 2011), *available at* http://www.sec.gov/news/speech/2011/spch031011tap.htm ("Indeed, the compliance burden on investment advisers

the burden of tracking this information is significant, it is a necessary step in order to ensure adequate compliance.

Fourth, if it is determined that any personnel qualify as lobbyists, investment advisers must then register personnel as lobbyists and comply with the relevant lobbying reporting requirements. This step requires paying the requisite registration fees and filing the necessary forms. In addition, some jurisdictions, like California, require lobbying and ethics training. Again, the legal and compliance departments must track registration requirements across jurisdictions and file the necessary forms.[201] This ongoing reporting requirement—requiring compliance departments to register, file, and continually report in all relevant jurisdictions—is a truly burdensome transaction cost.[202]

Furthermore, as the law is ever evolving and political positions are constantly changing, the duty to monitor continually persists. If an investment adviser already conducts business with a particular public pension plan that previously did not require lobbyist registration but now requires registration, the investment adviser may need to register in that jurisdiction. Legal and compliance departments are thus charged with the duty to preemptively monitor state laws for updates.[203] Investment advisers, and their covered employees, are prohibited from making any political contribution to any state candidate or politician affiliated with a public pension plan whose assets an investment adviser seeks to manage. Furthermore, investment advisers must monitor political contributions and shifts in political ambitions. For instance, if a governor of a state, for example California, were to run for president of the United States, investment advisers would be prohibited from making a political contribution to the presidential campaign if they do business with any state public pension plan in California.[204] Thus, legal and compliance departments must ensure that a political contribution is not associated with a candidate who is a state politician in a state in which the

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has increased of late due to, for example, the need to comply with the new 'pay to play' rule restricting political contributions by certain advisers.").

[201] *See, e.g.*, *supra* notes 111, 113 and accompanying text.

[202] Similar to the centralized reporting requirements of the SEC, a federal minimum reporting requirement for lobbyists would largely reduce this transaction cost.

[203] Although most regulations include a grace period for those affected to come into compliance, the sooner an investment advisory firm learns of changes in law, the more time that firm has to comply, which likely would result in relatively lower transaction costs. *See, e.g., e-Lobbyist User Guide*, N.Y.C. DEP'T. OF INFO. TECH. & TELECOMM. 65 (Jan. 2012), http://www.nyc.gov/html/misc/pdf/elobbyist_user_guide.pdf.

[204] *See* Doug Cornelius, *Presidential Campaign Season and the SEC's Pay-to-Play Rule*, COMPLIANCE BUILDING (Aug. 25, 2011, 8:00 AM), http://www.compliancebuilding.com/2011/08/25/presidential-campaign-season-and-the-secs-pay-to-play-rule/.

investment adviser seeks to do business.[205] This must be monitored through searching covered employees' political contributions and then determining whether there is a conflict.[206]

While the proposed compliance protocol is a hefty burden and creates more work,[207] it is necessary for investment advisers to take proactive and preemptive efforts to comply with local and state lobbying laws. Without an adequate compliance protocol, investment advisers are vulnerable to violating the numerous pay-to-play laws, and could be forced to endure bad publicity and pay high settlement costs.[208] The reputational consequences alone serve as a strong incentive for investment firms to incur the necessary compliance costs.[209]

CONCLUSION

The development of state laws requiring investment advisers who market to public pension plans to register as lobbyists is significant in that it establishes a legal precedent that does not clearly achieve its purpose and results in an economically detrimental outcome. The prototypes created by New York City and the State of California both attempt to increase transparency and reporting requirements for investment advisers in order to avoid the repeat of scandals and blatant corruption that propelled the pay-to-play to legislation. Both prototypes fail to achieve their purpose because their definitions of lobbying activity and purported exemptions are unclear. The development of lobbying laws in other states further complicates the regulatory environment investment advisers face when marketing to public pension plans. Public pension plans have also implemented their own self-imposed restrictions in order to protect themselves, their beneficiaries, and garner public confidence.

Unfortunately, the influx of regulations does the very opposite of what it sets forth to achieve: the four levels of regulation create uncertainty. The lobbying regulations increase disclosure requirements, but because it is unclear who qualifies as a lobbyist, the disclosures fail to paint a clear picture of investment adviser activity, provide adequate transparency, or directly

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205 *See*, *e.g.*, Stefan Passantino, *Can Investment Advisors, Private Fund Managers, and their Employees Contribute to Governor Perry?*, PAY TO PLAY BLOG (Aug. 25, 2011), http://www.paytoplaylawblog.com/2011/08/articles/sec/can-investment-advisors-private-fund-managers-and-their-employees-contribute-to-governor-perry/.

206 Political contributions can be tracked by searching http://www.opensecrets.org/ and http://www.fec.gov/.

207 *See supra* Part IV.A.1.

208 *See supra* note 132 and accompanying text.

209 Rose-Smith & Leefeldt, *supra* note 1.

prevent corruption. Furthermore, the various disclosure requirements result in an overflow of information that is insignificant because it simply reports permitted expenses and does not illustrate the overarching picture. As demonstrated above, not only do the increased regulations fail to achieve their purpose, they also place a financial burden on investment advisers, the SEC, and public pension plans. This financial burden increases transaction costs and creates a less efficient return for the beneficiaries of the public pension plans and the economy at large.

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