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CHINA UPDATE

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The Effect of New Placement Agent Policies on Asia

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EXECUTIVE SUMMARY

The placement agent industry has been under increasing scrutiny in the U.S. following scandals involving U.S. state governmental retirement plans and private equity firms or those raising money for such firms. State governmental retirement plans have proposed new policies requiring disclosure of placement agents used in funds in which they invest and in certain instances have banned the use of placement agents altogether in respect of their own investments. The U.S. Securities and Exchange Commission has proposed a rule curtailing, among other activities, the use of placement agents who have made campaign contributions to persons such placement agents would subsequently solicit for investments on behalf of plan sponsors. The overall effect of these policies and proposed rules remain to be seen, both domestically in the U.S. and in Asia, however, careful monitoring of this developing issue from the legal and regulatory side may prove to be critical for Asian fund sponsors.

THE MELEE

The placement agent industry has been under increasing scrutiny in the U.S. following several significant scandals involving interactions between U.S. state governmental retirement plans and private equity firms or those raising money for them (*i.e.*, the fund’s placement agent). This scrutiny has focused on allegations of wrongdoing tied to “pay-to-play” contributions. The most common variant of these scandals involves the hiring of a politically-connected placement agent by a fund sponsor to ensure that a public retirement plan will invest in the sponsor's fund. Fees paid to this placement agent subsequently flow back to the public official in charge of managing fund investments. In a different scenario, fund managers and placement agents make campaign contributions to public officials to get access to government retirement plans and secure an affirmative investment decision by the public official in charge of the government's investments. These activities were allegedly engaged in by prominent alternative investment asset class investors, including the New York State Common Retirement Fund (the second largest governmental retirement plan in the U.S.), the Illinois State Retirement Systems/Boards, and the state of New Mexico's retirement plan. Unfolding simultaneously was the Bernard Madoff "feeder fund" ponzi scheme.

The results of these closely-timed, highly-publicized scandals led U.S. federal and state governments to review current policies and regulations with respect to campaign contributions to public officials by placement agents or members of the fund sponsors represented by such placement agents. This review has led to reforms and proposed reforms both at the state level, mostly regulating the conduct of the state pension plans, and the federal level, through the U.S. Securities and Exchange Commission (the "SEC"), regulating the activities of placement agents and the managers that use them.

NEW POLICIES BY U.S. STATE GOVERNMENTAL RETIREMENT PLAN INVESTORS

The changes in policy and state laws have focused on regulating and controlling the actions of governmental retirement plans in connection with their interaction with placement agents and fund sponsors. The New York City Employees Retirement System, New York State Common Retirement Fund, the State of Connecticut Retirement and Trust Funds, and State Teachers' Retirement System of Ohio are now prohibited from investing in any fund that uses a placement agent with respect to their investment, or which has used a placement agent to market and promote the fund to them. Others, including the California Public Employees' Retirement System, New Jersey's Division of Investment, Teachers' Retirement System of Texas, New Mexico Educational Retirement Board and State Investment Council, and Los Angeles City Employees Retirement Systems, Fire and Police Pension System, and Water and Power Employees' Retirement Fund, require substantive disclosure by the fund's manager with respect to any placement agent used, any fees paid, and any political contribution made by a fund sponsor to a candidate for office in such state. These two groups of pension systems represent an aggregate of roughly US$760 billion of investment assets as of August 1, 2008. Another dozen or so governmental retirement plan investors have taken a "wait and see" attitude.

These policies may have a significant effect on investments as many governmental retirement plan investors rely on placement agents to do their diligence. Trusted placement agents are used by investors to support their often small, overworked internal investment staffs. When working with effective placement agents, governmental retirement plan investors often see more and better deals that have been "pre-screened" for them by the placement agents. Governmental plan staff forbidden from investing through a placement agent may find themselves completely overwhelmed by the volume of offering documents and inquiries they receive. Smaller, emerging managers may bear the brunt of this, as they may have the most difficult time getting the attention of governmental retirement plan investors whose programs are often legislatively mandated to support them.

PROPOSED SEC RULE

Responding to these "pay-to-play" schemes, the SEC has focused on fund managers and proposed a new rule to address concerns that fund managers and placement agents selected by public pension plans are based more on political connections than credentials. The rule would apply to both registered and unregistered advisers exempt from registration under the U.S. Investment Advisers Act of 1940. If enacted as proposed, the rule would prohibit for two years the engagement of a fund sponsor by a governmental retirement plan if the adviser had contributed to the campaign of a person associated with the governmental retirement plan making the investment. Another aspect of the proposal prohibits third-party solicitations of governmental retirement plans, including engagements of firms that have coordinated, arranged or solicited contributions to an elected official or candidate with respect to the proposed investment. Finally, the rule would require additional recordkeeping and disclosure to the SEC of campaign contributions by the placement agent and its employees to elected officials, candidates, and political action committees. While this proposed rule is directed at fund sponsors and third-party placement agents, a number of legal practitioners have voiced concerns over whether the rule will apply to in-house placement agents as well.

Legal practitioners have expressed concern that if a fund sponsor violates either the proposed rule upon being promulgated (or the policies of the governmental retirement plans prohibiting the use of placement agents in funds in which they invest), such violation may also violate the private placement exception under U.S. securities laws. U.S. securities laws provide that a private placement of securities must not contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements contained therein, in light of the circumstances under which they were made, not misleading. To the extent that information about a fund sponsor's or its placement agent's political contributions is not properly disclosed, a governmental retirement plan investor may have the right to rescind its commitment to the fund.

CONCLUSION

The overall effect of these policies and proposed rules remain to be seen, both domestically and in Asia. In an era of tougher regulation and oversight, the SEC will be looking to support the interests of investors, and governmental retirement plans in particular. On the other hand, some voices of reason will articulate the value that placement agents bring to both fund sponsors and investors alike, and perhaps persuasively make the case that prohibiting them outright or even overburdening them with regulation is only liable to increase the cost of capital raised rather than its safety. In particular, the effects of these policies on smaller fund sponsors, and many governmental investing agencies that are otherwise short-staffed and furloughed, may prove harmful to those most in need of the expertise of placement agents.

Asian fund sponsors will want to work with a legal fund counsel with expertise in this developing body of U.S. securities laws and regulations to tackle the complications associated with the proposed rules and new policies. Additionally, fund sponsors should consider working with fund counsel to perform substantive "due diligence" on their placement agent, seriously scrutinizing the placement agent agreement and obtaining proper indemnification in the event that the placement agent's acts violate U.S. securities laws. However, these precautions should not prevent fund sponsors from being prepped by their placement agents or obtaining their investor contacts, or ultimately from successfully raising funds with U.S. governmental retirement plan investors. ■

Morrison & Foerster LLP is an internationally recognized leader in the formation of private equity funds. We regularly represent fund sponsors and institutional investors in the formation of all types of private equity funds. Our attorneys are experts on the partnership, regulatory, and tax issues of concern to fund sponsors, tax-exempt investors, and offshore investors. The attorneys in our Private Equity Fund Group have represented fund sponsors or major institutional investors in the formation of private equity funds having committed capital in excess of $200 billion in the last two years alone. Our firm's 16 offices are strategically located in key financial and technology centers around the world, including San Francisco, New York, Hong Kong, London, and Tokyo, Shanghai, and Beijing.

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