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Alert Memo
NEW YORK MAY 20, 2009
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The New York Attorney General's Public Pension Fund Reform Code of Conduct: "New Rules of the Game"

On May 14, 2009, New York Attorney General Andrew M. Cuomo announced an agreement with private equity firm The Carlyle Group ("Carlyle") in connection with the Attorney General's investigation, started in 2007, into relationships between New York State's Common Retirement Fund ("NYCRF") and investment firms doing business with it.[1] Carlyle agreed to pay $20 million to resolve its part in the investigation, and to abide by the Attorney General's "Public Pension Plan Reform Code of Conduct" (the "Reform Code"). The Reform Code imposes strict requirements and prohibitions on dealings with retirement plans for federal or state governmental employees ("Public Pension Funds"),[2] including an outright ban on the use of placement agents, finders, lobbyists and other intermediaries (collectively referred to as "placement agents") in arranging investments by Public Pension Funds.

The principles reflected in the Reform Code are likely to extend beyond the agreement with Carlyle, whether other industry participants voluntarily agree to abide by them or they are incorporated into new federal and/or state legislation or regulations. The Attorney General's office has indicated that it expects the Reform Code to establish a generally applicable framework for relationships between Public Pension Funds and investment firms going forward; at a minimum, it appears likely that firms seeking to do business with New York Public Pension Funds will be asked to be bound by the Reform Code. Attorney General Cuomo has described the Reform Code as representing the "new

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[1] The investigation is being conducted under New York's "blue sky" law, the Martin Act, which permits very broad pre-lawsuit discovery by the Attorney General.

[2] The term "Public Pension Fund," as used in the Code of Conduct, means "any retirement plan established or maintained for its employees (current or former) by the Government of the United States, the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing." Thus, the restrictions that Carlyle agreed to by adopting the Code of Conduct are not, by their terms, limited to New York plans but purport to apply to any federal or state governmental pension plan. In a related development, New York State Comptroller Thomas P. DiNapoli announced on April 22, 2009 that he has banned the involvement of placement agents, paid intermediaries and registered lobbyists in investments with NYCRF.

rules of the game"[3] and praised Carlyle for "leading the industry toward critical change of the public pension investment system."[4] However, as noted below, the Reform Code includes a number of provisions that are ambiguous or may be difficult to implement in practice. It remains to be seen whether other jurisdictions will adopt new rules similar to the Reform Code and, if so, whether and how they may refine the details and mechanics of these rules.

In this memorandum we outline the key provisions of the Reform Code and suggest action steps for investment firms that do business (or seek to do business) with Public Pension Funds and may become subject to its requirements or similar requirements. The full text of the Reform Code and the Assurance of Discontinuance issued by the New York Attorney General in respect of Carlyle ("Assurance of Discontinuance"), are attached to this memorandum.

- **Placement Agents Banned**

Many private investment firms use third-party intermediaries to assist in introducing and marketing the investment opportunities they offer to investors, including Public Pension Funds. The Reform Code would impose a very broad prohibition on the engagement by investment firms of any placement agent, lobbyist, solicitor, intermediary or consultant in connection with any transaction with a Public Pension Fund. There are exceptions for (i) certain employees or officials of the investment firm acting within the scope of their professional duties, (ii) service providers whose sole basis of compensation is the actual provision of legal, accounting, engineering, real estate or other professional advice or services that is unrelated to soliciting business for the investment firm; and (iii) lobbying a government or legislature on issues unrelated to Public Pension Fund investment decisions.

Action steps:

- Investment firms should prepare for the ban on using placement agents to be extended more generally. The New York Attorney General's investigation has allegedly uncovered a scheme of kickbacks and favors to Henry Morris, who was a political advisor to former New York State comptroller Alan Hevesi. After Hevesi's election as comptroller, Morris is alleged to have sought the installation of David Loglisci as the Chief Investment Officer of NYCRF. Morris became a placement agent, and is charged with

[3] "Cuomo Announces Carlyle Settlement; Firm Will Adopt Code of Conduct for Funds," *Pension & Benefits Daily* (May 18, 2009).

[4] "Cuomo Announces Landmark Agreement With the Carlyle Group to Eliminate Pay-to-Play in Public Pension Funds Nationwide" (announcement on New York Office of the Attorney General website, May 14, 2009), available at http://www.oag.state.ny.us/media_center/2009/may/may14a_09.html.

conspiring with Loglisci, and other entities and persons linked to himself and Loglisci, to get kickbacks from investment managers in exchange for access to NYCRF investment funds. While the vast majority of placement agents provide valuable services and are not involved in any kind of corruption, the Attorney General concluded that the use of placement agents generally is "a practice fraught with peril and prone to manipulation and abuse"[5] and therefore that a blanket ban was appropriate. It is likely that other public officials and lawmakers will share this view and impose similar prohibitions.[6] Firms may need to focus on conducting marketing efforts and introducing their services through their own investor relations and marketing personnel, rather than engaging third parties.[7] Investment firms that are not registered broker-dealers (or do not have a registered broker-dealer affiliate) should consider and discuss with counsel the implications of increased in-house marketing responsibilities for their reliance on the so-called "issuer exemption" from broker-dealer registration, and may wish to consider registration.

- Investment firms should consider reviewing any prior or existing arrangements with placement agents and other intermediaries that have assisted them in dealing with Public Pension Funds (including any subcontractors that such intermediaries may use) to verify that such third parties are properly registered as broker dealers if so required and have complied with other applicable licensing

[5] Preamble to the Assurance of Discontinuance.

[6] In April, Illinois banned the use of placement agents whose fees are contingent upon the investment decision of an Illinois state or local retirement system, pension fund or investment board. New Mexico also announced in April a ban on the use of placement agents on investments of the state's permanent funds and a six-month ban on the use of placement agents for investments by education retirement plans, pending review of the long-term implications of a permanent ban. As noted above, New York has banned the use of all placement agents in dealings with NYCRF. However, a number of Public Pension Funds (Pennsylvania State Employees' Retirement System, Pennsylvania Public School Employees' Retirement System, Washington State Investment Board, and Massachusetts Pension Reserves Investment Management Board) continue to consider investments with investment firms that employ placement agents, as reported in the Wall Street Journal's Private Equity Beat blog ("Placement Agent Ban: Barking Up the Wrong Tree?" (May 5, 2009), available at http://blogs.wsj.com/privateequity/2009/05/05/placement-agent-ban-barking-up-the-wrong-tree/). The same blog entry quotes Robert Gentzel, spokesman for the Pennsylvania State Employees Retirement System, who pointed out that "[a] lot of the problem in New York was not the fact that a placement agent was involved, but the fact that there were corrupt employees working for the government…Regulation on placement agents is not going to change that."

[7] In this connection, the prohibition on "revolving door" employment, discussed below, should be borne in mind; the participation of politically connected employees or employees who have previously served in government in a firm's marketing efforts is likely to involve its own pitfalls.

requirements and regulations, and are not involved in improper activities.[8] Carlyle reportedly was not aware of the improper payments and kickbacks allegedly uncovered in the Attorney General's investigation. Nevertheless, Carlyle was required to pay a $20 million settlement to resolve its part in the matter.[9] There is little doubt that arrangements with placement agents will be subjected to increasing scrutiny, and it will generally be preferable to take the initiative in doing the appropriate due diligence and determining an appropriate course of action.

- Compensation arrangements with all third party service providers who assist the investment firm with transactions in which Public Pension Funds are involved – not just placement agents – should also be reviewed. We note that these compensation arrangements would be subject to disclosure under the Reform Code (as summarized below) and are likely to be scrutinized. The Reform Code includes an exception from the placement agent ban that should apply to an investment firm's engagement of investment bankers, accountants, lawyers and other outside professionals. The fact that this exception had to be spelled out highlights how broadly the *prima facie* ban is worded – broadly enough to pick up engagements with such professionals unless they expressly fall within the exception. The exception is limited to service providers whose compensation is based solely on the actual provision of services and is "unrelated to any solicitation, introduction, finding or referral of clients" to the investment firm or to "brokering, fostering, establishing or maintaining a relationship" between the firm and a Public Pension Fund. Contingent fee or success fee arrangements could, depending on the circumstances, be viewed as related to soliciting business and thus may raise concerns.[10]

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[8] It may be advisable to obtain appropriate representations and/or certifications from such professionals.

[9] In a press release on May 14, 2009, Carlyle stated that it intends to sue Morris and his company Searle & Co. for more than $15 million. The press release is available on Carlyle's website at http://www.carlyle.com/Media%20Room/News%20Archive/2009/item10682.html.

[10] We note that the NYCRF prohibition could potentially be read to have even broader application. The Comptroller has banned using the services of a placement agent, registered lobbyist or other intermediary to assist the Investment Manager in obtaining investments by NYCRF, *or otherwise doing business with NYCRF, whether compensated on a flat fee, a contingent fee, or any other basis*" (emphasis added). While it seems that the prohibition is aimed at placement agents and marketers who assist investment firms in soliciting business, it is worded broadly enough that it could be interpreted to apply to arrangements with other third-party service providers. Investment firms dealing with NYCRF should consider and discuss with counsel which arrangements with third-party professionals could be subject to the prohibition.

- **Campaign Contributions and Solicitations**

If an investment firm were to become subject to the Reform Code, it would be prohibited from taking investments from, or providing services to, Public Pension Funds within two years after certain political contributions are made to officials who would be in a position to influence the Public Pension Fund's investment decisions, and from making such contributions during the term of the investment firm's engagement. The ban would extend to contributions by the firm itself; its partners, members, executive officers, directors and employees[11] and their respective agents (but not to limited partners) (collectively, "Related Parties"); their respective relatives (including domestic partners residing in the same household); and political action committees controlled by any of the foregoing.[12] In addition, solicitations by any of the covered persons of banned contributions would be prohibited – in other words, a covered person could not persuade someone else to do what he or she was prohibited from doing. Exceptions apply (i) to contributions up to $300 to persons for whom the contributor is actually entitled to vote and (ii) to contributions made at least 14 days before the "effective date" of the Reform Code (the term "effective date" is not defined, but presumably means the date on which the investment firm agrees to begin being subject to the Reform Code or otherwise becomes subject to its provisions). The Reform Code would require investment firms to adopt internal written procedures to monitor and ensure compliance with these rules.

Action steps:

- Similar prohibitions on political contributions already apply to many Public Pension Funds. Compliance policies and procedures should be reviewed in comparison to the standards under the Reform Code, which may be more stringent than under existing rules.

- **Disclosure**

If an investment firm were to become subject to the Reform Code, it would be required to make specified disclosures regarding: (i) political contributions during the term of the engagement and the preceding two years (including not only those that would be banned under the Reform Code but also other contributions to political parties and candidates); (ii) the firm's executive officers, investor relations personnel and other employees responsible for dealing with Public Pension Funds; and (iii) all third party service

[11] It seems that these restrictions would apply to a newly hired employee's contributions made before becoming an employee.

[12] It appears that the Reform Code also intends to pick up contributions by investment firms and other covered persons to political parties for the purpose of assisting officials who would be in a position to influence the Public Pension Fund's investment decisions. The actual language of Section 3(a)(iii) of the Reform Code prohibits contributions *by* "any political party to aid" such an official, but this appears to be a drafting error.

providers engaged in connection with the investment by or transaction with the Public Pension Fund and the compensation paid to them, including fees for legal, government relations, public relations, real estate or other professional advice, services or assistance. The Reform Code would require the investment firm to publish the disclosures on its own website and to consent to their publication on the web site of the Office of the Attorney General of New York.

Action steps:

- Investment firms that deal with Public Pension Funds may already be subject to similar disclosure requirements regarding political contributions and professionals. The disclosure requirements regarding third party service professionals not involved in placement or solicitation activities appears to be a new development. Investment firms should compare the Reform Code disclosure requirements with any similar requirements to which they are already subject, and consider appropriate modifications to their policies and procedures. In some cases investment firms may wish to communicate with third-party service providers regarding the requirement to disclose their engagement and fees.

- **"Revolving Door" Employment and Prohibited Relationships**

The Reform Code includes restrictions that appear intended to prevent a culture of excessive "coziness" that could lead to implicit *quid pro quo* arrangements between investment firm personnel, on the one hand, and public officials in a position to influence Public Pension Fund investment decisions, on the other. If an investment firm were to become subject to the Reform Code it would not be permitted to employ or in any way compensate a person who was such an official, or who was an employee or fiduciary of a Public Pension Fund, within two years after the termination of the person's relationship with the Public Pension Fund (unless the person will have no contact with his or her Public Pension Fund). In addition, the investment firm and its Related Parties would be prohibited from having financial, commercial or business relationships with Public Pension Fund officials, advisors, employees and fiduciaries, or any of their respective relatives, unless the Public Pension Fund consented after full disclosure.

- **Prohibited Contacts**

The Reform Code provides that, upon a Public Pension Fund's release of a request for proposal or commencement of a similar procurement process, an investment firm subject to its provisions would be prohibited from communicating or interacting with the Public Pension Fund and its officials, advisors, employees and fiduciaries concerning the subject of the process until the process is completed. Investment firms would not be prohibited from requesting technical clarifications of the procurement process or responding to requests for information from the Public Pension Fund.

- **Prohibited Gifts**

In addition, at all times investment firms subject to the Reform Code, their Related Parties and their respective relatives would be prohibited from giving any gifts (including meals and entertainment) to Public Pension Fund officials, employees and fiduciaries and their relatives under circumstances "in which it could reasonably be inferred that the gift was intended to influence the person, or could reasonably be expected to influence the person, in the performance of the person's official duties or was intended as a reward for any official action on the person's part." The practical effect of this standard is likely to be a blanket ban on all gifts, including meals and entertainment, to officials and employees of Public Pension Funds. Investment firms will need to consider whether investor conferences, seminars, luncheons and other similar functions will fall within this ban.

Action steps:

- These standards, even if not actually imposed on an investment firm by law or otherwise, may become viewed as "best practices" to avoid actual or apparent conflicts of interest when dealing with Public Pension Funds. Therefore, investment firms that do business, or seek to do business, with Public Pension Funds should start thinking about how procedures can be put in place to comply with and monitor the prohibitions above or similar prohibitions (assuming that they have not already adopted such procedures). Any existing policies, procedures, compliance manuals and similar documents should be reviewed and compared with the requirements of the Reform Code.

- **Conflicts of Interest**

The Reform Code includes very broad conflict of interest provisions that would apply to an investment firm and its Related Parties (as distinct from the investment funds it sponsors). The Reform Code deems a "conflict of interest" to exist where circumstances create a conflict with the investment firm's duty, consistent with fiduciary standards of care, to act solely and exclusively in the best interest of the Public Pension Fund's members and beneficiaries (similar to the "exclusive benefit" rule that applies to fiduciaries under Section 404(a) of the Employee Retirement Income Security Act of 1974). The Reform Code would require prompt disclosure of any apparent, potential or actual conflict of interest. It also provides that the investment firm would have to cure the conflict by eliminating it, or terminate the relationship with the Public Pension Fund as soon as responsibly and legally possible. However, the Reform Code goes on to provide that the investment firm may resolve the conflict by taking steps to isolate the person or entity that is the source of the conflict from decisions involving the Public Pension Fund and by making full disclosure to the Public Pension Fund, and it appears that the firm's general counsel or a similar official would be entitled in those circumstances to conclude that no further action needed to be taken. In addition, it appears from other language in the relevant provisions that the conflict could be cured by disclosing it to the Public Pension Fund and obtaining a wavier. This exception seems to be potentially inconsistent with the broader requirement to eliminate all conflicts.

A separate set of conflict of interest rules governs investment funds sponsored by the firm. The Reform Code would require the fund's governing documents to include provisions for how to address conflicts of interest, which may include a process for approval by an independent advisory committee.

Action steps:

- Investment firms may wish to consider the implications of these conflict of interest provisions in consultation with legal counsel given their apparent breadth and the ambiguities in the text of the Reform Code. With respect to investment funds, existing provisions in the fund documents are likely in many cases to meet the Reform Code's requirements.

- **Education and Training**

If an investment firm were to become subject to the Reform Code, it would be required to provide a copy of the Reform Code to all of its partners,[13] executive officers, directors and employees and to publish the Reform Code on its internal computer network. In addition, investment firms would be required to conduct training seminars for personnel who might interact with Public Pension Funds, with retraining at least annually.

Action steps:

- In light of the extensive new compliance and disclosure requirements that could apply to employees and other personnel dealing with Public Pension Funds, it may be advisable for investment firms to begin discussions and training sessions with such personnel in advance of being required to do so under the Reform Code or any similar code of conduct or legislative or regulatory requirement. Employees "on the ground" who work with Public Pension Funds are likely to have valuable insights into existing practices that might need to be modified and other practical steps to be taken.

[13] Although the Reform Code does not expressly so state, presumably limited partners are not included.

Given the ambiguities and difficulties we believe investment firms will have in ensuring compliance with the Reform Code as discussed above, we are hopeful that other jurisdictions will refine their procedures to address these issues. However we also believe that there will be additional scrutiny in this area, and investment firms should not assume that "business as usual" will proceed. Accordingly, investment firms should be prepared for a thorough review of their current practices and procedures.[14] Firms that demonstrate a proactive approach to meeting the newly emerging standards for dealing with Public Pension Funds may have a competitive advantage in seeking Public Pension Fund investments, as well as a smoother transition to operating under potential new, stricter legal requirements.

Please feel free to call any of your regular contacts at the firm or any of the partners and counsel listed under Employee Benefits or Private Equity in the Practices section of our website (www.cgsh.com) if you have any questions.

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[14] An investment firm that agrees to or becomes subject to the Reform Code or other similar rules will also need to consider how the requirements might apply with respect to engagements with Public Pension Funds that are already in place when the rules become applicable.

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