



3PM

THIRD PARTY MARKETERS ASSOCIATION

September 13, 2010

Governor Arnold Schwarzenegger
State of California
State Capitol, First Floor
Sacramento, CA 95814

Re: AB 1743 (hernandez) – placement Agents: REQUEST FOR VETO

Dear Governor Schwarzenegger,

Please Veto Assembly Bill 1743!

I am writing this letter to you today regarding Assembly Bill 1743 (“AB 1743”) which was recently passed by the Assembly and Senate and if signed by you, will amend the Government Code relating to the Political Reform Act of 1974. I am sending you this letter in the hope that you will veto this ill-conceived bill.

In writing my letter, I represent our members, hundreds of small and independent firms who are all registered with the appropriate regulatory bodies. Most are firms or 10 or fewer employees, and many are California businesses.

All of us who are engaged in Third Party Marketing (Placement Agents) believe that increased regulation and oversight are appropriate measures which will help monitor and define the activities of third party marketers, restore integrity to the investment decision making process in California and eliminate the inappropriate behavior that took place at one of California’s pension plans.

That said, as passed, AB 1743:

- i) will create unintended consequences that are adverse to the best interests of the State of California and the beneficiaries of its public pension plans,
- ii) will result in the abrogation of responsibilities of being a Fiduciary with respect to these plans
- iii) will not adequately solve the problems the legislation attempts to address,
- iv) runs counter to what appears to be the emerging trend in addressing the issues regarding third party marketer, fixers, finders and lobbyists which, in our view, have incorrectly identified these parties as all performing the same function.

The Role of Placement Agents

Most placement agents provide investment managers with a comprehensive, value-added sales and marketing services. Unlike the finders, fixers and lobbyists that were the principal focus of New York

Attorney General Cuomo's inquiries, a placement agent's role is much more than merely arranging a meeting between an investment manager and potential investors. Most bona fide placement agents aid in identifying the most appropriate and suitable target markets for the fund manager's products, identify which distribution channels would be most effectively and efficiently utilized, and work with the fund manager to be as effective as possible in presenting the fund manager's story in those markets. In addition, most placement agents work with their clients to help them throughout the capital raising process, which typically includes helping fund managers put together the private placement memorandum, helping to develop with fund manager's investor presentations, helping to answer due diligence questionnaires and giving advice on governing document terms and conditions. This work is often driven by years of experience, and constant work with investors (both public and private) to understand the investors' programs and needs, so as to be able to present those investors with fund managers that are suitable to and satisfy the investors' interests and needs. This efficiency and effectiveness is of enormous benefit to both the fund manager represented as well as to the potential investor.

A small or emerging firm will generally not have the resources or background to recognize how to prioritize and approach the most likely prospective investors within a universe numbers in excess of 3,000 institutions. Conversely, institutional investors find value in knowing that products represented by placement agents will generally be more appropriate to that institution's investment program and strategy preferences.

I fully endorse a framework that increases the integrity of the investment decision making process and applaud the State of California for working towards achieving this goal. Despite our agreement with the intent of AB1743, I do have serious concerns with several areas of the final bill which is now in front of you for your signature.

Placement Agents Benefit Small CA Pension Plans

Placement agents provide important services to investors who, like many smaller California public pension plans, do not have the time, resources or experience to review all potential opportunities that cross their desks. Moreover, it is the Fiduciary responsibility of the stewards of these assets to ensure they are exposed to the "best and most appropriate" managers to maintain and build the asset base to meet the pension liabilities. You have been very vocal and appropriately so about the mismatch between California's assets and liabilities.

Several of the large pension plans who have the staff and infrastructure to implement open door policies, such as CalPERS and CalSTRS, believe that investment managers do not require their services because they are willing to meet with small managers. In keeping with CalPERS' policy mandates to invest in women and minority owned managers, placement agents help those managers to position themselves successfully so that they can rise above the noise, and get the attention of investors like PERS and STRS, even though they may not have the resources otherwise necessary to obtain

commitments from this kind of investor. In such cases, placement agents provide a number of services ranging from identifying the correct points of contact, scheduling meetings, evaluating and positioning the product, and creating and preparing marketing materials. All of these tasks are all extremely time consuming and necessary to win investment commitments. In small firms that cannot afford internal sales professionals these responsibilities are often handled by the Investment Team. Since time is a limited resource, more time spent working on sales and marketing means that less time is committed to managing clients' portfolios. From a fiduciary perspective, all investors should want to see legislation enacted that would ensure that portfolio managers have the time they need to do the jobs they were hired to do.

We believe that the limitations on fees currently embedded in AB 1743 which I will address later, will result in **California public pension plans becoming investors of last choice** because investment managers that require the services of placement agent will find no agents willing to work for free. This result is contrary to what California is trying to achieve.

Women, Minority and Emerging Managers

In the investment industry, small managers are often referred to as emerging managers. At one time, the term emerging manager referred exclusively to minority and women owned investment firms. In recent years, the emerging manager universe has expanded out to include spin-out groups (that is, groups that had previously worked in other, often larger firms) and small firms regardless of the gender or race of their principals. Today, investors are even conducting searches in the alternative investment space and including both private equity and hedge fund emerging managers in their capital allocations.

California has a longstanding tradition of encouraging investment with and in minority and women owned and operated businesses. This holds true in the fund manager arena as well¹. In our experience many of these women and minority owned fund sponsors tend to be newer, emerging managers. As a result, they tend to lack the resources both to be able to effectively present themselves to investors and to pay advisory fees to placement agents on a non-contingent basis. As a result, signing AB 1743 as written would severely impair minority and women managers' access to capital from public pension plans based in California.

The Importance of Emerging Managers

The impetus for the growth and evolution of this sector has been investors' search for superior performance returns. Over time, many studies have shown that small firms have consistently outperformed larger firms. In one such recent paper published by Northern Trust in July 2009, titled "Insights on Emerging Managers; Emerging Managers Holding Their Edge Versus Elephants", Ted Krum, Vice President of Portfolio Management writes, "In six studies of emerging investment manager

¹ For example, the CalPERS AIM California Initiative Program

performance spanning 16 years of stock market history, Northern Trust has demonstrated that the smallest firms, collectively accounting for only 1% of institutional market share, enjoy a consistent advantage over industry leaders.”

If you sign AB 1743, the probability that these firms will succeed will be greatly diminished, because they will have far more difficulty accessing the capital they need to be successful. These small firms frequently need the help of seasoned and experienced sales and marketing professionals who know what the investor community wants and needs, how to present that effectively, and who are motivated to obtain investor commitments.

Prohibition on Contingency Fees

Your signing AB 1743 will require Placement Agents to register as Lobbyist in the State. In these regulations is a prohibition to pay Placement Agents a Contingency Fee or what is also called a Success Fee. Your signing AB 1743 will not address the root of the issue that surrounds paying a successful Placement Agent a fee based on assets raised. State officials in California have said that when contingency payments are involved they can impact the decisions of public officials and therefore the potential for corruption exists. We believe this is no more relevant to the investments industry than to any other industry, such as real estate, legal services, or even manufacturing. Notably, all of these industries derive revenue from performance-related compensation.

Although some of the people accused of being involved in corrupt activities were identified as placement agents, we believe that these operators are not “true” placement agents, but rather finders, fixers or lobbyists. Furthermore, all of the cases of pay to play activities identified to date also included “public officials” who were involved in the investment process. I strongly believe that any proposed regulation should make a distinction between placement agents and those who are acting as finders, fixers or lobbyists.

If contingency fees are eliminated, placement agents would need to restructure their compensation structure to comply with this law. If you sign AB 1743 into law, the only acceptable form of payment would be in the form of a flat fee. As previously mentioned, most emerging managers lack the resources to pay a placement agent a flat fee or a “retainer” since much of their capital is allocated to the facilities and personnel required to manage portfolios.

If contingency fees were prohibited, we believe the consequences would harm both small and emerging funds and the public pension plans alike. First, since most small and emerging managers would have difficulty paying a fixed fee, their access to public pension funds would decrease. Second, many smaller public pension funds do not have the staff necessary to evaluate the wide array of investment options presented to them.

We believe the **restriction on contingency fees will drive opportunity away from California**. Placement agents working with more compelling managers will steer those managers towards other investors, creating an adverse selection process that will likely hurt the investment returns achieved by California public pension plans. Finally, since placement agents assist many investors by screening managers that are not a good fit for an investor's portfolio, a bias will likely develop for California pension managers whereby public pension funds will either continue to invest with existing managers, or place bigger amounts of money with managers because they do not have the bandwidth to properly assess and evaluate new offerings, resulting in an investment bias toward larger funds, which we believe runs counter to prudent investment strategy.

Contingent compensation arrangements help to align interests among all of the parties involved in the fund manager selection process. Placement agents need to make good manager choices, or they won't be successful or get paid. Managers win because they only have to pay a placement agent based on the results the placement agent is able to achieve. This type of fee structure also assists investors. Placement agents serve as a filter that weeds out managers not worthy of investment and narrows down the universe of managers which they need to review.

The manner in which placement agents are currently compensated is no different than any success-based compensation program. Contingency fees are used in a variety of industries as a way to incentivize service providers, align the interests of various parties and share the risks involved in processes with uncertain outcomes. Throughout the United States, contingent fee arrangements are used to compensate lawyers, real estate agents, brokers and sales professionals. They are also commonplace in the investment arena including many California state government agencies, where they are used as part of the compensation package for portfolio managers, investment analysts, traders and of course for sales professionals. The critical point for consideration should not be focused on the form of the payment, but rather on three key elements: i) knowing who is being incented, ii) making sure that the person or organization is legitimate and is providing an actual service, and iii) providing transparency as to how any such payment could influence investment decisions.

It should also be noted that **when a contingency fee is paid to a placement agent, the fee is not paid by the investors, but rather by the investment manager retaining the placement agent's services**. This approach is no different than the compensation an internal sales professional would receive. In fact, by hiring a placement agent, an investment manager could actually save money by reducing the overhead costs allocated to full-time employees. These funds could then be allocated to other areas of their businesses which could help achieve higher investment returns. I believe AB 1743 favors larger funds, funds capable of affording to allocate resources to internal infrastructure.

Placement Agents are not Lobbyists

Section 82039 of the California Government Code defines a lobbyist as an individual who is compensated for directly communicating with a qualifying official when trying to influence legislative or

administrative action. Placement Agents are not lobbyists. Such a comparison is undeniably inaccurate and assumes that every Placement Agent has connections with the people who are in a position to influence investment decisions whether they are politicians or the internal staff members of a public pension plan or that we are in a position to contribute significant funds to influence the process. Our mission is not to adversely influence the decision makers but rather to help present the managers we represent in a way that best demonstrates its investment capabilities. In order for us to be successful, these managers need to receive fair and equal consideration and participate in an investment environment where awards are made on the basis of merit rather than undue influence. No one wants to restore integrity back to the investment process more that the Placement Agents who have been labeled as the notorious villains responsible for causing the pay-to-play issues.

The Impact of AB 1743

Simply stated, we believe that rigorous registration, qualification and disclosure requirements will serve the interests of all constituents in this arena far better than the seemingly simple approach in AB 1743. This bill will not only have a negative effect on placement agents, but also on a variety of constituencies which include public pension plan sponsors and a variety of investment managers including women, minority and emerging managers, who, given their size often utilize the services of a placement agent.

SEC Rule 206(4)-5 Has Been Approved

Since AB 1743 was first introduced, the SEC has passed significant new regulation to target precisely the same violations as have been the genesis of AB 1743. This is important for many reasons, but primarily because:

1. the SEC has the regulatory and enforcement framework in place to monitor compliance with its new rule
2. the Financial Industry Regulatory Authority ("FINRA") has accepted a complementary role in enforcement aimed at broker-dealer compliance

I urge you to consider all the reasons expressed in this letter, and to please veto AB 1743.

Thank you in advance for listening to my plea to veto AB 1743, for the good of California's Pension Funds and the beneficiaries, for the survival and growth of emerging managers and for the fulfillment of the Fiduciary duties of the stewards of these most important assets.

Regards,



Stacy Hevener

President of the Third Party Marketers Association

Cc: Paul Navarro, Deputy Secretary, Legislative Affairs