Fund Democracy
Consumer Federation of America

October 6, 2009

FILED ELECTRONICALLY

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: File No. S7-18-09

Dear Ms. Murphy:

We are writing on behalf of Fund Democracy and the Consumer Federation of America to comment on the SEC's proposal regarding pay to play practices in the public pension industry. We enthusiastically support this proposal and applaud the Commission for resurrecting this initiative.

Pay to play practices have long been the bane of the public money management industry. Permitting advisers to win contracts to manage public money and provide other financial services (hereinafter referred to as "public pension business") by making contributions to elected officials results in the allocation of business not to the advisers best suited for the job, but to the advisers with the strongest political relationships. These practices adversely affect the economic interests of millions of America's public servants.

The evidence of pay to play practices in the public pension business is extensive and longstanding. Prior to releasing its initial proposal in 1999, the Commission collected substantial evidence of a nationwide pay to play culture where relationship-investing had become the norm and the economic interests of public employees had become secondary.[1] More recently, the SEC's experience with pay to play practices in the municipal dealers context, its findings of blatant conflicts of interest in the pension consulting arena, and its recent enforcement actions involving pay to play practices in the public pension industry, have directed particular attention to the role played by placement agents in facilitating pay to play practices.

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[1] Fund Democracy has summarized this record of pay to play abuses on a state-by-state basis at: http://www.funddemocracy.com/Pay-to-Play%20Page.htm.

While there appears now to be widespread acceptance of the necessity of prohibiting advisers from receiving management contracts from politicians whose political campaigns they finance, there are still some who do not understand the insidious influence of placement agents. We believe that the ban on pay-to-play placement is critical to the success of the SEC's rulemaking. We strongly encourage the Commission to resist the substantial pressure from financially conflicted politicians and advisers to abandon this crucial element of its proposal.

We discuss the proposed ban on placement agents further below and provide additional comments on other issues on which the Commission has requested comment.

Pay-to-Play Placement Agents

We strongly support the proposed ban on the use of outside solicitors to win public pension business. As the SEC's careful consideration of practices in the municipal underwriting industry has demonstrated, placement agents play a key role in pay to play practices. The municipal underwriting practices are reflected in recent enforcement actions involving placement agents who obtained public pension business for investment advisers.[2] We believe that banning political contributions by advisers seeking public pension business would, in the absence of a placement agent ban, actually exacerbate the placement agent problem by placing even more pressure on advisers to pay well-connected agents for access to public officials.

The proposal is based on the SEC's careful monitoring of the problem of placement agents in the municipal securities context. As the Commission has noted in its proposing release:

> After the adoption of rule G-37 in 1994, the MSRB observed that municipal securities dealers sought to circumvent rule G-37 by hiring third-party consultants to solicit government clients on their behalf. These third-party consultants would make political contributions or otherwise seek to exert influence designed to secure municipal business for the municipal securities firm. Two years later, in 1996, the Commission approved, and the MSRB adopted, rule G-38, which required municipal dealers to disclose publicly the terms of their agreements with consultants. In 2005, *after concluding that the required disclosure was neither adequate to prevent circumvention of rule G-37*, nor consistently being made, the MSRB (with the Commission's approval) amended rule G-38 to impose a complete ban on the use of third-party

[2] *See SEC v. Henry Morris*, 09-CV-2518(CM) (S.D.N.Y., May 12, 2009) *available at* http://www.sec.gov/litigation/complaints/2009/comp21036.pdf.

consultants to solicit government clients. (footnotes omitted, emphasis added)

The adviser/pension plan context directly parallels the dealer/municipal issuer context. In both cases, the adviser or dealer seeks contracts from a public entity and made contributions to politicians to win this business.

There is more than ample evidence that the same abuses that the Commission has found in the municipal securities business are occurring in the money management business. In its 2005 study of pension consultants, the Commission found rampant conflicts of interest.[3] It found, for example, that more than half of the inspected pension consultants "provided products and services to both pension plan advisory clients *and* money managers and mutual funds on an ongoing basis," with compensation received from money managers in some cases comprising "a significant part of [the consultant's] annual revenue." More than half of the consultants were affiliated or had relationships with broker-dealers through which they received undisclosed compensation. In 2007, the GAO found that pension consultants with significant undisclosed conflicts of interest with their defined pension fund clients had annual returns that were 1.3 percentage points lower than for other consultants.[4] The cost of conflicts in the money management business is significant, corrosive and longstanding.[5]

Even critics of the proposed ban concede that "many of the third party agents acting for municipal securities underwriters in the 1990s were nothing more than political influence peddlers," and that the ban on placement agents in the municipal securities markets was appropriate.[6] They also concede that the "role of the full-service placement agent in marketing an alternative asset investment fund is no different from that of an investment banking firm acting as underwriter for a small company's initial public offering."[7] We agree, and the role of placement agents in such *private underwritings* may be entirely appropriate. But their participation in the municipal marketplace – be it for underwriting or advisory business – is an invitation for abuse.

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[3] *See Staff Report on Examinations of Select Pension Consultants*, Office and Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (May 16, 2005) *available at* http://www.sec.gov/news/studies/pensionexamstudy.pdf.

[4] *See Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, GAO-09-503T (Mar. 24, 2009) *available at http://www.gao.gov/new.items/d09503t.pdf*.

[5] For a discussion of pay to play abuses, *see* Mercer Bullard, *Pay-to-Play in America*, TheStreet.com (Apr. 26-30, 2001)(four parts).

[6] Letter to SEC submitted by unnamed person at Simpson Thacher & Bartlett LLP on behalf of Park Hill Group, LLC, at 6 (Sep. 21, 2009) ("Simpson Thacher/Park Hill Letter").

[7] Simpson Thacher/Park Hill Letter at 5.

The need for reform in this area is no more strongly indicated than by comments provided by *opponents* of the SEC's proposal. These letters describe the importance of advisers' ability to buy money management deals by paying for personal access as if this process were something to be valued, rather than the blatant corruption of any reasonable ideal of a free market meritocracy that it actually reflects. For example, Blackstone describes how, after being rejected by CalPERS' own consultant, it hired a placement agent who "arranged for us to meet with the Chairman of CalPERS and the Trustee principally responsible for CalPERS' investments."[8] The placement agent "had a long relationship" with CalPERS. Blackstone concedes that CalPERS's subsequent investment with Blackstone occurred directly "as a result of the meeting." Blackstone's own description of the relationship-investing business of placement agents reflects precisely the abuses to which the current system of placement agents is subject. Where we disagree with Blackstone and Park Hill is in their contention that "relationship-based" awards of public pension business reflect an appropriate business practice.

Another political commenter argues that the placement agent ban would prevent public pension from "receiving valuable services."[9] Yet the commenter provides no explanation of how, exactly, receiving these "services" necessitates that they be paid for by advisers seeking public pension business rather than the public pensions themselves. Surely the commenter would agree that a final accounting would show that these "services" were indirectly paid for out of public pension funds.

Remarkably, the commenter concedes that her Office has had "a good deal of experience with this issue." The referenced "experience" is actually that of the:

> former Treasurer us[ing] third parties to effectuate his kickback and bribery scheme. Indeed, it became clear through investigation that several third party 'finders' were paid for little or no work at all. In some cases, those fees were funneled back to the former Treasurer and members of his family.

These are precisely the abuses that anything short of a complete ban cannot prevent. Again, it is the comments of opponents of pay to play reform that speak loudest in its favor.

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[8] Letter from Steven Schwartzman, Blackstone Group, to SEC (Sep. 14, 2009).

[9] Letter from Denise Napier, Treasurer, State of Connecticut, to SEC (Sep. 10, 2009). *Cf.* Letter from Thomas DiNapoli, New York State Comptroller, to SEC (Oct. 2, 2009)(expressing unqualified support for placement agent ban and noting that, since the adoption of a similar ban, the "Fund's ability to manage its investment strategies has not been impaired").

Some have argued that the ban "would deny public pension funds the opportunity to access the broadest range of alternative asset managers, since most of them have limited internal resources to seek alternative asset managers out independently."[10] The proposed ban would "deny access" to nothing. There is nothing preventing pension funds from retaining their own consultants whose sole responsibility is to the pension fund and its beneficiaries. Permitting advisers to circumvent pay-to-play restrictions by hiring solicitors would eviscerate the heart of the direct prohibition against advisers' bribing politicians in return for money management contracts.

Others have argued that the proposed ban would impose additional costs on public pensions. It is the height of disingenuousness to argue that proposed ban "would impose costs on Public Pension Investors that *they do not currently incur*."[11] This argument is the equivalent of arguing that the dinner rolls provided at a restaurant are free. No rational person would question the fact that the services of advisers' placement agents ultimately are paid by the advisers' clients.[12] The proposed ban would simply replace the indirect cost of placement agents incurred by pension plan sponsors with the direct cost of hiring their own placement agents – without the conflict of interest and potential for abuse that relying on advisers' placement agents creates. It is not the cost of independent advice that the Commission has not accounted for in its proposal, but the cost of conflicts that critics have failed to acknowledge in their analysis.

The premise of those arguing against the proposed ban on placement agents is that the quality of the substantive advisory services provided ultimately depends on the quality of the advisers' access to the political elite.[13] They believe that pension plans cannot obtain the best services unless the plans have been lobbied by the best political operatives. The competing premise on which the SEC's proposal is based is that the quality of the substantive advisory services provided

[10] Simpson Thacher/Park Hill Letter; *see also* Letter from William O. Bell, III, Westwood Distributors LLC to SEC (Sep. 23, 2009) (describing marketing activities of former Chief of Management Policy, Florida State Board of Administration, who was "responsible for the oversight, policy development and due diligence for all solicitations to the SBA by domestic and international investment providers, brokers, attorneys, consultants and custodians").

[11] Simpson Thacher/Park Hill Letter.

[12] The rational argument would be that efficiencies may be gained by bundling the cost of *bona fide* services provided by placement agents with advisory fees. We are not aware that any placement agents have made this argument, however, probably because any potential efficiencies realized from bundling would pale in comparison with the attendant costs of improperly awarded public pension business.

[13] *See* Letter from David Friedman, Wrightwood Capital, to SEC (Sep. 25, 2009) (describing Park Hill's role in making "introductions" to pension plans; "[w]ithout a placement agent, it would have been terribly challenging, if not impossible, to determine which investors to contact, *let alone to gain access to the responsible individuals within these organizations*.").

should be measured by the actual quality of the services. We agree that public pension contracts should be awarded on the basis of quality of the services, not the political influence of the adviser.

Two-Year Ban

We strongly agree that a two-year ban is necessary. As the Commission notes, the two-year ban appears to have been an effective deterrent in the municipal securities context. We disagree with the suggestion that the ban should be shorter because an adviser's relationships are likely to be longer term than those of an underwriter. This claim simply highlights the greater potential for abuse in the adviser context, where pay to play practices may have more adverse effects because of the relatively entrenched nature of the advisory relationship. The possibility that advisory relationships may be longer term militates for a stronger rather than weaker deterrent.

Persons Running for Federal Office

We also believe that the definition of "official" should be extended to include persons running for federal office. Some have argued that this would put state officials running for federal office at a disadvantage to contestants who are not state officials. First, this argument misunderstands the relevant comparison. The state official in this situation has the ability to extort contributions in return for advisory business that the non-state contestant does not have the authority to award. Extending the ban to federal campaign contributions removes this unfair advantage. Second, the SEC's proper concern is the abuse of advisory clients by advisers, not a largely theoretical concern about how to ensure that every candidate for office be allowed to tap every conceivable source of campaign funds.[14]

Look-Back Provision

We strongly agree that the look-back provision that attributes past contributions by recently hired persons is a necessary feature of the rule.[15] If such a ban were

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[14] We note that the U.S. Court of Appeals has found that MSRB Rule G-37 does not violate the First Amendment. *See Blount v. SEC*, 61 F.3d 938 (D.C. Cir. 1995), *cert. denied,* 517 U.S. 1119 (1996). Claims that the Supreme Court's decision in *Randall v. Sorrell*, 548 U.S. 230 (2006), cast doubt on the Court of Appeals decision are unavailing. *See* Letter from Hardy Callcott to SEC (Aug. 3, 2009). *Randall* involved a state campaign finance law. Its analysis is clearly inapplicable to the SEC's exercise of its federal statutory authority to regulate investment advisers.

[15] Claims that the look back provision is retroactive are incorrect. *See* Nappier Letter, *supra* note 10. The provision does not apply retroactively. It applies only prospectively from the time that an adviser hires a person who previously made a political contribution. One commenter claims that compliance would require advisers "to monitor all elections (local, county and state) in all 50 states and US possessions in anticipation of future hires." *Id*. This is absurd. It requires only that advisers ask potential hires if they have made contributions within the preceding two years. If the person has made a contribution that would trigger the application of the rule, the adviser can

not implemented, as the Commission notes, contributions by advisers could be funneled through departing employees or business "bought" by hiring past contributors. When a departing employee makes a contribution, the recipient will associate that contribution with the employee's former firm. This connection is likely to be broken only if the contributing person attempts to use his prior contribution as a means of obtaining business for a new employer, in which case the potential for abuse simply transfers from one relationship to another.[16]

Returned Contributions Exemption

We are concerned regarding the free pass afforded to "returned contributions." Advisers should establish procedures reasonably designed to ensure that inadvertent contributions are not made and should bear some responsibility when those procedures fail. For example, it is not clear why an adviser generally should be permitted two violations in any 12-month period. At a minimum, the rule should be revised to exempt returned contributions only once in any 12-month period where the second contribution occurred after the discovery of the first (with two exemptions being permitted when the second contribution occurred prior to the discovery of the first).

We also believe that allowing up to 4 months to discover the contribution is excessive, as is the 60-day period in which the contribution can be returned. These lengthy periods would permit a prohibited contribution to remain in the hands of the receiving politician for up to 6 months during which the relevant election could easily have been decided *and the expected advisory contract already awarded*. We recommend that the returned-contributions exception require that the contribution be discovered within one month and returned in no more than another 30 days and in no event after the election with respect to which the contribution was made.[17] If special circumstances warrant an exemption, the

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refrain from hiring the person or seek an exemption from the Commission. The argument that the provision will cause the suspension of existing contractual commitments with respect to illiquid investments has no basis in fact and, in any case, would be the effect not of hiring of a previous contributor, but of the entire rule. We note that the commenter claims to have operated under state pay to play laws without indicating that her illiquid investment concerns have actually been realized.

[16] If the Commission is concerned that politically active individuals will be prevented from joining advisory firms, it could create a returned contribution exemption that required that any prohibited contribution be returned prior the employment of the person. We strongly agree with the Commission that advisers may hire such persons precisely to win advisory business.

[17] We question the relevance of the SEC's reference to the reporting of contributions on a quarterly basis. *See* Political Contributions by Certain Advisers at n. 121. Quarterly reports of contributions would not be an adequate mechanism for ensuring that prohibited contributions were not made. The appropriate compliance procedure would be to require pre-clearance of all contributions to ensure that any contributions complied, for example, with the de minimis exception (thus, records of *de minimis* contributions should be required). The SEC's position implies that advisers need not worry about noncompliance as long as they require quarterly reports and there have been no more than 2 violations in the previous 12 months. We believe that a

adviser can apply for one under the rule. In addition, in order for an adviser to rely on the returned contribution exception, it should be required to document the time and circumstances of the belated "discovery" and return of the contribution apart from other records otherwise maintained regarding the contribution and report the infraction to the Commission.[18]

Covered Associates

We believe that the SEC's definition of covered associate generally strikes the right balance between ensuring coverage of the adviser's personnel who have the strongest incentive to make political contributions to win business and avoiding incidental effects on the political activities of other employees who do not present such a significant risk. We agree that all of the adviser's executive officers should be included because the nature of their status alone creates a strong incentive to engage in pay to play practices. We also strongly recommend, however, that the rule be extended to apply to any persons associated with the adviser or its affiliates who solicit government business, any director of the adviser or entity controlling the adviser or person holding a similar position, and any person who owns a 25% or greater interest in the adviser. In each of these situations, there is a significant risk that the rule will be circumvented by the making of political contributions by such persons.

Conclusion

Pay to play abuses have plagued public pension management for decades. Just as MSRB Rules G-37 and G-38 have substantially reduced similar abuses in the municipal underwriting market, the SEC's proposed pay to play rule will effectively prohibit much of the tacit bribery through which public pension contracts are often awarded. We heartily commend the Commission on its proposal and look forward to the rule's adoption.

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belated "discovery" of a prohibited contribution would reflect a material breakdown in the adviser's compliance procedures – a circumstance that certainly should not be tolerated on an automatic, unreviewable basis twice every 12 months.

[18] We understand that this exemption reflects the terms of similar exemptions in MSRB Rule G-37. We believe that Rule G-38 should be amended to reflect our concerns.

Thank you for your consideration of our comments.

Sincerely,

Mercer Bullard
Founder and President
Fund Democracy

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc by electronic mail:

Honorable Mary Schapiro, Chairman
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