

FIRST SETTLEMENT IN NEW YORK “PAY TO PLAY” PENSION CASES IS LIKELY TO CHANGE PLACEMENT AGENT PRACTICES

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The role of private placement agents in public pension fund investment decisions is facing increasing scrutiny, with the SEC and Attorney General’s offices in at least 37 states examining the issue. The issue first arose as a result of an alleged multi-million dollar fraud involving the New York state pension fund. A recent settlement of a related investigation in New York might have significant ramifications for hedge funds, private equity firms, investment managers and other intermediaries across the US. As a result, such firms can expect to be asked for information on relevant investments by government regulators, which will require a coordinated response to manage exposure.

Background – The New York Allegations

For several years, the New York Attorney General and the SEC have been investigating allegations that friends and relatives of Alan Hevesi, New York’s former Comptroller, who was the sole trustee of New York’s pension fund, received millions of dollars in cash and other benefits from firms acting as placement agents who arranged investments by the New York pension fund into various private investment firms. There was also evidence that thousands of dollars in campaign contributions to New York’s Comptroller were solicited from employees of those investment firms by the same placement agents. These alleged bribes and kickbacks, which have become known as “pay for play” schemes, have resulted in several criminal indictments in New York.

The Carlyle Settlement

The New York Attorney General announced a settlement with The Carlyle Group, a private investment firm accused of engaging in improper activities when using placement agents to obtain investment business from New York state pension funds.

Carlyle will adopt the Attorney General’s Public Pension Fund Code of Conduct. The Attorney General has announced that he hopes to use the Carlyle settlement and the Code of Conduct as the basis for changing industry practice in dealing with public pension funds. Details of the settlement are outlined below, and we will be sure to keep you apprised of any effects this may pose for your business as the fallout continues.

- **Monetary sanctions:** Carlyle has agreed to pay \$20 million to the state of New York.
- **Changes in pension business:** Carlyle will cease using intermediaries to solicit business from pension funds nationwide, not just the New York state pension fund. The firm must also disclose any potential conflicts of interest to public pension fund officials. The ban does not prevent the use of consultants to prepare marketing materials or perform due diligence.
- **Changes in political and charitable contributions:** Carlyle will refrain from doing business with a public pension fund for two years after it, or one of its executives or their family members, makes a campaign contribution to an elected official who can influence that pension fund’s investment decisions, unless the contribution is for less than \$300 and the elected official is someone for whom the donor is eligible to vote. This rule will eliminate out-of-state campaign contributions.

Reactions Outside New York

The SEC is still considering whether to propose new rules governing placement agents' role in pension fund investment decisions. Attorney General's offices in at least 36 other states have begun investigations into the investment practices of public pension funds, the involvement of placement agents in locating investment opportunities for such funds, and payments made by funds that receive investments from public pension funds. Those investigations have reached beyond the egregious conduct that initiated the New York investigation to the role of placement agents generally, producing a draconian proposal by some that placement agents and other middlemen be eliminated altogether.

The Massachusetts Reaction

The Executive Director of the Massachusetts pension system has announced that he has no plans to bar placement agents or other intermediaries from marketing private equity or hedge fund investments to the commonwealth's pension system. He recognized the legitimate place for such intermediaries and explained that their participation was well-established in the investment community. Unlike the New York pension system, where control is concentrated in a single elected official, the Massachusetts system is run by a larger board which makes it more insulated from political influence. The Massachusetts Attorney General is, however, investigating certain firms' business dealings with the Commonwealth's pension fund.

Conclusion

As the investigations by the New York Attorney General, the SEC, and the Attorneys General of other states continue, many private equity firms, hedge funds, investment managers, and advisers to pension funds may receive requests for information from government regulators and from their investors. Choate can help you to formulate a coordinated response and manage your exposure to a government investigation.

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