

Industry-Wide Investigation Announced – Investigators to Examine Role of Placement Agents, Intermediaries and Middlemen in Public Pension Fund Investments

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Multistate Task Force Formed and Dozens of Subpoenas Issued

Andrew Cuomo, the New York State Attorney General (“NYAG”), has announced that he and the attorneys general of 36 other states have formed a nationwide task force to share information about, and investigate, potential wrongdoing in the business of obtaining investments by state and local pension funds.¹ As part of Mr. Cuomo’s investigation into “pay-to-play” practices, his office issued more than 100 subpoenas to investment management firms and funds that received investments from public pension funds in New York and to the so-called “placement agents” or finders used by those firms to assist in obtaining the investments.²

The formation of the multistate task force and the flurry of investigatory subpoenas arrive on the heels of the announcement of civil charges by the SEC and criminal charges by Mr. Cuomo’s office against the former Deputy Comptroller of New York State and a placement agent. The defendants are charged with corrupting the approval process by which investment firms gained access to investments from the state’s largest public pension fund, in exchange for

kickbacks.³ Mr. Cuomo also recently, in a separate case, charged a national consultant to pension funds, Saul Meyer of Dallas-based Aldus Equity, with felony securities fraud.⁴

The Use and Payment of Placement Agents and Finders

For private equity funds, hedge funds, funds-of-funds and investment managers, public pension funds are an extremely important source of investment management clients. The New York Common Retirement Fund (“CRF”), for example, is one of the world’s largest pension funds with total assets of more than \$100 billion. Obtaining access to these public pension funds is extremely competitive. Fund managers seeking investments from the CRF frequently retain third parties, some known as “placement agents” and others as “finders,” to market their funds or make introductions.⁵ As discussed more specifically below, the SEC and the NYAG have alleged in recent cases that officials responsible for directing investments by the CRF used certain placement agents or finders to obtain bribes and kickbacks from private equity funds and hedge funds in exchange for CRF business.

Often Unregistered

Mr. Cuomo told reporters that a preliminary review by his office found that as many as half of the intermediary placement agents or finders in pension fund transactions in New York State and New York City were not properly registered as or with a broker-dealer firm. While he acknowledges that there can be exceptions in which a placement agent, finder or other intermediary would not have to be registered, he views this as a “troubling pattern” that is “fraught with peril and prone to abuse.”⁶ The NYAG has indicated that his office will be seeking answers to the following questions in its examination:

- Which firms used which unlicensed agents, why, and in what manner;
- What fees were unlicensed agents paid, and for what services, if any;
- How the firm came to retain the unlicensed agent;
- Whether the firms did any due diligence about the unlicensed agents; and
- Whether payments to unlicensed agents were disclosed to the pension fund.⁷

While the securities laws set forth specific conduct requiring registration – conduct that very well may not implicate the role placement agents typically played in these transactions – Mr. Cuomo has indicated that he will be taking a broader view and has said to reporters, “If you’re brokering a security, you need to be regulated.” Thus, one of the central areas of inquiry going forward will be the roles and legal obligations of lobbyists, political consultants and other third parties who brokered deals between investment firms and public pension funds, but were not registered to do so.⁸

Registration Requirements and Potential Penalties

There are limitations to the registration requirements. Only those persons who engage in

effecting transactions in securities are obliged under federal and state law to be licensed and satisfy registration requirements. Specifically, Section 15 of the Securities Exchange Act of 1934 requires the registration of any broker, dealer or person associated with a broker-dealer who takes steps to “induce or attempt to induce the purchase or sale of, any security.”⁹ A willful violation of the federal registration requirements can result in imprisonment for up to 20 years, criminal fines of up to \$5 million and disgorgement of any profits; civil penalties include fines up to the gross amount of the unregistered person’s pecuniary gain, permanent or temporary bars from the industry and any other equitable relief “appropriate or necessary for the benefit of investors.”¹⁰ In addition to liability for those persons who unlawfully fail to become registered, the 1934 Act also provides liability for those who knowingly aid and abet violations of these requirements, as well as for “control persons” under certain circumstances, such as employers.¹¹

Similarly, New York’s Martin Act requires the registration of any person who acts as a “broker,” that is, any person “engaged in the business of effecting transactions in securities for the account of others.” It also requires the registration of any and all “salesmen” employed by such brokers who “sell or offer for sale to, or purchase or offer to purchase from, the public . . . any securities.”¹² Failure to comply with these requirements could constitute a “fraudulent practice” within the meaning of the Martin Act and may be subject to criminal prosecution.¹³ In particular, the NYAG is authorized to seek restitution of any money obtained directly or indirectly in connection with any “fraudulent practice,” and to seek imprisonment for up to one year (misdemeanor liability) for any person found to have knowingly violated any of the registration provisions.¹⁴

A placement agent’s or intermediary’s obligations to obtain registration under the securities laws will thus depend on the facts and circumstances of that person’s conduct and role

in the particular transaction or in the course of business.

As of this date, no charges have been brought in either the SEC or the NYAG cases for violations of registration requirements – instead, the cases have been brought under more traditional criminal and civil anti fraud statutes. But Mr. Cuomo’s public pronouncements make clear that his office will be closely scrutinizing the conduct of those who acted as intermediaries in the investment of public pension fund money to see if their conduct ran afoul of federal or state registration requirements.

The Most Prominent Recent Charges

The recent cases brought by the SEC and the NYAG are instructive in showing the types of activity and conduct that prosecutors and regulators will be investigating. The lead defendants in the related cases are David Loglisci, the former Deputy Comptroller of New York State, and Henry “Hank” Morris, a longtime advisor, confidant and fund-raiser for former New York State Comptroller Alan Hevesi. The indictment alleges that Loglisci and Morris corrupted the alternative investment process by which investment firms gained access to the CRF. According to the charges, Morris had been instrumental in removing Loglisci’s predecessors and in arranging for Loglisci to rise to the Deputy Comptroller post. It further alleges that Loglisci returned the favor to Morris by granting Morris a significant role in determining which private equity and hedge fund investments CRF would make.

The centerpiece of the criminal case is the allegation that Loglisci required that certain private equity funds, funds-of-funds and hedge funds hire Morris or Morris’s associates as placement agents in exchange for preferential treatment in obtaining CRF investments. Indeed, the indictment alleges that Morris enjoyed broad access and influence over Loglisci and used that authority to cause Loglisci to steer CRF business to firms that were paying Morris. The indictment alleges that, as a result of the scheme, more

than \$4 billion worth of CRF investments were made in private equity funds, hedge funds and funds-of-funds that had paid more than \$10 million in placement agent fees to Morris or his associates. The indictment and parallel civil suit allege that these various conflicts-of-interest and Morris’s profits from these investments were kept secret and concealed from other individuals responsible for approving CRF’s investments.

As to the registration issue, the indictment notes that Morris was, in fact, properly registered. He took and passed the Series 7 and Series 63 examinations and was associated with a registered broker-dealer based in Connecticut.¹⁵

In the civil case, the SEC sued Morris, Loglisci and several investment managers, including Barrett Wissman and Saul Meyer (as noted above, the NYAG also charged Meyer criminally). The SEC complaint alleged a kickback scheme that involved the payment of sham “finder” and “placement agent” fees in order to obtain investments from the CRF.¹⁶

What This Means for Private Equity Funds, Hedge Funds and Funds-of-Funds

With the formation of the 36-state task force and the flurry of subpoenas, any investment management fund, private equity fund, fund-of-funds or hedge fund that has sought or received an investment from a public pension fund should determine whether and under what circumstances a placement agent, finder or other third-party intermediary was paid or was involved in the introduction or negotiations relating to the investment and whether such persons were registered under the securities laws. In addition, it would be advisable to determine what services the agent performed, how the firm came to retain the agent, what type of due diligence the fund performed on the agent, and whether payments to the agent were disclosed to the pension fund.

The Paul Hastings Team

If you would like further information on this issue, or if you receive a subpoena in the context of these investigations, please let us know. We have a strong team of experienced regulatory and enforcement lawyers which includes former

prosecutors and SEC regulators. Members of our group regularly represent clients in connection with investigations by the New York Attorney General's Office, the SEC, the Department of Justice, FINRA, NASAA and numerous other state attorneys general and regulatory organizations.



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¹ "Pay-to-Play Probes Go Nationwide," by Craig Karmin, *Wall Street Journal*, May 2, 2009.

² "Cuomo Serves Subpoenas in Placement Agent Probe," by Jessica Dye, *Securities Law 360*, May 1, 2009.

³ See *S.E.C. v. Henry Morris, et al.*, 09 Civ. 2518 (CM) (S.D.N.Y.) and *People v. Henry Morris and David Loglisci*, Ind. No. 25/2009 (Supreme Court, N.Y. County).

⁴ "Cuomo Issues Subpoenas in Pension Fund Inquiry," by Danny Hakim, *New York Times*, May 2, 2009; *People v. Saul Meyer*, Felony Complaint, Docket No. 2009NYO35023, Criminal Court, New York County.

⁵ *People v. Morris*, Indictment at pp. 2, 9.

⁶ "Cuomo Issues Subpoenas in Pension Fund Inquiry," by Danny Hakim, *New York Times*, May 2, 2009.

⁷ "Cuomo Announces Investigation Into Use of Unregistered Middlemen Marking New Phase in Pension Fund Investigation," Press Release, NYAG, May 1, 2009.

⁸ "Cuomo Issues Subpoenas in Pension Fund Inquiry," by Danny Hakim, *New York Times*, May 2, 2009.

⁹ Title 15, United States Code, Section 78o(a)(1).

¹⁰ Title 15, United States Code, Sections 78ff(a) and 78u(d)(3)(B) and (d)(5).

¹¹ Title 15, United States Code, Section 78t.

¹² N.Y. Gen. Bus. Law §§ 359-e(1), (3) and (13)(d).

¹³ N.Y. Gen. Bus. Law §§ 358 and 359-e(12).

¹⁴ N.Y. Gen. Bus. Law §§ 353(2) and 359-g(2).

¹⁵ *People v. Morris*, Indictment at p. 10.

¹⁶ *S.E.C. v. Morris, et al.*, 09 Civ. 2518 (CM) (S.D.N.Y.), Complaint at ¶¶ 1-2.