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Placement Agent Man

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With apologies to Johnny Rivers...

There's a man who leads a life of danger
To everyone he meets he stays a stranger
With every move he makes another chance he takes
Odds are he won't live to see tomorrow

Placement agent man, placement agent man
They've given you a number and taken away your name

Beware of pretty faces that you find
A pretty face can hide an evil mind
Ah, be careful what you say
Or you'll give yourself away
Odds are you won't live to see tomorrow

Placement agent man, placement agent man
They've given you a number and taken away your name

It all started a few weeks ago with allegations of kick-backs surrounding the sale of investment vehicles to the New York State Common Retirement Fund. As The Deal reported earlier this month, "go-betweens" (a.k.a. commissioned placement agents) are accused of surreptitiously linking investment allocations to political contributions.

Reactions: "disclosure" to "outlaw"

The reaction has been swift and has tainted the entire placement (a.k.a. "third party marketing") industry. CalPERS came out with a new policy last week governing the use of third party marketers. In a statement the plan said its new policy would require:

- "Investment partners and external managers disclose their retention of placement agents, the fees they pay them, the services performed, and other information about their engagement;
- "Placement agents register as broker-dealers with the U.S. Securities and Exchange Commission (SEC) through the Financial Industry Regulatory Authority (FINRA) or CalPERS would decline the opportunity to retain or invest with the external manager or investment vehicle; and
- "Disclosures include agents' identities, resumes of key people, description of compensation and services, copies of agreements, and if the agent is registered with the SEC or as a lobbyist."

So far, CalPERS hasn't gone nearly as far as the Illinois State Board of Investments did a few years ago when it banned third party marketers outright in response to a particular "episode". Bill Atwood, the Board's executive director recently told Bloomberg:

"There were no laws broken...(but the episode) cast a negative light on the more legitimate types of marketing services...From the perspective of legislators, they felt like they had to take action on that. Their response was to outlaw the entire practice."

It's difficult to argue against CalPERS's policies since they obviously decrease the likelihood of inappropriate channelling of placement commissions. But unlike Illinois' policies, they stop well short of banning placement agents outright.

Unfair?

As The Deal observed earlier in May, the New York scandal should not be taken as an indictment of the entire third party marketing industry:

"Many practitioners believe banning placement agents is over-reaching. For New York, it may not make a difference since less than 10% of the fund's transactions involve agents..."

"...'It's comical,' says Robert Morris, founder of Stamford, Conn.'s Olympus Partners, who believes the problem isn't placement agents but individuals that corrupt the process."

By happy coincidence, there was a conference earlier this month on the very topic of how to raise capital for private equity funds (with the unfortunate title: "How to Win at Fundraising Despite the Funding Famine: Where to Go, Who to See, What Not to Say" (their emphasis). Bloomberg News reports from the event that placement agents are not pleased with being tarred with the same brush as some of their nefarious colleagues..

"I'm amazed that a political corruption case has led people to question the legitimacy of a long-established part of the asset management business," said Michael Travaglini, executive director of the \$34.2 billion retirement fund for public employees in Massachusetts. "There's a legitimate place for placement agents."

"Just because you have bank fraud doesn't mean all banks are crooked; it's the same with placement agents," said Ash Williams, who helps oversee \$113 billion in pension funds and other investments as executive director of Florida's State Board of Administration. "There's been criminality in pay-for-play, but that doesn't mean all placement agents are bad."

The Third Party Marketing Association ("3PM") joined the debate last week with a position paper on the topic which implored policy makers not to throw the baby out with the bathwater.

"3PM believes a general ban on the use of legitimate third party marketers is an unreasonable and unjustified response that affects an entire industry segment as a result of the alleged illegal misconduct of a few.

A Personal Perspective

I used to be an internal hedge fund marketer who regularly used the services of a third party marketing firm. Here's my take on the issue...

There are two types of third party marketing firms - those that build relationships from scratch around a fund and those that rely solely on pre-existing relationships with investors (what many in the industry euphemistically call "monetizing their Rolodex").

Illinois' Atwood put it more bluntly to Bloomberg News when he observed:

"There's always a question about placement agents...Are they a legitimate business where you outsource marketing? Or are you using that payment schedule to basically purchase relationships?"

Obviously, all 3PMs involve some combination of both approaches. But there is a natural incentive for agents to strive for the latter ("Rolodex monetization") since that's how fund managers chose 3PMs and that's how the 3PM can achieve the same results with less effort.

The problem is that strong investor relationships suggests to those investors that the marketer is working for them - as if the marketer was some kind of investment consultant.

Compounding the problem is that any sales professional will tell you that a "consultative sale" where the salesperson is a "trusted adviser" is the Holy Grail of business-to-business sales. I have never heard of a sales person who was disappointed that a sales prospect seemed bias toward their offering prior to the creation of an RFP. So it's unfair to expect the third party marketers to hold back in situations where - according to the standards set out by their profession - their salesmanship has been "too good" (assuming, of course, that the salesman has operated within the rules).

Indeed, like third party marketers, internal sales people usually receive a sales commission too. So to indict 3PMs en masse is to indict the sales function itself (whether it is executed by a third party, an internal salesperson or the fund managers themselves).

CalPERS is right to demand transparency. But with most hedge funds too small to support an on-going marketing function, the third party marketer plays a critical role in the investment ecosystem.

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