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Client Alert

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SEC Adopts Rule to Prohibit "Pay to Play" Practices

On June 30, 2010, the US Securities and Exchange Commission (SEC) approved new Rule 206(4)-5 (Rule) under the Investment Advisers Act of 1940, as amended (Advisers Act). The Rule is aimed at preventing "pay to play" practices by investment advisers that seek investment advisory business from investment pools controlled by US state and local government entities. The SEC released the proposed rule, along with amendments to Rules 204-2 and 206(4)-3, on August 3, 2009, and, after receiving considerable public comment and revising certain aspects of the proposed rule, issued its adopting release on July 1, 2010. The Rule imposes limitations on the use by investment advisers of placement agents to solicit capital commitments from US government entities and effectively prohibits the making of political contributions or gifts to state and local government officials of a US government entity to whom an investment adviser provides investment advisory services, or is seeking to provide such services.

"Compliance with the Rule will require changes to internal compliance procedures of investment advisers and the adoption of new policies and procedures (or enhancements to existing policies and procedures)."

General

The Rule prohibits an investment adviser and, where applicable, its "covered associates" from:

- Providing or agreeing to provide payments (broadly defined) to a third party (generally, a "placement agent")[1] to solicit a US state or local government entity for investment advisory business on behalf of such investment adviser unless the third party itself is registered as an investment adviser or broker-dealer with the SEC and is subject to the Rule or is subject to similar "pay to play" rules imposed by another regulatory authority, such as FINRA
- Receiving compensation from a US government entity in exchange for the provision of investment advisory services within two years of making a contribution to an official of such government entity
- Soliciting any person or political action committee to make a political contribution to an official of a US government entity to which the investment adviser is providing or seeking to provide investment advisory services, or to a state or local political party located in the jurisdiction of such government entity

The Rule also requires an investment adviser to maintain detailed records relating to its "covered associates" and certain of their political contributions.

Applicable to All Investment Advisers and their "Covered Associates"

The Rule generally applies both to investment advisers registered with the SEC and to unregistered investment advisers.[2] It applies to investment advisers directly managing assets of US government entities, as well as those advising "covered investment pools" in which a US government entity invests (*e.g.*, a private investment fund registered under the Investment Company Act of 1940, as amended, or a private investment fund that would be registered but for an exemption provided by Section 3(c)(1), Section 3(c)(7) or Section 3(c)(11) of such Act). Non-US investment advisers will also be subject to the prohibitions in the Rule.

The Rule applies not only to investment advisers themselves, but also to their "covered associates," which is defined to include: (i) any general partner, managing member or executive officer or other individual with a similar status or function; (ii) any employee of the investment adviser who solicits a US government entity for investment advisory business for the investment adviser and any person who supervises, directly or indirectly, such employee; or (iii) any political action committee controlled by the investment adviser or a person described in clauses (i) and (ii).

The term "executive officer" includes any "president," "any vice president in charge of a principal business unit, division or function," and "any other officer" or "any other person" who performs a policy-making function, rendering the scope of the Rule potentially very broad. The SEC has explicitly stated in its adopting release that the Rule will be broad in scope and application, and therefore investment advisers should expect that any employees of reasonable seniority will be subject to the strictures of the Rule.

Third Party Solicitation of Government Entities: Placement Agents

After significant comment from the investment fund industry, academics and observers, the final version of the Rule does not include a ban on the engagement by investment advisers of third parties to solicit US government entities for investment advisory business, as originally proposed. Instead, the Rule provides that an investment adviser is permitted to hire a third party to solicit US government entities on its behalf to solicit investment advisory business, *so long as such* third party is: (i) registered with the SEC as either an investment adviser or broker-dealer; and (ii) subject to "pay to play" restrictions either under the Rule or under similar rules of a registered national securities association. FINRA is expected in the near-term to promulgate "pay-to-play" rules "as rigorous and as expansive" as the new SEC Rule; therefore, registered broker-dealers will likely be able to satisfy the foregoing requirements. Investment advisers are required to maintain a list of names and business addresses of all third parties paid to solicit US government clients on behalf of the investment adviser.

Proscribed Payments and Political Contributions

The Rule prohibits payments or contributions to, or in respect of, any US state or political subdivision of a state, including: (i) any agency, authority, or instrumentality of the state or political subdivision; (ii) a pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including but not limited to a "defined benefit plan" as defined in the Internal Revenue Code (*e.g.*, a public employees retirement fund), or a state general fund; (iii) a plan or program of a US government entity; and (iv) officers,

agents, or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

Prohibited "payments" are broadly defined to include any direct or indirect gift, subscription, loan, advance, or deposit of money or anything of value, and prohibited "contributions" include any gift, subscription, loan, advance, or deposit of money or anything of value made for: (i) the purpose of influencing any election for federal, state or local office; (ii) payment of debt incurred in connection with any such election; or (iii) transition or inaugural expenses of a successful candidate for state or local office.[3] The Rule prohibits acts done indirectly which, if done directly, would violate the Rule, and therefore also prohibits the solicitation of a third party to make gifts or contributions that would otherwise be proscribed.

In its adopting release, the SEC states that "an adviser and its covered associates could not funnel payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the adviser as a means to circumvent the rule." Thus, gifts or contributions by a family member, spouse, friend, or — particularly relevant to a private equity firm — portfolio company or its management made at the direction of an adviser or a "covered associate" to avoid the provisions of the Rule would fall within its scope.

The Rule defines "official" of any US government entity to include any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a US government entity, if the office: (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a US government entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a US government entity. In evaluating whether an officeholder is a qualifying government official for purposes of the Rule, the SEC will look to the scope of authority of the office occupied, and not the particular influence actually exercised by the officeholder.

Impact of Making a Prohibited Payment or Contribution

The Rule prohibits an investment adviser from receiving compensation for providing investment advisory services to a US government entity for a period of two years following the making of any prohibited payment or contribution to an official of such government entity by the investment adviser or any of its covered associates. While the term "compensation" is not defined in the Rule, it is expected to include an investment firm's management fee and profits or carried interest on a US government client's investment, as well as payments for organizational costs, *e.g.*, "partnership expenses."

Notably, the Rule only prohibits receiving compensation during such two-year period, but does not prohibit accepting capital commitments from, or providing investment advisory services to, a US government entity. Therefore, if gifts or contributions have been made in violation of the Rule, an investment adviser may be able to avoid sanctions by waiving any compensation from such government entity until the earlier of the expiration of the two-year period or when such government entity ceases to be a client of the investment adviser.

Importantly, the Rule applies a "look-back" such that if an investment adviser or one of its covered associates makes a prohibited political contribution or payment to a government official during any two-year period prior to the solicitation of the investment advisory business, then the investment advisory firm will be prohibited from

receiving compensation from the subject government entity for two years, measured from the time of the offending political contribution.[4] Accordingly, when hiring a new employee or promoting an employee to a position that may qualify as a covered associate, an investment adviser should review all of his or her political contributions made in the two-year period prior to his or her employment or promotion. The termination or departure of an employee will not prevent his or her political contributions from being attributed to the adviser, nor stay the application or continuation of the two-year prohibition period on receipt of compensation.

The general restrictions on political contributions are subject to the following limited exceptions: (i) a narrow de minimis exception for political contributions by a natural person of up to an aggregate of US$350 to a government official per election in which such person is entitled to vote, or US$150 per election in which such person is not entitled to vote; (ii) an exception, not to be effective more than three times per year (for larger investment firms) or two times per year (for smaller firms), for inadvertent breaches of the Rule in which the violation is discovered within four months of the contribution, if such contribution did not exceed US$350, and the full contribution is returned within 60 calendar days of the discovery of the contribution; and (iii) discretionary exceptions, to be granted upon an application to the SEC for exemptive relief upon specified grounds.

Record-Keeping

New amendments to Advisers Act Rule 204-2 will require each registered investment adviser with US government clients, or that provides investment advisory services to an investment pool in which a US government entity investor participates, to maintain records of all political contributions made by the investment adviser and its covered associates to government officials (including candidates), including payments to US state or local political parties and political action committees, along with a list of US government entities to which it provides (or has provided in the past five years) investment advisory services.

Effectiveness and Action Items for Investment Advisers

The Rule was published in the Federal Register on July 14, 2010, and thus will become effective on September 13, 2010. Investment advisers are generally required to be compliant with the Rule by March 14, 2011. However, the deadline for: (i) compliance with the prohibition on the use of third parties to solicit US government business; and (ii) general compliance with all aspects of the Rule by advisers to registered investment companies that qualify as covered investment pools for the purposes of the Rule, is September 13, 2011.

Compliance with the Rule will require changes to internal compliance procedures of investment advisers and the adoption of new policies and procedures (or enhancements to existing policies and procedures). Fund sponsors are advised to review their fundraising and political contribution practices in order to ensure that they may continue to seek investments from, and provide investment advisory services for compensation to, US government entities, prior to the effectiveness of the Rule, as the penalties for violating the Rule will be severe.

Endnotes

[1] The Rule does not prohibit payments made by an investment adviser to its own executive officers, general partners, managing members (or, in each case, persons with a similar status or function) or employees, thus allowing investment advisers to continue to provide compensation to such persons in connection with the solicitation of investment advisory business.

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on July 21, 2010, requires most sponsors of private equity funds, real estate funds and hedge funds to register with the SEC. *See "Financial Services Regulation Bill Will Require Most Sponsors of Private Equity, Real Estate and Hedge Funds to Register as Investment Advisers"*, Latham & Watkins LLP *Client Alert*, July 15, 2010.

[3] The SEC has clarified in its adopting release that a donation of time, or a donation to a 501(c)(3) tax-exempt organization — even at the specific request or direction of a qualifying official — will not be considered a "contribution" for purposes of the Rule.

[4] Note that the Rule includes a limited exception to the two-year "look-back" by imposing only a six month "look-back" on political contributions or payments to government officials made by an employee who is promoted or hired into a position that qualifies the employee as a "covered associate" but is not involved in the solicitation of government entities for investment advisory business.

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