PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the Firm

August 2009

Proposed SEC Rule Would Curtail Use of Placement Agents and Campaign Contributions by Investment Advisers to Private Investment Funds

On August 3, 2009, the Securities and Exchange Commission ("SEC") proposed for comment a new rule under the Investment Advisers Act of 1940 (the "Advisers Act") designed to address alleged "pay to play" practices by investment advisers when seeking to manage assets of government entities.[1] If adopted in its current form, new Advisers Act Rule 206(4)-5 (the "Rule") would prohibit investment advisers from providing advisory services to a government entity for compensation for two years after the adviser or certain of its associates make a contribution to a government official who can influence the entity's selection of investment advisers. Further, the Rule would prohibit an investment adviser from making any payment to a third party to solicit investment advisory business from a government entity. The proposed Rule clearly takes aim at alleged "pay to play" abuses in New York and New Mexico[2] and is intended to address policy concerns that such payments (i) can harm government pension plan beneficiaries who may receive inferior services for higher fees and (ii) can create an uneven playing field for advisers that cannot or will not make the same payments.

Rule Would Impact Virtually All Private Investment Fund Managers

As proposed, the Rule would apply to U.S. and non-U.S. investment advisers registered or required to be registered under the Advisers Act *and* that are currently exempt from registration under Section 203(b)(3) of the Advisers Act. Most private investment fund managers that are not currently registered under the Advisers Act rely on the Section 203(b)(3) exemption, which provides a safe harbor from SEC registration for investment advisers with fewer than 15 advisory clients[3] within the preceding 12 months and that do not hold themselves out to the public as investment advisers. Under the Rule, an investment adviser to a pooled fund in which a government entity invests would be treated as though the investment adviser were advising the government entity directly. As a result, most investment advisers to private investment funds, including venture capital, private equity and hedge funds, would be subject to the Rule as proposed, even if they are not presently required to register under the Advisers Act.

Contributions Would Result in a Two-Year "Time Out"

The Rule would restrict contributions by an investment adviser or any "covered associate" of an investment adviser to an "official" of a "government entity." If an investment adviser or covered associate contributes to a government official, then the adviser may not receive compensation in connection with providing advisory services to the applicable

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1 SEC Release No. IA-2910; File No. S7-18-09; 17 CFR Part 275. Also available at www.sec.gov.

2 *See* Proskauer Rose Client Alert, "Probe into Placement Agent Practices Expands," May 5, 2009.

3 In the case of an investment adviser to private investment funds, the adviser typically is permitted to count each individual limited partnership or limited liability company comprising a fund as one client for purposes of determining the availability of the Section 203(b)(3) exemption. However, recent legislative proposals have sought to remove this exemption for all domestic and many foreign advisers to private investment funds. *See* Proskauer Rose Client Alert, "Obama Administration Proposes Investment Adviser Registration for Most Hedge Fund and Private Equity Managers," July 2009.

government entity for two years. If the government entity were an existing investor in a private investment fund, then the adviser must waive or rebate the management fee and carried interest otherwise payable by the government entity for two years. The SEC notes that waiving carried interest for one investor would result in "various calculation issues," but notes that, alternatively, the adviser could seek to cause the fund to redeem the government entity's interest.

Two types of contributions are exempted under the Rule – (i) aggregate contributions of $250 or less per election made by natural persons to candidates for whom they can vote and (ii) other contributions of $250 or less that are discovered within four months of the contribution date and returned within 60 days of discovery (limited to two such returned contributions in any 12-month period). However, soliciting or coordinating political contributions made by others (such as by political action committees) to an official or political party is specifically prohibited.

"Government entity" is broadly defined under the Rule as any U.S. state or political subdivision of a U.S. state, including its agencies, authorities, instrumentalities, plans, programs and pools of assets. "Official" is also broadly defined to include any candidate for elective office or incumbent holding elective office (including his or her election committee) if the office holder (i) is directly or indirectly responsible for, or can influence the hiring of, an investment adviser by a government entity, or (ii) has the authority to appoint any person who is directly or indirectly responsible for, or can influence the hiring of, an investment adviser by a government entity. Given the breadth of the definition of "official," investment advisers seeking to do business with state, county and municipal government entities may be virtually prohibited from making political contributions, unless they comply with the limited $250 exemption.

A "covered associate" of an investment adviser includes its president, vice presidents, general partners, managing members, executive officers in charge of principal business units and employees that perform (or supervise those who perform) advisory services or engage (or supervise those who engage) in solicitation of government entities. Contributions by an employee performing administrative services (such as a comptroller) would not be restricted, unless the contributions were made in an attempt to circumvent the Rule. Also permitted under the Rule are contributions made by family members of covered associates, although the SEC is requesting comments as to whether such contributions should be prohibited.

Of note, the two-year "time out" resulting from a covered associate making a contribution would follow that person if he or she subsequently works for another investment adviser. In other words, if covered person X made a restricted contribution to an official of State Y on September 1, 2009, and began working as a covered associate of a different investment adviser on September 1, 2010, X's new employer could not provide advisory services for compensation to government entities of State Y until September 1, 2011.

Payments to Third-Party Solicitors Prohibited

The Rule would prohibit an investment adviser from making or agreeing to make any payment to any person to solicit a government entity for investment advisory services on behalf of the adviser. However, a broad exception is made for in-house marketing and sales personnel, which would include a broker-dealer that is a controlled subsidiary of the adviser. Specifically, the prohibition does not encompass general partners, executive officers, managing members and employees of the adviser, "related persons" of the adviser (defined as any person or entity controlling, controlled by or under common control with the adviser) and employees of such related persons. The SEC notes that "there may be efficiencies in allowing advisers to rely on these particular types of persons to assist them in seeking clients," but invites comments as to whether the proposed exception is too broad.

As proposed, the Rule would take effect upon its adoption, although the SEC is seeking comments on whether a transition period is warranted. Neither the Rule nor the accompanying comments address the question of tail payments to third-party solicitors payable after the Rule takes effect but relating to prior solicitation. For example, a placement agent agreement entered into prior to the Rule's effective date could provide for payments to the agent over a two-year period or upon an investor's subsequent investment in a successor fund, in each case after the Rule's effective date.

Record Keeping

The SEC's proposal would also require registered investment advisers to maintain detailed records with respect to (i) the identities of their covered associates, (ii) all government entities for which the advisers or their covered associates provide or seek to provide advisory services or have provided advisory services over the past five years and (iii) all contributions to government officials listed in chronological order.[4] Such records would be open to SEC inspection during its regular periodic audits of the adviser.

[4] Proposed Rule 204-2(a)(18).

Ramifications of Placement Agent Prohibition

The proposed Rule would apply a nationwide proscription against investment advisers (including advisers to private investment funds) using placement agents, finders and other third parties to solicit investments by public plans. Currently, only a handful of states (including New York, Illinois and New Mexico) impose legislative or policy-based bans on the use of placement agents to solicit government entities, although several more require varying levels of disclosure. The Rule, if adopted, could impose uniformity on what is becoming a patchwork of regulation that differs from state to state. However, the Rule is certain to be opposed by investment advisers, placement agents and public plans that believe placement agents serve a legitimate and worthwhile function by introducing government entities to potential investment advisers. Such opponents will argue that potential "pay to play" abuses can be effectively prevented by enhanced disclosure or other means less draconian than a total ban on using placement agents. In addition, smaller investment advisers are sure to argue that the Rule places them at a competitive disadvantage, as larger advisers with deep pockets can hire in-house marketing personnel to take the place of third-party placement agents.

In its comments accompanying the proposed Rule, the SEC argues that the benefits of eliminating potential "pay to play" abuses outweigh potential objections. The SEC argues that contributions to public officials and the use of third-party placement agents can distort the adviser selection process so that "a more qualified adviser may not be selected, potentially leading to inferior management, diminished returns or greater losses." The SEC further argues that the Rule would level the playing field for investment advisers by eliminating "artificial barriers to competition for firms that cannot, or will not, make [pay-to-play] contributions or payments." Finally the SEC argues that mere disclosure of contributions or payments offers insufficient protection, as government entity trustees may have been the beneficiaries of the payments and would be unlikely to act on the disclosure. Moreover, the SEC points out that pension plan beneficiaries are unable to act on the disclosure by shifting assets out of the plan or opposing the adviser's selection.

Comments on the Rule are due to the SEC on or before October 6, 2009. We will continue to monitor these and any new proposals that are relevant to our private investment fund clients. Please call any of the attorneys listed below with any questions.

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Proskauer's Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

Please feel free to call any of the Proskauer lawyers listed below at any time if you have additional questions, or if we can be of additional assistance with the issues raised in this alert.

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