Proskauer

SEC Rule Curtails Political Contributions by Investment Advisers; Use of Regulated Placement Agents Permitted

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On June 30, 2010, the U.S. Securities and Exchange Commission (the "SEC") unanimously adopted Rule 206(4)-5 and amendments to Rules 204-2 and 206(4)-3 (the "Rule") under the U.S. Investment Advisers Act of 1940 (the "Advisers Act").[1] The Rule is designed to curtail practices commonly known as "pay to play," where an investment adviser makes contributions or other payments to public officials with the intent of generating investment advisory business.

The Rule prohibits investment advisers from receiving compensation for advisory services provided to a government entity for two years after the adviser or its partners, members or certain employees make a contribution to a government official who can influence the government entity's selection of investment advisers. In addition, an investment adviser may pay third parties to solicit advisory business from government entities, including public pension plans, only if the solicitor is a broker-dealer or investment adviser registered with the SEC and, in the case of a broker-dealer, is subject to rules of a self-regulatory organization, such as the Financial Industry Regulatory Authority ("FINRA"), designed to prohibit pay-to-play activity.

The final Rule differs significantly from the original version of Rule 206(4)-5 proposed by the SEC in August 2009 (the "Proposed Rule"),[2] as the Proposed Rule would have broadly prohibited an investment adviser from making any payment to a third party to solicit investment advisory business from government entities. During the Proposed Rule's comment period, the SEC received more than 250 comment letters from investment advisers, placement agents, public pension plans and other interested parties, many in opposition to a complete ban on payments to third-party solicitors.

Rule to Take Effect in September but Includes Transition Periods

The Rule will apply to U.S. and non-U.S. investment advisers registered (or required to be registered) under the Advisers Act and investment advisers that are exempt from registration under Section 203(b)(3) of the Advisers Act, an exemption on which many private investment fund managers not currently registered with the SEC rely.[3] Under the Rule, an investment adviser to a pooled fund in which a government entity invests (a "Covered Investment Pool") will 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, will be subject to the Rule's restrictions, even if they do not directly advise government entities.

The Rule will take effect September 13, 2010 (the "Effective Date"). Advisers to private investment funds must be in compliance with the Rule's restrictions on campaign contributions and accompanying record-keeping requirements within six months after the Effective Date (i.e., by March 14, 2011, March 13 being a Sunday). Due to this transition period, the Rule will not impact most contributions an investment adviser may wish to make with respect to the November 2010 election cycle.

The Rule's prohibition on making payments to third parties to solicit government entities for investment advisory business becomes effective one year after the Effective Date (September 13, 2011).

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

Following the applicable transition period, the Rule will impose potential penalties in the event of any "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 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 or, alternatively, redeem the entity's interest in the fund or permit the entity to withdraw from the fund. In the Adopting Release, the SEC suggests that an adviser could comply with the time out requirement by reducing the fee payable by the entire fund by the amount then payable by the government entity or by rebating to the fund the portion of the fee payable by the government entity.[4]

The Rule also prohibits an investment adviser or any of its covered associates from coordinating or soliciting other persons (including political action committees, or "PACs") to contribute to an official of a government entity or to make payments to a political party of a state or other locality. Such coordination or solicitation would not trigger a two-year time out, but would none the less constitute a violation of the Rule.

Small contributions made by individuals are specifically exempted under the Rule. Individuals may contribute $350 or less per election to a candidate for whom they can vote and $150 or less per election to a candidate for whom they cannot vote (a "Di minimis Contribution"). However, bundling separate Di minimis Contributions for the purpose of making one large contribution is prohibited.

The Rule does not generally apply to contributions to candidates for federal office. However, if a candidate for federal office is also an official of a government entity by virtue of a state or local office held during the campaign, then the Rule will apply to contributions to that candidate. Nor does the Rule generally apply to contributions to PACs, political parties or charitable organizations.

“Contribution” under the Rule includes any gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing an election to an elective office, including payment of debts incurred in such an election and transitional or inaugural expenses.   An individual’s donation of his or her time to a campaign would not count as a contribution, provided that the adviser did not solicit the individual to donate his or her time; the adviser’s resources, such as office space, computers and telephones, are not used; and the individual’s campaign activities did not otherwise take place during business hours.

“Government entity” includes any U.S. state or political subdivision of a U.S. state, including its agencies, authorities, instrumentalities, plans, programs and pools of assets. Government entities include all pension plans and collective government funds, including participant-directed plans such as 403(b), 457 and 529 plans. “Official” includes 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 that the definition of “official” broadly includes even persons with indirect influence over adviser selection and given the economic penalties imposed, investment advisers seeking to do business with government entities may be, as a practical matter, virtually prohibited from making political contributions to individual candidates. Investment advisers should consider adopting stringent policies to ensure that restricted contributions are not made inadvertently.

A “covered associate” of an investment adviser includes (i) any general partner, managing member or executive officer[5] of the adviser (or any other individual with a similar status or function); (ii) any employee who solicits a government entity for the adviser[6] and any person who directly or indirectly supervises that employee; and (iii) any PAC controlled by the adviser or a covered associate. Contributions by an employee performing administrative or advisory services that do involve solicitation of government entities are not restricted, provided that such employees are not also general partners, managing members or executive officers. The Rule also does not expressly extend to contributions made by family members of covered associates.

Of note, the two-year time out resulting from a covered associate making a contribution will continue to apply even if the covered associate is no longer employed by the adviser. Also, prior contributions follow an individual if he or she subsequently becomes a covered associate of an investment adviser. In other words, if person X made a restricted contribution to an official of State Y on September 1, 2011, and became a covered associate of investment adviser Z on September 1, 2012, adviser Z could be prohibited from providing advisory services for compensation to government entities of State Y until September 1, 2013, two years after the date of person X's restricted contribution. However, the two-year look back period is shortened to only six months if person X does not actually solicit clients on behalf of adviser Z. In addition, the look back only applies to contributions made after the date that mandatory compliance with the Rule is required. As a result of this look-back requirement, investment advisers should inquire as to prior campaign contributions made by a prospective covered associate as part of the hiring or promotion process.

Otherwise Unrestricted Contributions Still Prohibited if Made for the Purpose of Circumventing the Rule

As discussed above, contributions by an adviser's employees that are not covered associates, contributions to political parties, PACs or charities associated with a candidate and contributions by family members of a covered associate generally would not result in a two-year time out under the Rule. However, the Rule broadly prohibits an adviser or any of its covered associates from taking any action indirectly that, if done directly, would result in a time out or violation under the Rule. For example, if a covered associate's spouse were to make a campaign contribution that would result in a two-year time out if made by the covered associate directly, the SEC may deem the contribution as having been made by the covered associate directly and impose the resulting time out. Also, if a donation to a PAC or political party were being funneled to a particular candidate, the SEC may deem the contribution as having been made to the candidate directly and impose the resulting time out.

Exemptive Relief Available

An adviser may apply to the SEC for an order exempting it from a two-year time out on compensation that the Rule would otherwise impose if (i) the adviser discovers unpermitted contributions or solicitations after they occur, and (ii) imposition of the penalty is unnecessary to achieve the Rule's intended purpose. In the Adopting Release, the SEC cites the example of a disgruntled employee who makes a prohibited contribution before exiting the firm as one case in which exemptive relief might be warranted.

In addition, an adviser may avoid a time out that would be imposed as a result of an impermissible contribution by a covered associate in the following limited circumstances: (i) the contribution is discovered within four months of when it was made and returned within 60 days after discovery, (ii) the contribution did not exceed $350,[7] (iii) no more than two or three contributions may be returned in any calendar year, depending on how many employees the adviser has, and (iv) no more than one contribution may be returned with respect to any covered associate, regardless of the time period.

Payments to Regulated Third-Party Solicitors Permitted

The Rule prohibits an investment adviser and its covered associates from making or agreeing to make any direct or indirect payment to any person to solicit a government entity for investment advisory services on behalf of the adviser, unless such person is either a regulated person or a general partner, managing member or employee of the investment adviser.

A "regulated person" can be either an investment adviser or a broker or dealer (as defined under the U.S. Securities Exchange Act of 1934) that is registered with the SEC.[8] In addition, a regulated person that is a registered investment adviser cannot have made (nor can its covered associates have made), within two years of soliciting a government entity, a contribution to an official of that government entity other than a Di minimis Contribution. If a regulated person is a broker-dealer, then (i) the broker-dealer must be a member of a national securities association (currently FINRA), and (ii) FINRA rules must prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made. The SEC, by order, must find that such FINRA rules impose equivalent or more stringent restrictions on broker-dealers as the Rule and such restrictions are consistent with the Rule's objectives.

FINRA currently does not have rules in place that prohibit pay-to-play activities by its members as required under the Rule. However, FINRA has generally indicated willingness to impose regulatory requirements "as rigorous and expansive" as those under the Rule.[9]

If an investment adviser considers adding partners, members or employees to perform the services of third party solicitors, it must keep in mind that such "in-house placement agents" may be required to be affiliated with a broker-dealer registered with the SEC. Advisers should consult with qualified counsel prior to engaging in-house client solicitation personnel.

Record Keeping

The Rule requires investment advisers registered with the SEC that provide advisory services to government entities or Covered Investment Pools to maintain detailed records of contributions made by the adviser and its covered associates to government officials (including candidates) and payments to state and local political parties and PACs. Contributions and payments must be listed in chronological order, identifying the contributor and recipient and the date and amount of each contribution or payment. Any such adviser that has government entity clients also must keep a list of its covered associates and the government entities to which it has provided advisory services during the past five years. Any such adviser (regardless of whether it has government entity clients) must keep a list of the names and business addresses of each regulated person retained by the adviser to solicit investment advisory business from government entities.

Questions and Issues Remain

In adopting the Rule in its final form, the SEC abandoned the complete prohibition on payments to third-party marketers for soliciting government entities that was in the Proposed Rule in favor of a regulatory approach. However, the situation remains cloudy in some respect for third-party marketers and the advisers that retain them. For example, the SEC predicates its regulatory approach on FINRA adopting pay-to-play regulations at least as rigorous as the Rule, which the SEC must subsequently approve. FINRA has indicated a willingness to propose such rules, but what form they will take is still unknown.

Also, various states, local governments and individual public pension plans have passed legislation, issued regulations or promulgated policies prohibiting or restricting the use of placement agents to solicit public pension plans and/or requiring extensive disclosure. These requirements will remain in place and may change over time. As a result, investment advisers and the third-party marketers they retain will need to monitor state, local and plan-specific regulations that will need to be followed. In other words, an adviser may be in perfect compliance with the Rule – but in violation of a state statute that also mandates a time out or other penalties for alleged violations.

Please call any of the attorneys listed with any questions.

[1] SEC Release No. IA-3043; File No. S7-18-09; 17 CFR Part 275, available at www.sec.gov (the "Adopting Release").

[2] SEC Release No. IA-2910; File No. S7-18-09; 17 CFR Part 275 (the "Proposing Release"); *see* Proskauer Client Alert, "Proposed SEC Rule Would Curtail Use of Placement Agents and Campaign Contributions by Investment Advisers to Private Investment Funds" dated August 2009.

[3] Legislation currently before Congress would require the vast majority of private equity and hedge fund advisers to register with the SEC under the Advisers Act. Venture capital fund advisers, however, are specifically excluded from registration under the proposed legislation. *See* Proskauer Client Alert, "Private Equity and Hedge Fund Advisers Will Be Required to Register with the SEC Under House-Senate Compromise Legislation" dated June 28, 2010.

[4] Neither the Rule nor the Adopting Release address nuances with respect to carried interest, such as whether allocations of carried interest during the time-out period or only actual distributions of carried interest during the time-out period need be reduced.

[5] Executive officers include an adviser's president; vice presidents in charge of significant business units, divisions or functions; and any other officer who performs policy making functions.

[6] “Solicit” means, with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser. An employee need not be primarily engaged in solicitation activities to be a covered associate under the Rule.

[7] Such a contribution would not need to be returned if it qualified as a valid Di minimis Contribution.

[8] A registered investment adviser functioning as a placement agent likely will be required to also register with the SEC as a broker-dealer.

[9] *See* letter from Richard G. Ketchum, Chairman and Chief Executive Officer, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (Mar. 15, 2010), available at www.sec.gov/comments/s7-18-09/s71809-252.pdf.

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