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SEC ADOPTS FINAL RULES TO ELIMINATE PERCEIVED "PAY-TO-PLAY" PRACTICES BY INVESTMENT ADVISERS AND PRIVATE FUND MANAGERS

On June 30, 2010, the U.S. Securities and Exchange Commission (the "SEC") voted unanimously to adopt amendments to the U.S. Investment Advisers Act of 1940 (the "Advisers Act") to eliminate perceived "pay-to-play" practices by investment advisers providing advisory services to government clients.[1] The rules apply to registered investment advisers, as well as investment advisers and fund managers that are exempt from registration pursuant to the "private adviser exemption" provided by Section 203(b)(3) of the Advisers Act,[2] but not to most small advisers with less than $25 million in assets under management that are registered with state authorities rather than the SEC. This includes many private equity funds, venture capital funds, hedge funds, real estate funds, and structured finance vehicles.

The new rules, among other things, prohibit an investment adviser from providing advisory services for compensation to a government entity (including managing a fund in which a government entity invests) for two years after making a contribution to certain officials or candidates. The new rules also prohibit an investment adviser from paying a third party to solicit business from any government entity on its behalf unless such third party is an investment adviser or broker-dealer registered with the SEC and is subject to comparable "pay-to-play" restrictions under the oversight of a national securities association, such as the Financial Industry Regulatory Authority ("FINRA").

The final rules vary in some respects from the proposed rules published by the SEC in August 2009, with the most notable being the permitted use

1 The full release of the final rules is available at http://www.sec.gov/rules/final/2010/ia-3043.pdf.

2 The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act will make Section 203(b)(3) unavailable to many investment advisers.

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of certain third-party solicitation agents under certain conditions and delayed effective dates for the new rules.

"PAY-TO-PLAY" RESTRICTION

The new rules prohibit covered investment advisers from providing advice for compensation to a government entity, including certain government-sponsored pension plans and other plans,[3] within two years after a direct or indirect contribution to an "official" of the government entity has been made by the investment adviser or by any of its "covered associates."

An "official" includes an incumbent or candidate for a government office that is directly or indirectly responsible for, or can influence the outcome of, the selection of an investment adviser, or that has authority to appoint any person who is directly responsible for or can influence the outcome of the selection of such an investment adviser. The rules do not define "influence," which could be interpreted to run up the chain from lower-level state officials to a gubernatorial candidate.

The term "covered associates" includes the investment adviser's general partners, managing members, executive officers,[4] and other individuals with similar status or function; any employee who solicits advisory clients for the adviser and any direct or indirect supervisor of such employee; and any political action committee controlled by the adviser or its covered associates.

Once triggered, the two-year prohibition will continue in effect even if the covered associate who makes the contribution leaves the employ of the investment adviser. Similarly, the prohibition is attributed to any other investment adviser that employs or engages the person who made the contribution for six months after the date the contribution was made, unless the person solicits clients on behalf of the investment adviser, in which case the look-back period is two years.[5] The broad definition of "covered associates" and the look-back period for new hires creates new monitoring and hiring burdens for investment advisers, as oversights may cause significant consequences.

The new rules do not prohibit the provision of advisory services during such two-year period, only the receipt of compensation for providing such services. This approach mirrors that of rules G-37 and G-38 of the Municipal Securities Rulemaking Board, which address "pay-to-play" practices in the municipal securities market. An underwriter of municipal securities that becomes subject to a two-year time out may elect not to perform underwriting services for a particular government entity until the two-year period lapses. However, an investment adviser that triggers a two-year time-out may already have funds under management and/or commitments from the relevant government entity, in which case the adviser could be forced to provide services without compensation.

The new rules do not explicitly define "compensation"; however, they suggest that an investment adviser would be required to waive or rebate not only fees, but also any performance allocation or carried interest related to the government entity's investment in a fund or other similar arrangement. In the final release, the SEC noted that, to comply with the new rules, some investment advisers might cause the redemption of the government entity investment or, alternatively, maintain the government entity investment and relationship by continuing to provide investment advisory services without compensation.

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3 Under the final rules, an adviser to a registered investment company is subject to the two-year ban only if the registered investment company is selected as an investment option for a participant-directed government investment plan, such as a 403(b) plan, 457 plan, or 529 plan, regardless of whether the registered investment company's shares are registered under the Securities Act and whether government entities own shares of the investment company.

4 "Executive officers" include the president; any vice president in charge of a principal business unit, division, or function; and any other officer or person who performs a policy-making function.

5 The proposed rules had a look-back period of two years for all individuals, regardless of whether they solicited clients.

In connection with the new rules, investment advisers need to consider amending their compliance materials, fund-raising guidelines, and solicitation agreements; review and possibly revise their advisory and investment management agreements with government entities to address proper remedies and exit strategies in the event that a two-year time out is triggered; and review and possibly revise disclosures regarding redemptions of government entity interests.

RESTRICTION ON USE OF SOLICITATION FIRMS

The new rules prohibit the use of third parties, including placement agents, to solicit government entities for investment advisory services unless such third parties are "regulated persons." "Regulated persons" include registered broker-dealers and registered investment advisers that are subject to prohibitions against participating in "pay-to-play" practices and are subject to oversight by the SEC and, in the case of broker-dealers, a national securities association, such as FINRA.[6] Advisers compensating placement agents for soliciting government entities must adopt policies and procedures designed to prevent a violation of the rules, including careful vetting of placement agents and ongoing review of whether the placement agent has made political contributions or otherwise conducted activity that would disqualify it as a "regulated person."

OTHER PROVISIONS

The new rules also prohibit an adviser and its covered associates from soliciting from others or coordinating contributions to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services, or payments to a political party of a state or locality where the adviser is providing or seeking to provide investment advisory services to a government entity.

6 The proposed rules banned the use of any third-party solicitors.

The new rules do, however, contain *de minimis* exceptions for individual covered associates who make aggregate contributions of $350 or less per election if they are entitled to vote for the official or candidate and $150 or less per election if they are not entitled to vote for the official or candidate.[7] There is an additional exception for contributions by individual covered associates that do not fall within the *de minimis* exception if the contribution is discovered by the adviser within four months after the contribution is made and the funds are returned to the contributor within 60 days after the adviser learns of the triggering contribution. This exception can be used only a limited number of times per calendar year (three times for investment advisers with more than 50 employees performing investment advisory functions and twice for smaller investment advisers)[8] and can never be used more than once for the same covered associate. An investment adviser would also be able to apply to the SEC for an order to exempt it from the two-year compensation ban under certain circumstances, including where the adviser has a compliance plan in effect, discovers a triggering contribution after it has been made, and takes all available steps to cause the return of the contribution, and where the imposition of the prohibition is unnecessary to achieve the intended purposes of the rule.

Lastly, there will be new recordkeeping requirements imposed upon investment advisers covered by the new rules. Such advisers will need to make and keep records of contributions made by them and their covered associates to government officials and state and local political parties and to political action committees, as well as a list of all third-party solicitors used. As a result of the recently enacted Wall Street Reform and Consumer Protection Act, more advisers to private funds may now be required to register as investment advisers and will be subject to these recordkeeping requirements.

7 The proposed rules provided an exception of $250 per election if the contributor was entitled to vote for the candidate and no exception if not entitled to vote for the candidate.

8 The proposed rules provided this exception to all investment advisers, regardless of size, only twice per 12-month period.

EFFECTIVE DATE

The rules are effective September 13, 2010, but provide for a six-month transition period for investment advisers to establish compliance programs. Accordingly, investment advisers must be in compliance with the new rules by March 14, 2011, except that investment advisers have until September 13, 2011, to comply with the rules prohibiting the use of third-party solicitation agents that are not "regulated persons" (with the broker-dealer exception being effective only if FINRA, as expected, adopts similar "pay-to-play" prohibitions prior to such date) and the related recordkeeping requirements. Investment advisers to registered investment companies that are covered investment pools will also have until September 13, 2011, to comply with the new rules. Investment advisers with government clients, if they have not already done so, should begin establishing "pay-to-play" compliance programs as soon as possible.

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