Hunton & Williams

Private Investment Fund Update

August 2009

SEC Proposes Pay-to-Play Rules—Restricts Political Contributions and Prohibits Certain Uses of Placement Agents

On August 3, 2009, the Securities and Exchange Commission ("SEC") proposed for comment new Rule 206(4)-5 (the "Proposed Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") relating to "pay-to-play" practices among investment advisers, including certain private investment fund sponsors. The Proposed Rule would both (1) limit the ability of private investment fund sponsors to make or coordinate political contributions to government officials in a jurisdiction where the sponsor raises investment capital from government pension funds, and (2) eliminate the ability of private investment fund sponsors to use third-party placement agents to solicit government pension fund investors. A copy of the SEC's Proposing Release is available here.

Background

The Proposed Rule is intended to address concerns that an investment adviser might seek to influence a public official overseeing a government pension plan to engage the adviser or commit capital to a fund sponsored by that adviser by directly or indirectly making political contributions or other payments to the public official. The SEC's focus on these and similar "pay-to-play" practices intensified recently in the wake of several investigations and enforcement actions involving investment advisers and government entities in New York, New Mexico, Illinois, Ohio, Connecticut and Florida. The SEC first proposed (but did not adopt) similar rules in 1999. Using its rulemaking authority under Section 206(4) of the Advisers Act and citing the federal fiduciary standard of conduct for investment advisers, the SEC modeled the Proposed Rule on rules G-37 and G-38 of the Municipal Securities Rulemaking Board to address pay-to-play practices in the municipal securities markets.

Scope of the Proposed Rule

The Proposed Rule applies to investment advisers registered (or required to be registered) under the Advisers Act and those that rely on the "private adviser exemption" under Section 203(b)(3) thereof. Further, the Proposed Rule applies to advisers to any "covered investment pool" managed by the adviser through which any government entity invests. A "covered investment pool" includes any "investment company" as defined in the Investment Company Act of 1940 (the "Investment Company Act"), any private investment funds relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, and collective investment trusts relying on Section 3(c)(11) of the Investment Company Act. Many unregistered investment advisers rely on the private adviser exemption and thus would be subject to the Proposed Rule. Similarly, since many private investment funds rely on Sections 3(c)(1) or 3(c)(7), an adviser to such a fund would need to "look through" the fund to its investors for purposes of the Proposed Rule.

Two-Year "Time-Out" Following Political Contributions

The Proposed Rule prohibits an investment adviser from receiving compensation for investment advisory services provided to a "government entity" within two years after the investment adviser or any "covered associate" of the investment adviser makes a "contribution" to an "official" of the government entity.

For purposes of the Proposed Rule:

- "governmental entities" include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds;
- "covered associates" of an investment adviser include

any general partner, managing member or "executive officer" of the adviser or other individuals with a similar status or function, and any employee who solicits a governmental entity for the investment adviser or any political action committee controlled by such persons. "Executive officer" is defined to include executive officers who perform or supervise those performing investment advisory services (such as portfolio managers) or who perform soliciting activities;

- a "contribution" includes any gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing an election for federal, state or local office, and any payment of debt incurred in connection with any such election or transition or inaugural expenses of a successful candidate; and
- an "official" includes any incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the selection of any investment adviser by the government entity, or 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.

The two-year time-out would continue in effect even after the covered associate who made the contribution left the advisory firm. In addition, the contribution would be attributed to any other investment adviser that employs or engages the contributor within the two-year period.

Exceptions to the Two-Year Time-Out

The two-year time-out does not apply to certain limited contributions, including:

- *De minimis* contributions of $250 or less by a covered associate during an election cycle to an official for whom the covered associate is entitled to vote; and
- A limited number of returned contributions if:
  - the adviser discovers within four months of the date of the contribution that the contribution would trigger the time-out period;
  - the contribution did not exceed $250; and
  - the contributor obtains a return of the contribution within 60 days after discovery.

In addition, the Proposed Rule grants the SEC exemptive authority, subject to consideration of a number of specified factors, with respect to the two-year time-out.

Ban on Use of Third-Party Placement Agents to Solicit Government Entities

The Proposed Rule also prohibits investment advisers and covered associates from making any payment to a third party for solicitation of government entities for advisory business on behalf of the adviser. The term "solicit" would broadly include "communications for the purpose of obtaining or retaining a client or a contribution." The ban on third party solicitors does not apply to certain affiliates of an investment adviser, who may continue to solicit governmental entities. These exempted affiliates include: (i) "related persons" of the investment adviser and (ii) any executive officer, general partner, managing member (or a person with similar status or function) or employee of the investment adviser. "Related persons" include any person controlling, controlled by or under common control with the investment adviser.

This prohibition, if adopted in its present form, would preclude the use of third-party finders, solicitors, placement agents, pension consultants and similar consultants to solicit state and local pension plans for advisory business. The SEC noted that when a less restrictive version of this provision was proposed in 1999, it included a two-year time-out on the use of placement agents rather than a flat prohibition, but that it was opposed by several commenters because it would create compliance difficulties. For this reason, the current proposal includes a flat prohibition. The SEC requested comment as to whether the complete ban or a two-year time-out would be more appropriate.

Many placement agents are retained as the exclusive placement agents for a particular fund and help prepare all fund solicitation documents used for that fund. Often these placement agents are compensated on the basis of total funds raised for the fund, rather than on an investor-by-investor basis. In addition, certain placement agent arrangements may include tail payments based on a particular investor's investments in subsequent funds. While the Proposed Rule clearly prohibits payments for communications, it is not clear the extent to which these practices may need to change to comply with the Proposed Rule in its current form.

Ban on Coordinating Political Contributions

The Proposed Rule also prohibits investment advisers and covered associates from coordinating or soliciting any person or political action committee to make any contribution to an official of a government entity to which the adviser is providing (or is seeking to provide) advisory services, or any payment to a political party of a state or locality where the investment adviser is providing (or seeking to provide) investment advisory services to a government entity. The SEC intends this prohibition to prevent investment advisers from coordinating or otherwise "bundling" the political contributions of its employees or others.

Additional Recordkeeping Requirements

The SEC also proposed amendments to Rule 204-2 under the Advisers Act to require investment advisers to keep certain records to allow the SEC to examine compliance with the Proposed Rule. The required records would include:

- names, titles, business and residence addresses of all covered associates;
- all government entities (i) for which the adviser or any of its covered associates provides or seeks to provide advisory services, or (ii) who are investors or are solicited to invest in any covered investment pool managed by the adviser;
- all government entities for which the adviser has provided advisory services, along with any related covered investment pool managed by the adviser in which the government entity has invested, within the past five years (but not prior to the effective date of the Proposed Rule); and
- all direct or indirect contributions made by the adviser or any covered associate to an official of a government entity, political party of a state or subdivision thereof or a political action committee, including the names of the contributor and recipient, dates and amounts of such contributions and whether the contribution was subject to the limited exception for returned contributions.

Timing of the Proposed Rule

If the Proposed Rule is adopted in its current form, it would apply to contributions and payments made on or after the effective date of the Proposed Rule, although the SEC has solicited comment on whether to implement a transition period. The SEC's deadline for submitting comments is October 6, 2009.

Conclusion

Since the SEC requested comments on a number of aspects of the Proposed Rule, we do not have any current visibility as to whether the final rule, if adopted, will closely resemble the Proposed Rule. The Proposed Rule, if promulgated in its present form, however, would effectively eliminate the ability of private investment fund sponsors to use third-party placement agents to solicit government pension fund investors and would restrict the ability of investment advisers and their covered associates to make or coordinate political contributions to officials in a state or locality where the adviser raises investment capital from government pension funds. In addition, the proposed recordkeeping requirements would impose an additional compliance mandate upon fund sponsors. Accordingly, investment advisers with government entities as clients or investors should consider what internal policies and procedures could be implemented to comply with these rules, including monitoring the political contributions of their covered associates and practices with respect to third-party placement agents.

Additional Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of this proposal and other relevant trends in private investment fund regulation and can assist with the submission of comments to the Proposed Rule.

For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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