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SEC Proposes Rule to Prohibit Pay-to-Play Practices

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(Editor's Note: This post is based on a client memorandum by Kathleen Walsh, Andrea Schwartzman and Matthew Chase of Latham & Watkins LLP.)

On August 3, 2009, the US Securities and Exchange Commission (the SEC) released a proposed rule under the Investment Advisers Act of 1940 (the Advisers Act) aimed at preventing "pay to play" practices by investment advisers that seek investment advisory business — including investment commitments in private equity funds — from state and local government entities. As described in the proposing release, pay to play practices "may take a variety of forms, including an adviser's direct contributions to government officials, an adviser's solicitation of third parties to make contributions or payments to government officials or political parties in the State or locality where the adviser seeks to provide services, or an adviser's payments to third parties to solicit (or as a condition for obtaining) government business." Referencing a number of enforcement proceedings in the area, the proposing release further states that "it has become increasingly clear that pay to play is a significant problem in the management of public funds by investment advisers."

Proposed Rule

In response, the proposed rule would prohibit an investment adviser, as well as its "covered associates" from:

(1) providing or agreeing to provide payments (broadly defined) to a third party to solicit a government entity for investment advisory business on behalf of such investment adviser;

(2) receiving compensation from government entities within two years of making a contribution to an official of the government entity; and

(3) soliciting third parties to make a political contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services. The proposed rule would also require an investment adviser to maintain detailed records relating to its covered associates and their political contributions.

Applicable to All Investment Advisers. The proposed rule generally applies both to registered investment advisers and to unregistered investment advisers that rely on the "private adviser" exemption.[1] In the private investment fund context, the proposed rule would apply to the fund sponsor, e.g. a private fund's general partner and/or manager entities. The proposed rule further clarifies that in the case of a covered investment pool (e.g., a private investment fund relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940), the adviser to the pool will be treated as if it were providing or seeking to provide advisory services directly to any governmental entity that invests or is solicited to invest in the pool.

Non-US Advisers. As currently drafted, the proposed rule would apply to US and non-US advisers alike (to the extent such advisers are subject to the Advisers Act). Specific application of the rule to non-US advisers will need to be clarified.

"*Covered Associates*." The proposed rule would reach the activities of the personnel of an investment adviser, and applies to (1) any general partners, managing members or executive officers or other individuals with a similar status or function, (2) any employee of the investment adviser who solicits a government entity for investment advisory business for the investment adviser, or (3) any political action committee controlled by the investment adviser or a person described in clauses (1) and (2). As currently drafted, this term would include all of a fund sponsor's principals and all of its employees who are engaged in soliciting, directly or indirectly, investment advisory business from government entities (which would include soliciting investments in private investment funds).

Payments. Prohibited "payments" are broadly defined to include the provision of any gift, subscription, loan, advance or deposit of money or anything of value), directly or indirectly, to any third party in exchange for soliciting any government entity for investment advisory services on behalf of such investment adviser.

Government Entities and their Officers, Agents or Employees. The proposed rule applies to payments or contributions 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 plan, program or pool of assets sponsored or established by the state or political subdivision or any agency,

[1] Section 203(b)(3) of the Advisers Act currently exempts from registration any adviser which (i) does not hold itself out to the public as an investment adviser and (ii) has had less than 15 clients during the last 12 months to be exempt from registration. We note that The Private Fund Transparency Act introduced earlier this year by Senator Jack Reed (D—Rhode Island) would repeal the "private adviser" exemption from registration under the Advisers Act.

authority or instrumentality thereof; and (iii) officers, agents or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

Officials. An “official” of any government entity would 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 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 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 government entity.

Contributions. The proposed rule would adopt a broad definition, including 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 the successful candidate for state or local office.

Scope. The proposing release makes clear that the rule is intended to be broad in scope and application. The proposed rule expressly provides that it would be unlawful for any adviser or its covered associated to do anything indirectly which, if done directly, would result in a violation of the rule.

Effectiveness; Application. The proposed prohibitions on providing advisory services and payments to solicit would arise only from contributions and payments made on or after the effective date of the proposed rule.

Application to Private Fund Placement Agent Arrangements

In the private investment fund context, the proposed rule would, among other things, prohibit the making of any payments by an investment adviser to any placement agent or finder in exchange for assisting the investment adviser with securing capital commitments from state or local government entities. The broad definition of payment would include, with respect to existing and prospective clients that are government entities, compensation arrangements based on a percentage of the capital commitments or investment secured with the assistance of the placement agent or finder, as well as flat fee arrangements. Activities that would constitute a solicitation under the proposed rule would include any communications, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser. Thus, as currently drafted, the arranging of meetings and the distribution of offering materials to

government entities by third parties on behalf of an investment adviser in exchange for payment would be covered by the proposed rule.

Internal Payments

The proposed rule does include an important exclusion in that it permits the making of payments made by an investment adviser to its affiliates or its, or its affiliates', executive officers, general partners, managing members or employees. Accordingly, the proposed rule would not restrict an adviser's ability to pay its own employees and its affiliates and the employees of its affiliates who engage in soliciting potential investors that are government entities. Thus, any investment adviser that, directly or indirectly, controls, is controlled by or is under common control with a person or entity that serves in a similar role to a placement agent or finder, would not be prohibited from making payments to such person or entity in exchange for soliciting any government entity for investment advisory services on behalf of such investment adviser.

Political Contributions

The proposed rule would make it unlawful for an investment adviser to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of a government entity is made by the investment adviser or any covered associate of an investment adviser. While the proposed rule does not define "compensation," it would likely include management or advisory fees, and performance fees and incentive payments. A political contribution made in violation of the proposed rule would cause an investment adviser to be ineligible to receive any compensation from the relevant government entity for a period of two years.

Two-year Lookback. The proposed rule would also apply to contributions made by any person who becomes a "covered associate" of an adviser within two years after the relevant contribution was made. Accordingly, when hiring a new employee, an investment adviser would need to review the political contributions made by a prospective employee in the two years prior to his or her employment to determine if any of such contributions would trigger the compensation prohibition for the adviser. Moreover, the termination or departure of an employee would not prevent his or her contributions from being attributed to the adviser, nor stay the application of the two-year waiting period for receipt of compensation.

Limited Exceptions. The general restriction on contributions would be subject to the following exceptions: (i) a narrow de minimis exception for political contributions by a natural person of up to an aggregate of $250 to a government official per election in which such person is entitled to vote; (ii) an exception for inadvertent breaches of the rule in which the violation is discovered

within four months of the contribution and such contribution did not exceed $250 and is returned within 60 days of the discovery; and (iii) discretionary exceptions, to be granted upon application to the SEC for exemptive relief upon specified grounds.

No Solicitation of Political Contributions. The proposed rule also prohibits the solicitation by an investment adviser or its covered associates of any other person to make a political contribution to an official of a government entity or a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services.

Record-keeping. Investment advisers would be required to maintain a record of the names, addresses and titles of all covered associates, all government entities to which the investment adviser is providing or is seeking to provide, or has provided in the last five years, investment advisory services and, in chronological order, the amount of all direct or indirect political contributions made by the covered associates, who they were made to and the date that they were made. These records would cover all political contributions, even those below the $250 de minimis threshold. It is unclear from the text of the proposed rule if this record-keeping requirement would only apply to registered investment advisers, but the SEC release accompanying the proposed rule suggests that this rule is intended to cover all investment advisers, whether registered or unregistered, that provide or are seeking to provide investment advisory services to any government entity.

Outlook

The public comment period on the proposed rule expires on October 6, 2009. After the expiration of the comment period, there is no specific timetable for the adoption of the final rule. However, based on various statements by SEC personnel in advance of the release of the proposed rule, it is clear that addressing “pay to play” practices is a priority for the SEC.

While the shape of final rulemaking in this area cannot be predicted, fund sponsors would be prudent to review their fundraising and political contribution practices. Greater scrutiny in this area—whether through formal rulemaking or through such mechanisms as adviser inspections or other regulatory action—may well continue.