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"Pay to Play": Implications for Investment Advisers and Placement Agents
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Yukako Kawata
Davis Polk & Wardwell LLP
450 Lexington Avenue
New York, NY 10017
212 450 4896 tel
212 701 5896 fax
yukako.kawata@davispolk.com

Andrew L. Wright
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
(212) 446-4793 tel
(212) 446-6460 fax
andrew.wright@kirkland.com
Overview of SEC Proposed Rule

• On August 3, 2009, the Securities and Exchange Commission published a proposed rule to proscribe so-called “pay-to-play” practices by investment advisers.

• The proposed rule (to be adopted under the Advisers Act antifraud provisions) would prohibit an investment adviser:
  
  o from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates;

  o from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business; and

  o from providing or agreeing to provide, directly or indirectly, payment to any third party (i.e., placement agents, solicitors, finders or similar parties) for a solicitation of advisory business from any government entity on behalf of such adviser.

• The proposed rule also contains broad anti-avoidance/anti-structuring language prohibiting any adviser from doing anything indirectly which, if done directly, would result in a violation of the rule.
**Who does the rule apply to?**

- The proposed rule would apply to SEC registered advisers as well as advisers currently exempt from registration under the fewer-than-fifteen-client exemption and their “covered associates.”
  
  - Registered advisers would also be subject to additional recordkeeping obligations to demonstrate to SEC examination staff the adviser’s compliance with the rule’s requirements.

- Adviser “covered associates” consist of:
  
  - (1) any general partner, managing member, or executive officer (defined below), or other individual with a similar status or function; (2) any employee who solicits a government entity for the adviser; and (3) any political action committee controlled by the adviser or persons described in (1) and (2) above.

  - “Executive officer” is defined as president, vice president in charge of a principal business unit, division, or function (such as sales, administration, or finance), or any other executive officer who in connection with regular duties: (1) performs, or supervises any person who performs, investment advisory services; (2) solicits, or supervises any person who solicits, advisory clients or investors; or (3) supervises, directly or indirectly, any person described in (1) or (2) above.
Who does the rule apply to? (cont.)

- The rule’s prohibitions also apply to investment advisers to “covered investment pools” in which a government entity invests or is solicited to invest.

- “Covered investment pools” include:
  - Unregistered funds formed in reliance on Investment Company Act of 1940 (“Investment Company Act”) Section 3(c)(1), (c)(7) or (c)(11).
  - Investment Company Act registered funds the shares of which are not registered under the Securities Act of 1933 (“Securities Act”).
  - Investment Company Act registered funds the shares of which are registered under the Securities Act, but, for the purpose of the contribution prohibitions, only to the extent that the fund is an investment or an investment option of a plan or program of a government entity (i.e., a “qualified tuition plan” authorized by section 529 of the Internal Revenue Code, a retirement plan authorized by section 403(b) or 457 of the Internal Revenue Code or other similar plans).
Contributions and government clients that are covered

• The proposed rule covers “contributions” to designated “officials” of “government entities.”
  - “Contributions” means any gift, subscription, loan, advance, or deposit of money or anything of value made for (1) the purpose of influencing any election for federal, state, or local office; (2) payment of debt incurred in connection with any such election; or (3) transition or inaugural expenses of the successful candidate for a state or local office.
  - “Government entities” means any state or political subdivision of a state, including (1) agencies, authorities, or instrumentalities of the state or political subdivision; (2) a plan, program, or pool of assets sponsored or established by the state or political subdivision or any agency, authority, or instrumentality thereof; and (3) officers, agents, or employees of the state or political subdivision or any agency, authority, or instrumentality thereof, acting in their official capacity.
  - “Official” means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate, or election winner if the office (1) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (2) has the authority to appoint any person described in (1) above.
Prohibition is Compensation not Contributions

- The proposing release makes it clear that the restriction in the proposed rule is not the political contribution, instead it is the adviser’s receipt of compensation from the government client that is prohibited.

  - If a covered contribution is made to a government client, the prohibition on receiving compensation may require an adviser to a separate account, at a minimum, to provide uncompensated advisory services for a reasonable period of time until the government client finds a successor adviser.

  - In the case of a private fund, the adviser may be required to waive or rebate fees and any performance allocation or carried interest and may seek to cause the private fund to redeem the investment of the government entity. For private funds without redemption rights (e.g., a typical private equity fund), the proposing release requests comments on possible solutions.

  - In the case of a registered investment company, the proposing release suggests that the adviser may be required to waive its advisory fee for the fund as a whole in an amount approximately equal to fees attributable to the government entity.
Exceptions and exemptions

- Exceptions and exemptions related to contributions:
  - There is a de minimis exception for contributions of $250 or less per election if the adviser’s covered associate is entitled to vote on the elected official.
  - Limited relief exists in cases of small inadvertent (and then refunded) prohibited contributions.
  - The SEC may also exempt contributions under a multi-factor exemptive relief analysis.

- Exceptions related to ban on use of solicitors:
  - Excepted out of the placement agent ban are related persons (i.e., control affiliates) of the investment adviser. However, these persons are subject to the direct prohibitions on receiving advisory compensation if restricted political contributions are made.

Look-back

- The rule’s restrictions would continue to apply to the adviser for two years even if the covered associate ceased to be employed with the adviser.
- Similarly, the rule’s prohibitions will attach to the adviser even if the covered associate made the contribution before becoming employed by the adviser.
Use of Placement Agents

- Private fund advisers prohibited from paying third-party placement agent, solicitor, finder or similar party to solicit a governmental agency.
- Breach of prohibition if private fund pays a success fee to a 3rd party based on all money raised for the private fund (including from governmental agencies) and if the 3d party communicates with a governmental agency for purpose of raising money.
- May permit third party to receive fee based on all money raised so long as third party did not communicate with any governmental agency for purpose of raising money.
- Governmental agency would apparently include state university’s endowment fund.
Comment Period & Comments Received to Date

• The public comment period ends October 6th and the proposing release suggests that any final rule could have a very limited (e.g., 90 day) implementation date following final SEC action suggesting the rule could be in effect in early 2010.

• As of 9/15/09, more than 70 comment letters regarding the Proposed Rule were posted on the SEC’s website

• A number of state plans, including Connecticut, Wisconsin, South Dakota, Mass P.R.I.M and Missouri, have submitted comment letters objecting in writing to placement agent ban

• A number of leading placement agents firms, including Credit Suisse, MVision, C.P. Eaton, Atlantic-Pacific and others have submitted written objections to the proposed placement agent ban

• A recent survey indicates that a majority of U.S. institutional private equity investors oppose an SEC ban on the use of placement agents, although most largely support the SEC’s efforts to restrict political contributions from money managers
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