The Final SEC Rule on Political Contributions by Investment Advisers

July 29, 2010

INTRODUCTION

On June 30, 2010, the U.S. Securities and Exchange Commission (the "SEC") approved Rule 206(4)-5 (the "Rule") under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), intended to address so called "pay to play" practices by investment advisers involving campaign contributions and other payments to government clients and elected officials able to exert influence on such clients.[1] The Rule prohibits an investment adviser from doing the following:

– providing advisory services for compensation to a government client for two years, subject to very limited exceptions, after the investment adviser, its senior executives or its personnel involved in soliciting investments from government entities make contributions to certain candidates and officials in position to influence the hiring of an investment adviser by such government client;

– making or agreeing to make, directly or indirectly, payments to any person to solicit a government entity on behalf of such adviser unless such person either is registered with the SEC as an investment adviser or is registered with the SEC as a broker-dealer and is a member of a registered national securities association that has adopted substantially equivalent rules addressing political contributions and "pay to play" practices; and

– engaging in "bundling," which is a practice of soliciting or coordinating contributions from others to elected officials or candidates who are able to exert influence on the selection of an investment adviser or to political parties of a state or locality where the adviser is seeking to provide advisory services to a government entity.

Advisers are required to implement compliance policies designed, among other matters, to track contributions by certain of the adviser's employees and engagements of third parties that solicit government entities and to keep certain records in order to enable the SEC to determine compliance with the Rule. Given the broad application and complexity of the Rule and the significant economic exposure associated with its violation, advisers will need to establish strong internal compliance procedures and policies to implement the Rule. In addition, the Rule may warrant amendments to engagement agreements with placement agents, disclosure to investors and clients of risks involved in potential violations of the Rule, and changes to governing documentation of investment vehicles managed by investment advisers that are covered by the Rule.

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[1] See the SEC adopting release (that includes the full text of the Rule) at: http://www.sec.gov/rules/final/2010/ia-3043.pdf

Compliance Dates. The Rule becomes effective as of September 13, 2010; however, investment advisers are granted a six month transition period and must be in compliance with the Rule as of March 14, 2011 and with the limitations on the use of third party solicitors described above as of September 13, 2011.

Advisers Subject to the Rule. The Rule applies to a wide category of investment advisers, including advisers to private investment funds.[2] In addition to advisers registered (or required to be registered) with the SEC, it also covers advisers that are currently exempted from registration in reliance on the "private adviser" exemption by not holding themselves as investment advisers to the public and having fewer than 15 clients.[3] The Rule does not apply to investment advisers that are not registered with the SEC but are registered with state securities authorities and advisers that are unregistered with the SEC in reliance on exemptions other than the "private adviser exemption."

TWO-YEAR COMPENSATION BAN FOLLOWING A CONTRIBUTION

The Rule prohibits investment advisers from receiving compensation for advice to a "government entity"[4] within two years after a "contribution"[5] is made (a so-called "two-year time out") to an "official"[6] of such government entity by the adviser or its "covered associates."[7]

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[2] This memorandum focuses on the implications of the Rule for investment advisers to private funds. Additional considerations apply to investment advisers to registered investment companies.

[3] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") that was recently passed by the Congress and signed into law by the President, repeals the private adviser exemption except for certain foreign advisers, and therefore will require registration of a number of advisers that are currently exempt because they advise less than fifteen investment vehicles and other clients. However, the Bill also raises a minimum threshold of assets under management for an investment adviser to be eligible for the registration with the SEC, and is likely to cause certain smaller advisers to deregister and not be subject to the Rule.

[4] A "government entity" under the Rule means any state or political subdivision of a state and includes their agencies, authorities and instrumentalities, public pension funds and other collective government funds and participant-directed plans such as 403(b), 457 and 529 plans.

[5] A "contribution" is defined as any gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing any federal, state or local election, payment of debt incurred in connection with any such election and transition or inaugural expenses of the successful candidate for state or local office. However, generally, a donation of time or a charitable donation made to a tax exempt organization at the request of an official or candidate is not considered a contribution. In addition, the Rule imposes no restrictions on independent expenditures to express support for candidates, making speeches or other expressive conduct or on a covered associate's contribution to his or her own campaign.

[6] An "official" means any person (including any election committee for the person) who is at the time of a contribution an 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 hiring of an investment adviser by the governmental entity or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of the investment adviser by the governmental entity. It should be noted that the Rule

An adviser is subject to the two-year time out regardless of whether it is aware of a prohibited contribution (and, indeed, subject to limited exceptions, regardless of whether the contribution violated the adviser's compliance policies).

It should be noted that the advisory services do not have to be discontinued in the event that a contribution is made to an official of a government client. In fact, the adviser may have a fiduciary or contractual duty to continue providing services without compensation and assist in arranging for a proper transition. If a contribution triggering the two-year time out is discovered, the adviser is also obligated to return any compensation received by it subsequent to the date of the contribution.

Look Back and Look Forward. In order to prevent circumvention of the Rule by the adviser's hiring, transfer or promotion of individuals that make campaign contributions before or after they become covered associates with the investment adviser, the Rule includes "look back" provisions that result in prior campaign contributions by new covered associates being attributed to the adviser. With respect to a new covered associate who does not solicit clients on behalf of the adviser after becoming a covered associate, contributions made during the six month period before such person becomes a covered associate of the adviser are attributed to the adviser. With respect to a covered associate who solicits clients on behalf of the adviser, such period is two years. In addition, the Rule has a "look forward" aspect such that if a covered associate leaves the adviser or ceases to qualify as such, it will not relieve the adviser from the two-year time-out on compensation following a prohibited contribution by such covered associate made while such person was a covered associate of the adviser. As a result, dismissal of a covered associate who makes a prohibited contribution does not "cure" the two-year time-out resulting from the contribution.

Exceptions. The ban has two *de minimis* exceptions where a contribution does not result in a compensation ban: (i) if the contribution by a covered associate does not exceed $350 (per covered associate) per election (primary and general elections being considered separate elections) to an official or candidate for which such covered associate is entitled to vote or (ii) if the contribution by a covered associate does not exceed $150 (per covered associate) per election to an official or candidate for which such covered associate is not entitled to vote.

An additional exception is provided for certain returned contributions by a covered associate that do not exceed $350 per election to any one official. To qualify for the exception, the contribution must be discovered by the adviser within four months of the date of contribution

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focuses on authority as opposed to its exercise by a particular official in determining whether contributions to such official are covered by the prohibition.

[7] A "covered associate" whose contributions are attributed to the adviser under the Rule means a general partner, managing member, executive officer or other individual with a similar status or function, any employee that solicits a government entity for the investment adviser, any person that supervises such soliciting employee and any political action committee controlled by the investment adviser or any of its covered associates. The Rule does not "look through" the investment adviser and does not cover its shareholders or limited partners unless such holders are already covered by the definition.

and its return must be obtained by the contributor within sixty days of the discovery of the contribution by the adviser. The Rule further limits the scope of the exception by restricting its use to two or three times per calendar year (depending on the size of the adviser) and no more than once per covered associate regardless of the time period.

An adviser may apply to the SEC and request an order exempting it from a two-year compensation time-out. The SEC views this procedure as an additional avenue to cure inadvertent violations, such as in situations when a disgruntled employee makes a prohibited contribution. Among the factors the SEC will consider in deciding whether to grant an exemption are the public interest and investor protection, whether, prior to the time of the contribution, the adviser adopted and implemented policies and procedures reasonably designed to prevent violations of the Rule, whether the adviser had prior knowledge of the contribution, whether remedial measures were taken, the timing and amount of the contribution, the nature of the elections and the contributor's intent or motive.

BAN ON UNREGULATED THIRD PARTY SOLICITORS

The Rule prohibits an investment adviser from making or agreeing to make, directly or indirectly, payments to a placement agent or other third party[8] for solicitation of a government entity on behalf of such adviser unless such agent or party is a "regulated person." A regulated person is (i) an investment adviser that is registered with the SEC or (ii) a broker-dealer that is registered with the SEC and is a member of a registered national securities association such as the Financial Industry Regulatory Authority ("FINRA").

In order to qualify as "regulated persons" under the Rule solicitors that are investment advisers registered with the SEC must adhere to similar requirements as investment advisers providing services to government clients: they are not allowed to make a contribution to a candidate or official of a government client or coordinate or solicit such contribution or a payment to a political party in a relevant state or locality. Solicitors that are broker-dealers are required to be regulated by a national securities association, such as FINRA, with restrictions on political contributions and "pay-to-play" practices at least as stringent as the SEC's requirements. The SEC indicated that one of the reasons for this part of the Rule taking effect a full one year after its adoption is to provide time for FINRA to implement this regulatory framework. Notably, FINRA has informed the SEC in a letter to the SEC staff that it intends to impose rigorous "pay-to-play" rules on its members.

Investment advisers that use third party solicitors will need to consider these restrictions in engaging such parties and negotiating solicitation agreements. Additionally, an adviser will need to implement policies and procedures to monitor its relationships with solicitors so that any prohibited contributions or other conduct by a solicitor that would disqualify it from being a regulated person would result in the adviser no longer being obligated to make any payment to such solicitor for solicitation of a government entity on behalf of such adviser.

[8] The Rule's ban does not apply to the adviser's payments to its own employees, general partners, managing members or executive officers. It does apply to payments to any solicitors that are affiliates of the adviser.

BAN ON BUNDLING; INDIRECT VIOLATIONS

The Rule prohibits so-called "bundling", a practice of coordinating, or soliciting[9] any person or political action committee to make, (i) any contribution to an official of a government entity to which the adviser is providing or seeking to provide advisory services or (ii) any payment to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity.[10] A violation of the "bundling" prohibition does not trigger a two-year time out but is a violation of the Rule.

The Rule also prohibits an adviser and its covered associates from doing anything indirectly which, if done directly, would violate the Rule. However, generally, contributions by attorneys, family members, friends and affiliates of investment advisers and covered associates do not trigger the compensation time out unless used as a means of circumventing the Rule.

POLICIES AND PROCEDURES; RECORD KEEPING

Restrictions and monitoring of political contributions should be added to internal employee policies of investment advisers. For example, advisers should consider adopting a policy requiring prior approval of political contributions or "bundling" activity by any employee. In addition, prior to an adviser hiring, transferring or promoting an individual to a position where the individual becomes a covered employee, the adviser should diligence the political contribution history of the individual to confirm that no two-year time out will be triggered as a result. As mentioned above, the existence and rigor of internal compliance policies will be considered by the SEC among the criteria whether to provide exemptive relief to the adviser for an inadvertent violation (if ever requested).

The Rule requires an investment adviser to maintain a list of all governmental entities to which it has provided investment advice in the past five years and to keep a record of all contributions made by the investment adviser and its covered associates to an official of a government entity and of payments to state and local political parties and political action committees. An investment adviser must also maintain a list of all covered associates.

In addition, an investment adviser must keep a record of each regulated person to which the adviser provides or has agreed to provide payment for the solicitation of government entities on its behalf and will need to implement policies and procedures to monitor the valid "regulated person" status of solicitors engaged by the investment adviser.

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[9] A solicitation on behalf of a candidate would include use of one's name in fundraising literature for a candidate or sponsorship of a meeting or conference which features the candidate as an attendee or speaker and at which contributions are sought for the candidate.

[10] Although the Rule prohibits an adviser and its covered associates from coordinating or soliciting any person or political action committee to make payment to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity the Rule does not restrict contributions directly by the adviser or its covered associates to a political party or political action committee unless they are a means to do indirectly what the rule prohibits if done directly (e.g., if the contributions are earmarked or known to be provided for the benefit of a particular candidate).

FEDERAL ELECTIONS; STATE REGULATIONS

By covering only a "state or political subdivision of a state" in the definition of a "government entity," the Rule does not apply to incumbents and candidates running for a federal office, with the exception of holders of state or local office that run for federal office. The Rule does not preempt additional state-level regulation of political contributions by investment advisers and other "pay to play" practices, which should be monitored carefully. We note that a number of states have banned[11] or restricted[12] the use of placement agents with respect to government clients, and certain governmental clients have adopted policies in this regard.[13]

IMPLICATIONS FOR ADVISERS OF COLLECTIVE INVESTMENT VEHICLES

The prohibitions of the Rule apply to investment advisers that manage assets of a government entity in a "covered investment pool" which include private equity funds, hedge funds, venture capital funds and collective investment trusts. Subject to the prohibition on indirect actions that are used as a means of doing what the adviser is not permitted to do directly, the SEC has clarified, however, that advisers to underlying funds with a funds of funds investor do not need to look through the investing fund of funds to determine whether a government entity is an investor. Additionally, in connection with the use of subadvisers, if an adviser or subadviser makes a contribution that causes a two year compensation time out, the subadviser or adviser, as applicable, which did not make such contribution can continue to receive compensation from the government entity.

CONCLUSION

New requirements imposed by the Rule require enhancement of compliance procedures and will likely result in additional administrative burdens and higher compliance costs, particularly with respect to smaller advisers. For more information about the Rule and its potential implications, please contact a member of our Private Funds group.

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[11] As an example, Illinois enacted a ban on placement agents in April 2009.

[12] As an example, beginning from October 2009, California imposes new disclosure and other requirements upon the involvement of placement agents in the investment activities of California public pension plans.

[13] As an example, the policies of New Mexico State Investment Council and New York Common Retirement Fund do not currently allow use of placement agents in connection with investments by these entities. Similar policies were recently adopted by the New York City Employees' Retirement System (NYCERS) and Teachers' Retirement System (TRS).

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