HUNTON& WILLIAMS

PRIVATE INVESTMENT FUND UPDATE

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

On June 30, 2010, the Securities and Exchange Commission ("SEC") approved new Rule 206(4)-5 (the "Final 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 Final 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 unless those third-party placement agents are registered investment advisers or registered broker-dealers subject to comparable pay-to-play restrictions. A copy of the SEC's Final Release is available here.

Background

The Final 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 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 proposed rules on August 3, 2009.

Scope of the Final Rule

The Final 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 but does not apply to smaller state-registered investment advisers or advisers that rely on an exemption other than Section 203(b)(3). Further, the Final Rule applies to advisers to any "covered investment pool" managed by the adviser through which any government entity invests. A "covered investment pool" includes (i) any "investment company" as defined in the Investment Company Act of 1940 (the "Investment Company Act") that is an investment option of a government plan and (ii) any private investment funds relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, as well as collective investment trusts relying on Section 3(c)(11) of the Investment Company Act.

Many unregistered investment advisers currently rely on the private adviser exemption and thus would be subject to the Final Rule.[1] Similarly, since many private investment funds rely on Section 3(c)(1) or Section 3(c)(7), an adviser to such a fund would need to "look through" the fund to its investors for purposes of the Final Rule. Advisers to underlying funds in a fund-of-funds arrangement generally would not need to look through the investing fund.

Two-Year "Time-Out" Following Political Contributions

The Final 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

1 Note that the private adviser exemption will be eliminated effective July 21, 2011 under the Dodd-Frank Wall Street Reform and Protection Act.

"contribution" to an "official" of the government entity.

For purposes of the Final Rule:

- "government entities" include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds (including 403(b), 457 and 529 plans);
- "covered associates" of an investment adviser include (i) any general partner, managing member or "executive officer" of the adviser or other individuals with a similar status or function, (ii) any employee (including such employee's supervisors) who solicits a governmental entity for the investment adviser, and (iii) any political action committee controlled by such persons;
- "executive officer" is defined to include the president, any vice president in charge of a principal business unit, division or function and any other officer or person performing policy-making functions for the investment adviser;
- 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, as well as 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 hiring 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 Final Rule's prohibition on the receipt of compensation would permit the investment adviser to continue providing investment advisory services after a problematic contribution consistent with its fiduciary duties for no compensation, although the provision of uncompensated services to government entities may run afoul of certain state or local laws.

Exceptions to the Two-Year Time-Out

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

- *de minimis* contributions of $350 or less by a covered associate during an election cycle to an official for whom the covered associate is entitled to vote (or $150 or less if the covered associate was not entitled to vote for such official);
- contributions made by a new covered associate more than six months prior to becoming a covered associate of the investment adviser unless that covered associate solicits clients on behalf of the investment adviser (in which case the look-back is two years); 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 $350; and
  - the contributor obtains a return of the contribution within 60 calendar days after discovery.

Since the *de minimis* contribution threshold is quite low and the scope of who constitutes an official of a government pension fund is broad, investment advisers will need to carefully monitor political contributions — even those that seem innocuous, such as invitations to a neighborhood BBQ — to ensure compliance. In addition, the Final 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 Final 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.

The ban on third-party solicitors does not apply to (i) "regulated persons" and (ii) any executive officer, general partner, managing member (or a person with similar status or function) or employee of the investment adviser. "Regulated persons" include

(A) registered investment advisers that have not, and whose covered associates have not, within two years of soliciting a government entity made a contribution to an official of that government entity; and (B) registered brokers or dealers that are members of a registered national securities association that impose substantially equivalent or more stringent restrictions on pay-to-play. Currently, the Financial Industry Regulatory Authority ("FINRA") is the only registered national securities association. Although FINRA rules do not currently prohibit pay-to-play activities, FINRA has informed the SEC that it is preparing such rules for consideration by its members. The exception for regulated persons was added to the Final Rule in response to comments to the proposed rule.

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. Advisers with such arrangements will need to review them for compliance with the Final Rule's effective and compliance dates.

Ban on Coordinating Political Contributions

The Final 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 Record-keeping Requirements

The SEC also adopted 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 Final Rule. The required records would include:

- if the investment adviser provides advisory services to a government entity or a government entity is an investor in a covered investment pool advised by the investment adviser, the names, titles, business and residence addresses of all covered associates;
- all government entities for which the adviser provides or has provided investment advisory services, or who are investors or were investors in any covered investment pool managed by the adviser, in the past five years (but not prior to September 13, 2010);
- if the investment adviser provides advisory services to a government entity or a government entity is an investor in a covered investment pool advised by the investment adviser, all direct or indirect contributions made by the adviser or any covered associate to an official of a government entity, as well as all direct or indirect payments to a political party of a state or subdivision thereof or a political action committee;
- name and business address of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity on its behalf; and
- 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.

Effective Date/Compliance Dates

The Final Rule is effective September 13, 2010. Investment advisers must be in compliance on March 14, 2011 and may no longer use third parties to solicit government business except in compliance with the rule as of September 13, 2011. Accordingly, the two-year time-out will not be triggered by contributions made prior to March 14, 2011. In addition, the one-year transition period applicable to the ban on third-party placement agents will give FINRA time to adopt pay-to-play rules.

Conclusion

The Final Rule restricts 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 Final Rule effectively eliminates the ability of private investment fund sponsors to

use third-party placement agents other than registered investment advisers or registered broker-dealers (assuming FINRA adopts appropriate rules) to solicit government pension fund investors. Moreover, the record-keeping requirements impose an additional compliance mandate upon fund sponsors. Accordingly, investment advisers with government entities as clients or investors should implement internal policies and procedures 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 relevant trends in private investment fund regulation.

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.

Hunton & Williams Offices

Atlanta
Bank of America Plaza, Suite 4100
600 Peachtree Street, NE
Atlanta, Georgia 30308-2216
(404) 888-4000

Austin
111 Congress Avenue, Suite 1800
Austin, Texas 78701-4068
(512) 542-5000

Bangkok
34th Floor, Q. House Lumpini Building
1 South Sathorn Road
Thungmahamek, Sathorn
Bangkok 10120 Thailand
+66 2 645 88 00

Beijing
517-520 South Office Tower
Beijing Kerry Centre
No. 1 Guanghua Road
Chaoyang District
Beijing 100020 PRC
+86 10 5863 7500

Brussels
Park Atrium
Rue des Colonies 11
1000 Brussels, Belgium
+32 (0)2 643 58 00

Charlotte
Bank of America Plaza, Suite 3500
101 South Tryon Street
Charlotte, North Carolina 28280
(704) 378-4700

Dallas
1445 Ross Avenue, Suite 3700
Dallas, Texas 75202-2799
(214) 979-3000

Houston
Bank of America Center, Suite 4200
700 Louisiana Street
Houston, Texas 77002
(713) 229-5700

London
30 St Mary Axe
London EC3A 8EP
United Kingdom
+44 (0)20 7220 5700

Los Angeles
550 South Hope Street, Suite 2000
Los Angeles, CA 90071-2627
(213) 532-2000

McLean
1751 Pinnacle Drive, Suite 1700
McLean, Virginia 22102
(703) 714-7400

Miami
1111 Brickell Avenue, Suite 2500
Miami, Florida 33131
(305) 810-2500

New York
200 Park Avenue
New York, New York 10166-0091
(212) 309-1000

Norfolk
500 East Main Street, Suite 1000
Norfolk, Virginia 23510-3889
(757) 640-5300

Raleigh
One Bank of America Plaza Suite 1400
421 Fayetteville Street
Raleigh, North Carolina 27601
(919) 899-3000

Richmond
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219-4074
(804) 788-8200

San Francisco
575 Market Street, Suite 3700
San Francisco, California 94105
(415) 975-3700

Washington
1900 K Street, NW
Washington, DC 20006-1109
(202) 955-1500

If you have any questions about these regulations or other matters of private investment fund law, please contact:

Private Investment Fund Law

James S. Seevers, Jr.	Cyane B. Crump
(804) 788-8573	(804) 788-8214
jseevers@hunton.com	ccrump@hunton.com

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