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## *SEC Proposes Pay-to-Play Rules That Would Significantly Restrict Political Contributions by Investment Advisers and Prohibit Payments to Placement Agents for Marketing to Public Pension Plans*

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On August 3, 2009, the Securities and Exchange Commission (the "SEC") published the provisions of its proposed rule that would prohibit investment advisers from compensating placement agents to market private funds to certain governmental entities, including public pension plans, and restrict political contributions by investment advisers and certain of their employees.<sup>1</sup> In support of the proposed rule, the SEC claims that pay-to-play schemes cause pension plans to pay higher fees and manipulate the market for advisory services, and that third-party solicitors played a central role in several recent pay-to-play scandals. The SEC is seeking public comments on the proposed rule until October 6, 2009.

### **Prohibition on Payments to Third-Party Solicitors**

The proposed prohibition on investment advisers compensating placement agents and other third-party solicitors who market private funds (and investment advisory services) to public pension plans and other governmental entities would apply not only to investment advisers that are registered with the SEC, but also to investment advisers that are exempt from registration because they have fewer than 15 clients (collectively, "Covered Investment Advisers").<sup>2</sup> The proposed rule would prohibit Covered Investment Advisers from paying a third party to solicit or communicate, directly or indirectly, with a Government Entity<sup>3</sup> for the purpose of obtaining the Government Entity as a client for the Covered Investment Adviser or having the Government Entity become an investor in a Covered Investment Pool managed by the Covered Investment Adviser.<sup>4</sup> This proposed rule is expressly intended by the SEC to apply to finders, solicitors, placement agents or pension consultants who are compensated by investment advisers to market to public pension plans and other Government Entities.

The proposed rule would expressly not apply to persons or entities that solicit Government Entities for a Covered Investment Adviser, but are (a) directly or indirectly controlled by the Covered Investment Adviser or under common control with the Covered Investment Adviser, (b) employees of such an entity, or (c) an executive officer, general partner, managing member, or employee of the Covered Investment Adviser.

The SEC requested comment on whether the proposed prohibition on third-party solicitors is an appropriate means to deter pay-to-play practices or whether other less restrictive alternatives could accomplish this objective (e.g., subjecting Covered Investment Advisers to the two-year ban (discussed below) for contributions made by their third-party solicitors). The SEC also asked whether the third-party solicitor ban would disproportionately impact the ability of smaller investment advisers to compete in the market to provide advisory services to government clients.

### **Restrictions on Political Contributions**

The proposed rule would prohibit a Covered Investment Adviser from providing advice for compensation to any Government Entity, including a public pension plan, within two years after the Covered Investment Adviser or certain of its executives or employees made a contribution to any elected government official (as an incumbent or a candidate) who is in a position to influence the hiring of an investment adviser by the Government Entity or the making of an investment by the Government Entity in a Covered Investment Pool.<sup>5</sup> This two-year ban would continue to apply even if the employee who made the triggering contribution has left the investment advisory firm. Furthermore, if a Covered Investment Adviser hires an employee who made a triggering political contribution within the two-year period before being hired, then the time remaining on the two-year period would be imputed to the Covered Investment Adviser for purposes of imposing the ban.

The proposed rule includes two notable details. First, it would prohibit Covered Investment Advisers only from receiving compensation within the applicable two-year period; it would not prohibit a Covered Investment Adviser from continuing to provide investment advisory services to the Government Entity within the two-year period without compensation. In the context of private funds, the SEC stated that Covered Investment Advisers could either waive or rebate the related fees and any performance allocation or carried interest or seek to redeem the investment of the Government Entity. However, the SEC stated that the latter alternative is typically unavailable because forcing a Government Entity to withdraw or cancel its commitment would likely harm the other investors. Accordingly, the SEC requested comments on whether other measures exist that would prevent Covered Investment Advisers from benefiting from prohibited political contributions while protecting other investors in a fund.

Second, the proposed rule does not apply to political contributions by every employee of Covered Investment Advisers. Instead, the proposed rule would apply only to a Covered Investment Adviser's general partners, managing members, employees who regularly solicit Government Entity clients on behalf of the Covered Investment Adviser and executive officers who are in charge of a principal business unit, perform investment advisory services or solicit for the Covered Investment Adviser. Thus, the proposed restriction would not apply to executive officers who are unconnected with investment advisory services (e.g., the head of human resources) and non-executive employees who do not regularly solicit Government Entities. The SEC requested comments on whether the two-year ban applied to too many employees of Covered Investment Advisers or, alternatively, whether it should broaden the proposed rule to include all managers of Covered Investment Advisers and certain family members of managers.

### **De Minimis Exception**

The proposed rule would provide a *de minimis* exception that would permit certain employees of Covered Investment Advisers to contribute up to \$250 per candidate per election as long as such employees were entitled to vote for that candidate. The *de minimis* exception would not apply to

contributions to candidates for whom the employee is not entitled to vote, or to contributions to political parties.

***Restrictions on Soliciting and Coordinating Contributions and Indirect Pay-to-Play Practices***

To prevent investment advisers from circumventing the proposed rule by soliciting others to make or coordinate contributions to government officials, the proposed rule would prohibit Covered Investment Advisers and certain of their employees from (i) coordinating or soliciting any person or political action committee to make a contribution to an official of a Government Entity to which the Covered Investment Adviser provides or seeks to provide investment advisory services, and (ii) making a payment to a political party of a state or locality where the Covered Investment Adviser provides or seeks to provide investment advisory services to a Government Entity. These restrictions would effectively prohibit Covered Investment Advisers from bundling contributions or payments and coordinating contributions through a third party.

The SEC stated that it could not feasibly anticipate every possible arrangement designed to evade the prohibitions of the proposed rule. Consequently, the SEC included a catchall provision in the proposed rule that would prohibit Covered Investment Advisers or certain of their employees from indirectly engaging in prohibited pay-to-play conduct (e.g., paying a pension consultant for attending or sponsoring a conference if the conference is intended as a means of soliciting government clients for a Covered Investment Adviser).

**Maintenance of Books and Records**

Under the proposed rule, investment advisers registered with the SEC will be required to maintain records of contributions made by them or certain of their employees if they (i) have or seek government clients or (ii) provide investment advisory services to a Covered Investment Pool in which a Government Entity invests or is solicited to investment. Registered investment advisers will also be required to keep records of all Government Entities to which the investment adviser provided advisory services and Covered Investment Pools in which the investment adviser has provided advisory services and a Government Entity has invested in the past five years.

The SEC explained that the recordkeeping requirement would serve two functions. First, it would allow the SEC to determine whether a registered investment adviser has complied with the proposed rule. Second, it would require registered investment advisers to adopt internal procedures to document contributions which, in turn, would help prevent the proposed rule's prohibitions from being triggered.

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*We will continue to keep you informed of significant developments as they occur. If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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- <sup>1</sup> The proposed rule is modeled after rules G-37 and G-38 of the Municipal Securities Rulemaking Board, which, according to the SEC, have successfully curtailed pay-to-play practices in the municipal securities market.
  - <sup>2</sup> An investment adviser means, generally, any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. Investment managers should consult with their legal counsel to determine whether any of their activities constitute advice with respect to investing in "securities."
  - <sup>3</sup> The SEC's proposed rule defines a Government Entity as (i) any agency 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, (iii) and any officers, agents or employees of the state or political subdivision acting in their official capacity. Thus, a Government Entity would include a qualified tuition plan authorized by section 529 of the Internal Revenue Code (the "Code"), a retirement plan authorized by section 403(b) or 457 of the Code, or any similar program or plan.
  - <sup>4</sup> In the context of investment funds, the proposed rule only applies to investments by Government Entities in Covered Investment Pools managed by Covered Investment Advisers. The proposed rule defines Covered Investment Pools as registered investment companies and entities that are exempt from registering as investment companies because they (i) have less than 100 shareholders, (ii) have only qualified purchasers, or (iii) are collective investment funds maintained by a bank. Accordingly, the proposed rule would neither prohibit payments to placement agents who solicit investments for other types of investment funds nor restrict political contributions by investment advisers who advise other types of investment funds, such as funds that are exempt from registration because they restrict their investments to certain types of real estate-related assets.
  - <sup>5</sup> The SEC's proposed rule defines an official to include an incumbent, candidate or successful candidate for an elective office that either is directly or indirectly responsible for, or can influence the outcome of, the selection of an investment adviser or has the authority to appoint a person who is directly or indirectly responsible for, or can influence the outcome of, the selection of the investment adviser.