CLIENT ALERTS & INSIGHTS

SEC Publishes "Pay-to-Play" Proposal

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On August 3, 2009, the Securities and Exchange Commission (the "SEC") released a proposed rule under the Investment Advisors Act of 1940 (the "Investment Act") intended to prohibit investment advisory funds (including private equity funds, hedge funds, and their managers, principals, officers, and employees) from making political contributions to state and local governmental officials or candidates for office of governmental entities in exchange for compensation for investment advisory services from that entity.

Specifically, the proposed rule would prohibit investment advisors and their covered associates from:

1. Receiving compensation for investment advisory services from a state or local government entity for a period of two years after the investment advisor or a covered associate makes a contribution to a governmental official or candidate who (i) could influence the entity's hiring of an investment advisory fund or (ii) has the authority to appoint a person who could hire such fund. The prohibition period would continue for two years even if the advisory fund ceased employing the person who made the contribution. The proposed rule also looks back two years for contributions made by persons prior to becoming a principal or covered associate of the advisory fund.

2. Soliciting or coordinating political contributions or payments on behalf of a governmental official to which the investment advisor is providing or is seeking to provide investment advisory services for compensation.

3. Providing, directly or indirectly, payment to any unaffiliated third-party for soliciting investment advisory work from state and local government entities on behalf of the investment advisor.

To be clear, the proposed rule would not prohibit investment advisors from making political contributions to governmental officials or candidates per se, but from accepting compensation for such services from governmental entities influenced by the officials or candidates to whom it made the contributions (for a period of two years). Accordingly, the proposed rule provides that an investment advisory fund could avoid violating the rule for a period of time by simply refusing compensation for investment advisory services from the governmental entities to which it has contributed.

The SEC has indicated that its rationale for proposing this rule is the fact that pay to play practices based upon political contributions to government officials undermine the fairness and propriety of the selection process between state and local governments and investment advisors, as well as

compromise the quality of management that such government sponsored investment funds would receive.

In addition, a covered investment pool, which is a pooled investment vehicle in which a state or local governmental entity invests or is solicited to invest, would be treated as a governmental entity for purposes of the proposed rule. Most mutual, private equity, hedge, venture capital, and other private investment funds would qualify as a covered investment pool with one major exception: pooled investment vehicles whose shares are registered under the Securities Act of 1933 would not qualify as covered investment pools for purposes of the two year limitation on political contributions.

Investment advisory funds would also be required to institute recordkeeping procedures designed to monitor the political contributions of all covered associates, which records would include: (i) identification of all covered associates, (ii) the governmental entities serviced or targeted to be serviced by the fund; (iii) the governmental entities serviced by the fund during the last five years; and (iv) all contributions or payment made to governmental officials or candidates.

Such recordkeeping would also help ensure that employees of the fund do not inadvertently prohibit it from receiving compensation from certain governmental entities. Accordingly, greater onus will be placed on hiring practices of investment advisory fund managers, which will require a review of the political contributions of all new employees over the last two years.

Proposed penalties for violations of this rule would likely include administrative actions brought by the SEC against the investment advisory fund, and potentially its principals and managers, which could include monetary penalties and require adverse disclosures. Additionally, investment advisory funds would likely be required to forfeit all compensation received in violation of the proposed rule.

If promulgated, the proposed rule could severely restrict the ability of many investment advisory funds to make political contributions or to raise capital from government entities to which they may have made prior political contributions. Public comments regarding the proposed rule may be submitted to the SEC on or before October 6, 2009 and a final rule may be promulgated as soon as next year. Benesch Friedlander Coplan & Aronoff LLP will continue to monitor this and other developments in the private equity field that could potentially affect investment funds and investment fund advisors.

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[1]Covered associates is defined broadly to include any general partner, managing member or executive officer of the investment advisory fund, any employee who solicits government entities on behalf of the advisor, and any political action committee that is controlled by the advisor or any covered associate thereof.

Additional Information

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