SEC ADOPTS NEW PAY-TO-PLAY RULE

July 12, 2010

To Our Clients and Friends:

On June 30, 2010, the Securities and Exchange Commission (the "SEC") adopted Rule 206(4)-5 (the "Rule") under the antifraud provision of the Investment Advisers Act of 1940 (the "Advisers Act"). The Rule is designed to address "pay-to-play" practices in the investment advisory industry[1] and *is applicable to both registered investment advisers and advisers that are currently exempt from registration because they have fewer than 15 clients.*

As outlined in greater detail below, the Rule contains three major prohibitions. First, the Rule contains a "Two-Year Timeout" that prohibits an investment adviser from receiving compensation of any kind (including management fees and carried interest distributions) for providing advisory services to a state or local government client (a "Government Client") (including a Government Client that is an investor in a private fund sponsored by the adviser) for two years after the adviser or certain of its affiliates, executives or employees ("Covered Associates") make a contribution to certain types of elected officials or candidates ("Government Officials"). Second, the Rule prohibits an adviser and its Covered Associates from compensating a third party (such as a placement agent) to solicit advisory business (for example, an investment in a private fund that is advised by the adviser) from a Government Client unless the third party is a registered broker-dealer or registered investment adviser (a "Regulated Person"). Finally, the Rule prohibits an adviser and its Covered Associates from engaging in a broad range of fundraising activities for Government Officials or political parties in the localities where the adviser is providing or seeking business from a Government Client.

In general, an investment adviser must be in compliance with the aspects of the Rule relating to political contributions by March 14, 2011 and the aspects of the Rule relating to solicitors and placement agents by September 13, 2011. The dates by which investment advisers must be in compliance with the various provisions of the Rule are discussed at the end of this memorandum.

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[1] *Political Contributions by Certain Investment Advisers, SEC Rel. No. IA-3043 (July 1, 2010) (available at http://www.sec.gov/rules/final/2010/ia-3043.pdf) (the "Adopting Release").*

The Rule will have a significant impact on investment advisers with Government Clients, including advisers to private funds that have investors that are Government Clients. Among the expected effects are:

- Advisory firms will have to develop policies that restrict certain political contributions by employees. These policies will need to assure, among other things, that Covered Associates do not make political contributions that trigger the Two-Year Timeout and that the firm does not hire a new employee whose prior contributions trigger the Two-Year Timeout. Private fund sponsors should identify their current or probable Government Client investors in order to determine how to craft their policies.
- Advisers should review their arrangements with solicitors and, in the case of private equity fund sponsors, placement agents to assure that such solicitors and agents are subject to "pay-to-play" restrictions substantially equivalent to those found in the Rule.
- Fund sponsors may need to review their fund organizational and disclosure documents to assure that they have the flexibility to address the possibility that the adviser may, at some point, be prohibited from receiving compensation (including management fees, performance fees and carried interest) attributable to a Government Client investor.

THE TWO-YEAR TIMEOUT

The Two-Year Timeout provision prohibits an investment adviser from receiving compensation for providing advice to a Government Client for two years after the adviser or one of its Covered Associates makes a "contribution" to certain Government Officials. *The Two-Year Timeout will not be triggered by contributions made prior to March 14, 2011.* Among other things, this transition period should assure that the Rule will not affect contributions made, or committed to, with respect to the 2010 election cycle.

Definitions

The Rule's definitions are key to understanding the scope of the Rule. Each of these definitions may present complex compliance issues.

- **Contribution.** A contribution includes a gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such election. This includes transition or inaugural expenses incurred by a successful candidate for state or local office, but not for federal office. The term does not include independent expenditures (as defined under federal election law), the donation of time by an individual or a bona fide charitable donation made at the request of a Government Official.

Contributions to a political action committee ("PAC") or a local political party would not trigger the Two-Year Timeout unless the contribution effectively operates as a "funnel" to the campaigns of Government Officials. The Adopting Release states that an adviser should inquire how any funds received in a PAC or political party contribution will be used (if the use is not identified) in order to determine whether the contribution will trigger the Two-Year Timeout or otherwise indirectly violate the Rule.

- **Government Client.** Government Clients can include all state and local governments, their agencies and instrumentalities and all public pension plans and other collective government funds, including participant-directed plans; however, the term Government Client does not include the federal government or any non-U.S. government.

- **Government Official.** A Government Official includes an incumbent, candidate or successful candidate for elective office of a Government Client if the office is (or has the authority to appoint any person who is) directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser. Candidates for federal office are also covered, if they are currently state or local office incumbents who otherwise satisfy the definition. It should be noted that a Government Official must hold an elective office; therefore, the Rule does not apply where an official holds an appointed office and is a candidate for a separate office that does not meet this definition.

  It may be difficult to determine whether a particular official is in a position to "indirectly" influence the selection of an investment adviser. The SEC was generally unsympathetic to this problem, noting the possibility that Government Officials might restructure their relationships to avoid application of the Rule. The SEC did clarify that "it is the scope of authority of a particular office of an official, not the influence actually exercised by the individual, that would determine whether the individual" has the requisite influence. This may require investment advisers to review the laws and administrative regulations applicable to particular elected officials in order to understand the scope of authority of a particular person or to seek advice from the particular office involved.

- **Covered Associate.** A Covered Associate is (i) any general partner, managing member, president, vice president in charge of a principal business unit, division or function, or any other officer or person who performs a policy-making function for the adviser; (ii) any employee who solicits a Government Client and any person who supervises, directly or indirectly, such an employee; and (iii) any PAC controlled by the investment adviser or by any of its Covered Associates. The definition is designed to exclude persons who may hold formal titles but who do not have a policy-making function. In general, whether a person is a Covered Associate depends on the actual activities and responsibilities of a person and not his or her title. In some instances, it may be necessary to consider whether an employee of the adviser's parent company should be categorized as a Covered Associate by virtue of his or her supervisory responsibilities with respect to adviser employees involved in the solicitation of Government Clients.

- **Solicit.** In the context of the Two-Year Timeout, to "solicit" means to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser. Generally, any communication made under circumstances reasonably calculated to obtain or retain an advisory client would be considered a solicitation. Responding to inquiries made by Government Clients concerning the firm's asset management capabilities may not constitute a solicitation. If an employee receives a finder's fee or referral fee, any communication between that employee and a Government Client is likely to be viewed as a solicitation.

The Timeout

During the Two-Year Timeout, the adviser is not prohibited from providing investment advisory services–only from receiving compensation for such services. The SEC recognizes that an adviser's fiduciary duty may require the provision of uncompensated advisory services for a reasonable period of time until the Government Client can find a replacement.

The Two-Year Timeout includes both "look back" and "look forward" elements. For example, the Two-Year Timeout is not limited to new business entered into after the contribution; compensation payable under existing contracts would be subject to the Two-Year Timeout.

The look back and look forward aspects are particularly important with regard to Covered Associates. With one significant exception, a contribution made by a person within two years of becoming a Covered Associate, whether or not the adviser is aware of the contribution, will trigger the Two-Year Timeout; therefore, contributions made by new hires or promoted employees prior to becoming Covered Associates could trigger the Two-Year Timeout. An exception from this look back approach provides that a contribution made by a natural person more than six months prior to becoming a Covered Associate will not trigger the Two-Year Timeout unless the employee, after becoming a Covered Associate, solicits *any* clients (not simply Government Clients). In addition, the Two-Year Timeout continues after the Covered Associate that made the contribution leaves the firm. Advisers may want to consider requiring *all* employees to provide information with respect to political contributions to determine the consequences under the Rule if an employee subsequently becomes a Covered Associate.

Application to Covered Investment Pools

Each of the prohibitions of the Rule, including the Two-Year Timeout, applies to an investment adviser that manages the assets of a Government Client through a "covered investment pool."

A "covered investment pool" is defined as (i) any investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") that is an investment option of a plan or program of a Government Client that is participant-directed (a "RIC Investment Option") and (ii) any company that would be an investment company but for section 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act (a "Private Fund"). The term RIC Investment Option generally includes college saving plans (*e.g.*, "529 plans") and state employee retirement plans (*e.g.*, "403(b) plans" and "457 plans") that allow participants to select among pre-established investment options that a Government Official has directly or indirectly selected.

The Adopting Release notes that a manager of a pooled investment vehicle may have difficulties complying with the Two-Year Timeout, in particular, relating to the provision of uncompensated advisory services, and has suggested three different approaches:

- For hedge funds and other Private Funds with liquid assets, the adviser could seek to cause the fund to redeem the investment of the Government Client. The possibility of such a redemption and its adverse consequences would likely require disclosure by the fund.

- For venture capital funds, private equity funds and other Private Funds without liquid assets, where redemption is not practical, the adviser could waive or rebate to the fund or the Government Client the portion of its fees or any performance allocation or carried interest attributable to assets of the Government Client.

- For RIC Investment Options, the adviser could either (i) waive its advisory fee for the fund as a whole in an amount approximately equal to the fees attributable to the Government Client or (ii) permit the Government Client to continue to pay its portion of the advisory fee but the adviser would then rebate that portion of the fee to the fund.

In the Adopting Release, the SEC also provided some guidance with regard to subadvisers and fund of fund arrangements. Subadvisers to pooled investment vehicles are not excluded from the provisions of the Rule; however, if the adviser (or one of its Covered Associates) makes a triggering contribution, the subadviser could continue to receive compensation for its advisory activities (and vice versa). Furthermore, an adviser to an underlying fund in a fund of funds arrangement would not be subject to a Two-Year Timeout if it or one of its Covered Associates made a contribution to an official of a Government Client that is an investor in a fund investing in the underlying fund, unless the donation is being made or the structure is being used for the purpose of evading the Rule.

Exceptions and Exemptions

There are exceptions from the Two-Year Timeout for *de minimis* contributions and certain returned contributions. A Covered Associate may make aggregate contributions of up to $350 per election (with primaries and general elections being considered to be separate elections) to a single Government Official for whom the individual is entitled to vote and up to $150 to a Government Official for whom the individual is not entitled to vote. A person would be considered entitled to vote for a Government Official if the person's principal residence is in the locality in which that Government Official is seeking election.

The Rule also provides an automatic exception for certain political contributions that are subsequently returned to the donor. Such political contributions may not exceed $350 to any one Government Official per election. The exception is available if (i) the person making the donation is *not* entitled to vote for the Government Official; (ii) the adviser discovers the contribution within four months; and (iii) the contribution is returned to the contributor within 60 days after discovery. This exception may be used only two times (or in the case of advisers with more than 50 employees, three times) per twelve-month period. However, the exception may be used only once for each Covered Associate regardless of the time period.

In addition to these exceptions, the Rule also provides for an exemptive process by which an adviser can seek relief if it can demonstrate that the imposition of the Two-Year Timeout is unnecessary to achieve the Rule's intended purpose. Among other factors, the SEC will consider whether (i) appropriate policies and procedures had been adopted and implemented prior to the donation; (ii) the adviser had prior knowledge of the contribution; and (iii) the adviser took appropriate remedial steps after the discovery of the contribution. An exemption can only be sought after a contribution has been made; however, the SEC has suggested that, during the period in which the exemptive application is being considered, the adviser may continue to provide advisory services and place the relevant advisory fees in an escrow account.

BUNDLING AND OTHER MEANS OF CIRCUMVENTION

The Rule prohibits an adviser from doing anything indirectly which, if done directly, would result in a violation of the Rule. In addition, an adviser and its Covered Associates are also prohibited from coordinating or soliciting (i) any contribution to an official of a Government Client to which the investment adviser is providing or seeking to provide investment advisory services and (ii) any *payment* to a political party of a state or locality where such Government Client exists (the "Bundling Ban"). The term "payment" is designed to make it clear that payments to political parties addressed by this prohibition need not be related to elections. In addition, the Bundling Ban is not limited to the bundling of Covered Associate contributions and can include the contributions (or payments) of any persons, such as contributions from service providers provided at the request of the investment adviser or its Covered Associates.

The Adopting Release provides examples of the types of communications that would be viewed as solicitations in this context. They include: (i) the use of the adviser's name in fundraising literature for a Government Official or (ii) the sponsorship by the adviser of a meeting or conference which features a Government Official as an attendee or guest speaker and which involves fundraising for the Government Official.

PLACEMENT AGENTS AND SOLICITORS

The most controversial aspect of the proposed rule was a ban on the use of placement agents and solicitors in connection with obtaining government business. In response to comments, the Rule imposes a much narrower restriction (the "Solicitor Restriction"). An investment adviser may retain a solicitor or placement agent to solicit Government Clients if the solicitor is, in effect, a Regulated Person who is subject to "pay-to-play" restrictions substantially equivalent to those contained in the Rule.

An adviser may retain a registered investment adviser as a client solicitor. (Under the "cash solicitation" rule, Advisers Act Rule 206(4)-3, as a general matter, a client solicitor need not be a registered investment adviser; however, if a cash solicitor is retained by an adviser to solicit a state or local government, the adviser should confirm that the solicitor is registered.) Neither the investment adviser solicitor nor any of its Covered Associates may have made a contribution to an official of the Government Client that it will be soliciting or have taken any other action that would be prohibited if the retaining investment adviser had undertaken such action directly. A political contribution by a solicitor would not trigger the Two-Year Timeout for the adviser. Rather, the adviser would be required to immediately cease compensating the solicitor.

More typically, a solicitor or placement agent for a private fund will and must be a registered broker-dealer. Under the Rule, a solicitor or placement agent may qualify as a Regulated Person if it is a member of Financial Industry Regulatory Authority ("FINRA") and the SEC finds that FINRA has adopted its own rule that imposes substantially equivalent or more stringent restrictions as the Rule. FINRA has not yet promulgated such a rule, but the SEC expects it to do so within the next year (before advisers are required to comply with this provision of the Rule).

The Solicitor Restriction does not apply to the adviser's employees, general partners, managing members or executive officers. However, an exception that had been included in the proposal for related persons (*i.e.*, affiliates) of the investment advisers was not adopted. In order for such related persons to act as solicitors or placement agents, they must be Regulated Persons.

RECORDKEEPING

The Rule imposes detailed recordkeeping requirements on registered investment advisers. Advisers that have Government Clients must retain a record of, among other things: (i) contributions made by the adviser and Covered Associates to Government Officials (including candidates); (ii) payments to state or local parties and PACs; (iii) a list of Covered Associates; (iv) a list of Government Clients to which the adviser has provided advisory services or which have acquired interests in investment pools managed by the adviser during the prior five years; and (v) information concerning Regulated Persons that act as solicitors or placement agents for the adviser.

COMPLIANCE DATES

The compliance dates for the various sections of the Rule are as follows:

- Two-Year Timeout & Bundling Ban: March 14, 2011 (any contributions made prior to this date will not trigger the Two-Year Timeout or the Bundling Ban).
- Solicitor Restrictions: September 13, 2011.
- Provisions applicable to RIC Investment Options: September 13, 2011.
- Recordkeeping: March 14, 2011.

Please call us if you have any questions.

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