SEC Proposes Rule Addressing "Pay to Play" Practices Involving Investment Advisers

On August 3, 2009, the Securities and Exchange Commission (SEC) released a proposed rule under the Investment Advisers Act of 1940 (Advisers Act) to address "pay to play" practices by investment advisers (including advisers to private equity, hedge, venture capital, and other private funds) with respect to U.S. state and local government investment management opportunities. The purpose of the proposed rule is to address the concern that political contributions or gifts made to elected officials responsible for overseeing the investment of government assets are influencing the selection of investment advisers. The rulemaking comes in the wake of a series of criminal and civil actions involving alleged abuses in the selection of investment advisers to public pension funds, including recent high-profile cases involving the New York State Common Retirement Fund.

Most notably, the proposed rule would prohibit virtually all investment advisers (whether or not registered) from compensating third-party placement agents to solicit investments from U.S. state and local government entities (e.g., state pension funds, any state or local government-controlled fund, any state-directed 529 college savings plans, or any other investment program or plan sponsored or established by a government entity). Additionally, the placement agent ban has the potential to affect the distribution of other pooled investment vehicles such as registered investment companies by third parties. The proposed rule would also regulate certain contributions and fund raising activities by investment advisers and their employees for the benefit of U.S. government officials, candidates for political office and political parties.

Subject to narrow exceptions, the proposed rule would prohibit any investment adviser that (i) is registered with the SEC or (ii) has at least $30 million in assets under management and is unregistered in reliance on the exemption available under Section 203(b)(3) of the Advisers Act (for advisers with fewer than 15 clients), and the "covered associates" (as defined below) of such investment advisers, from the following activities:

- Providing investment advisory services to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or covered associate. Contributions covered by the proposed rule would include repayments of election-related debt and payment of transition or inaugural expenses of the successful candidate. "Government officials" for purposes of the rule would include (i) elected officials directly or indirectly responsible for, or able to influence, the hiring of an investment adviser or that has the authority to appoint any person having such responsibilities or influence and (ii) candidates for such offices (whether or not ultimately successful) and election committees for such persons.
- Providing, directly or indirectly, payment to any person that is unaffiliated with the investment adviser (e.g., third party placement agents) to solicit a government entity for investment advisory services on behalf of such investment adviser.
- Coordinating, or soliciting any person or political action committee to make, (i) any contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services or (ii) 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.

In addition, under the proposed rule, an investment adviser to a "covered investment pool" (as defined below) in which a government entity invests or is solicited to invest would be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity. A "covered investment pool" would include any investment company within the meaning of the Investment Company Act of 1940 (Investment Company Act) (e.g., mutual funds) and any entity that would be an investment company under the Investment Company Act but for the exclusions provided under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act (e.g., most private equity, hedge, venture capital and other private funds). For purposes of the two-year ban on campaign contributions under the proposed rule, a registered investment company whose shares are registered under the Securities Act of 1933 would not be treated as a "covered investment pool" except in certain limited circumstances.

Under the proposed rule, "covered associates" of an investment adviser would include any general partner, managing member or executive officer of such adviser, any employee who solicits a government entity for such adviser, and any political action committee controlled by such adviser or the any of the foregoing persons.

The proposed rule would effectively ban placement agents and other third parties (including both registered broker-dealers and other types of "finders") from soliciting capital on behalf of investment advisers from public pension plans and other government entities that invest in registered and private investment funds. The proposed rule, if adopted in its present form, has the potential to negatively affect the ability of many investment advisers (including advisers based outside the United States) to raise capital from U.S. government entities unless they have in-house placement staff. Additionally, investment advisers would need to adopt and enforce strict internal reporting and compliance procedures for political contributions to ensure that they are not inadvertently prohibited from providing investment advisory services to governmental entities as a result of the activities of their partners, executives and other "covered associates."

The proposed rule is currently subject to the 60-day public comment period. Public comments must be submitted to the SEC on or before October 6, 2009. Ropes & Gray will continue to monitor developments relating to the proposed rule and potential impacts on investment funds and their investment advisers.

For more information, please contact your usual Ropes & Gray attorney.