

Torys on Private Equity

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SEC's Proposed "Pay-to-Play" Restrictions Will Affect Private Equity Funds

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The Securities and Exchange Commission (SEC) has proposed a new rule titled "Political Contributions by Certain Investment Advisers" designed to prevent advisers, including the management companies of private equity funds, from making political contributions or hidden payments in order to be rewarded with, or given the opportunity to compete for, contracts to manage the assets of public pension plans and other government accounts. This proposal has been made in response to widely reported "pay-to-play" scandals.

On July 22, 2009, the SEC voted unanimously to propose the rule for a 60-day public comment period ending on October 6, 2009.

Application of the Rule to Private Equity Funds

The proposed rule would apply to registered investment advisers and those that are unregistered in reliance on the exemption in Section 203(b)(3) of the Investment Advisers Act of 1940, as amended, (the Advisers Act). That section, relied upon by many private equity funds, provides an exemption for any investment adviser that during the course of the preceding 12 months has had fewer than 15 clients (a private equity fund is generally counted as one client for this purpose) and that does not hold itself out to the public as an investment adviser.¹ Advisers that are not registered because they manage less than \$30 million in assets would not be subject to the proposed rules. The Advisers Act is relevant to private equity funds that have U.S. investors, even if the fund itself is formed in a foreign jurisdiction.

Implications of the Rule's Adoption

Two-Year "Time-Out" After Certain Political Contributions

Under the proposed rule, an investment adviser that makes a political contribution (including gifts) to an elected official in a position to influence the selection of the adviser would be barred for two years from providing advisory services for compensation, either directly or through a fund, to state or local government clients

¹ Note that the Obama administration has recently proposed legislation, the Private Fund Investment Advisers Registration Act of 2009, that would significantly curtail the availability of the Section 203(b)(3) exemption and would require managers of most hedge funds, private equity funds and venture capital funds in the United States to register with the SEC. For further information, see Torys' bulletin [Obama Administration Proposes Registration of Most Private Fund Advisers](#).

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(including public pension plans, for example). The rule would apply to the investment adviser as well as to certain of its executives and employees, such as the adviser's general partner, managing members, executive officers and other individuals with a similar status or function. Additionally, the rule would extend the restriction to political incumbents as well as to candidates for a position that could influence the selection of an adviser.

There is a *de minimis* provision that permits an executive or employee to make contributions of up to \$250 per election per candidate if the contributor is entitled to vote for the candidate.

Banning Third-Party Solicitors

The proposed rule would also prohibit an investment adviser and certain of its executives and employees from paying a third party, such as a placement agent, finder or person acting in a similar capacity, to solicit a government client on behalf of the investment adviser. The justification for this broad restriction is that pay-to-play practices take a variety of forms, including an adviser's payments to third parties to solicit (or as a condition of obtaining) government business. The SEC is concerned that the adoption of the rule addressing pay-to-play practices by advisers would lead to investment advisers using consultants or placement agents to circumvent the rule. Furthermore the SEC contends that third-party solicitors have played a central role in each enforcement action involving pay-to-play schemes that the SEC has brought against investment advisers in the past several years.

Banning Solicitation of Contributions

The proposed rule would also prohibit an investment adviser and certain of its executives and employees from coordinating, or asking another person or political action committee to provide, (i) contributions to an elected official (or candidate for the official's position) who can influence the selection of the adviser or (ii) payment to a political party of the state or locality where the adviser is seeking to provide investment advisory services to a government entity.

Restricting Indirect Contributions and Solicitations

The proposed rule would prohibit an adviser and certain of its executives and employees from circumventing the rule by directing or funding contributions through third parties, such as spouses, lawyers or companies affiliated with the adviser, if that conduct would violate the rule if the adviser did it directly.

Record Keeping

All investment advisers subject to the proposed rule would be required to maintain records regarding their political contributions and payments and those of their covered executives and employees. These records would be available to the SEC as part of the adviser-examination process. Advisers would need to establish procedures to comply with the proposed rule. **1**