Cooley

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On June 30, 2010, the Securities and Exchange Commission ("SEC") unanimously adopted Rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Act") addressing so called "pay to play" practices by investment advisers, including venture capital and other fund managers. Pay to play practices involve payments, including political contributions, made or solicited by fund managers to government officials or candidates who may directly *or indirectly* influence the awarding of advisory contracts for state and local government entities including, for example, public pension plans or other government funds. The rule applies to fund managers registered as investment advisers with the SEC or exempt from registration under Rule 203(b)(3) (the "private adviser" exemption)[1].

Rule 206(4)-5 has three main elements:

1. Two-year "time out" for contributions

Under Rule 206(4)-5(a)(1), fund managers are prohibited from receiving compensation (including management fees and carried interest) for providing advice to a state or local government entity within two years after a payment has been made to an official of the government entity by a fund manager, its executive officers or certain other "covered associates." This two-year time out is intended to discourage fund managers from participating in pay to play practices by requiring a period during which the effects of a political contribution on the selection process can be expected to dissipate. Government entities include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds. If those entities invest in a fund, the fund manager is considered to be providing advice to, and receiving compensation from, those entities directly. The term official includes incumbents, candidates or successful candidates for elective office of a government entity if the office, or a person that the office has authority to appoint, is directly *or indirectly* responsible for, or can influence the outcome of, the hiring of a fund manager or an investment in an underlying fund. As an example, contributions to the Governor of California, among others and subject to a *de minimis* exception, would result in a two-year time out period with respect to CalPERS, CalSTRS and the University of California Regents.

The rule provides a *de minimis* exception for contributions of under $350 made to candidates for whom the contributor may vote and $150 to other candidates and, in very limited cases, a limited cure period. In addition, the rule contains a "look-back" provision that in certain cases may attribute to the fund manager previous contributions made by newly hired "covered associates." Finally, fund managers registered under the Act are required to maintain certain records that will allow the SEC to monitor compliance with the rule.

2. Ban on using third parties to solicit government business

Under Rule 206(4)-5(a)(2), a fund manager, its executives and certain other "covered associates" are prohibited from making or agreeing to make payments to any unaffiliated third-party (*e.g.,* a placement agent) for soliciting government clients or investors on its behalf. The prohibition does not apply to solicitations made by "regulated persons," a term that includes certain broker-dealers and registered investment advisers that are themselves subject to prohibitions against participating in pay to play practices and are subject to SEC oversight and, in the case of broker-dealers, the oversight of a registered national securities association, such as FINRA.

3. Restrictions on soliciting and coordinating contributions and payments

Under Rule 206(4)-5, a fund manager, its executives and certain other "covered associates" are prohibited from coordinating or soliciting any person or political action committee to make (i) any contribution to an official of a

government entity to which the fund manager is providing or seeking to provide investment services, or (ii) any payment to a political party of a state or locality where the fund manager is providing or seeking to provide investment services to a government entity. These restrictions are intended to prevent fund managers from circumventing the rule's prohibition on direct contributions to certain elected officials by methods such as "bundling" a large number of small employee contributions to influence an election or making contributions indirectly through a political party.

Effective date

Fund managers subject to Rule 206(4)-5 must be in compliance with the rule on March 14, 2011. However, the SEC is allowing a six month transition period to provide time to identify "covered associates" and current government clients and to modify compliance programs to address obligations under the rule. Thus, contributions made before March 14, 2011 will not trigger the "two-year timeout." Fund managers may no longer use third parties to solicit government business except in compliance with the rule beginning on September 13, 2011.

Recommendations

Although the new rule may be the subject of legal challenge, for example, as a violation of the First Amendment, we recommend that fund managers establish an internal compliance policy governing political contributions of "covered associates." Such policy should prohibit "covered associates" from making contributions to certain political candidates or coordinating contributions or political fundraisers. Additionally, should a fund manager engage placement agents or other unaffiliated solicitors, we recommend that such engagements should only be with agents that are "regulated persons" as defined by the Rule 206(4)-5. Should a placement agent who is not a "regulated person" be engaged, such placement agent should be restricted from soliciting a government entity on behalf of the fund manager. Finally, fund managers should develop procedures for ensuring that individuals being considered for hire and promotion into restricted positions have not made political contributions in violation of the rule during the two-year period prior to the hire or promotion.

If you have any questions about this *Alert,* please contact one of your Cooley team members.

Notes

1 The recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act removes the private adviser exemption while creating new exemptions to investment adviser registration, including an exemption for a "venture capital fund" adviser. It is anticipated that investment advisers covered by these new exemptions will be subject to Rule 206(4)-5.

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