SIDLEY AUSTIN LLP

SIDLEY

JULY 6, 2010

INVESTMENT MANAGEMENT UPDATE

The Investment Management Practice of Sidley Austin LLP

Sidley has a premier, global practice in structuring and advising investment funds and advisers. We advise clients in the formation and operation of all types of alternative investment vehicles, including hedge funds, fund-of-funds, commodity pools, venture capital and private equity funds, private real estate funds and other public and private pooled investment vehicles. We also represent clients with respect to more traditional investment funds, such as closed-end and open-end registered investment companies (*i.e.*, mutual funds) and exchange-traded funds (ETFs). Our advice covers the broad scope of legal and compliance issues that are faced by funds, their managers and their boards under the laws and regulations of the various jurisdictions in which they may operate. In particular, we advise our clients regarding complex federal and state laws and regulations governing securities, funds and advisers including the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the USA PATRIOT Act and comparable laws in non-U.S. jurisdictions. Our practice group consists of approximately 150 lawyers in New York, Chicago, London, Hong Kong, Singapore, Los Angeles and San Francisco.

To receive future copies of this and other Sidley updates via email, please sign up at www.sidley.com/subscribe

This **Sidley update** has been prepared by Sidley Austin LLP for informational purposes only and does not constitute legal advice. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this without seeking advice from professional advisers.

Attorney Advertising - For purposes of compliance with New York State Bar rules, our headquarters are Sidley Austin LLP, 787 Seventh Avenue, New York, NY 10019, 212.839.5300 and One South Dearborn, Chicago, IL 60603, 312.853.7000. Prior results do not guarantee a similar outcome.

SEC Adopts Rule to Eliminate “Pay-to-Play” Practices

On June 30, 2010, the U.S. Securities and Exchange Commission (the “SEC”), in a unanimous vote, approved new Rule 206(4)-5 (the “Rule”) under the Investment Advisers Act of 1940 (as amended, the “Advisers Act”) designed to eliminate “pay-to-play” practices. The Rule:

- imposes a two-year “time out,” with certain exceptions, on receiving compensation for providing investment advisory services to a government client after any one of certain specified persons makes a contribution to certain candidates or elected officials;
- limits the use of placement agents to regulated persons that are subject to either the Rule itself or comparable rules governing political contributions; and
- bans solicitations or “bundling” of contributions for certain candidates or elected officials.

The Rule is based significantly on Rules G-37 and G-38 of the Municipal Securities Rulemaking Board (“MSRB”), which address pay-to-play practices in the municipal securities market, and follows similar state rules or guidance.

Rule 206(4)-5 applies to all investment advisers registered, or required to be registered, with the SEC, and advisers currently exempt from registration under Section 203(b)(3) of the Advisers Act, often referred to as the “private adviser exemption.” The rule does not apply to most state-registered advisers and certain other advisers that are exempt from SEC registration. The Rule applies with equal force to direct contractual arrangements between an adviser and a government entity for advisory services and participation by a government entity in an adviser’s “covered investment pools,” which include private investment funds or registered investment companies that are investment options for government plans.

Two-year “Time Out.” Rule 206(4)-5 prohibits an adviser from receiving compensation for providing investment advisory services to a government client within two years of any contribution made by the adviser or a “covered associate” to an elected official in a position to direct or influence the investment activities of the

government client. For purposes of the Rule, a "covered associate" of an adviser is:

- any general partner, managing member or executive officer;
- any employee who solicits government entity clients; and
- any political action committee controlled by the adviser or any of the above persons.

The term "executive officer" is defined in the Rule to include an adviser's president, any vice president in charge of a principal business unit or function, any other officer who performs a policy-making function and any other person who performs similar policy-making functions for the adviser.

The application of Rule 206(4)-5 is broad and goes beyond straightforward campaign contributions. "Anything of value" that is provided to influence the election for a federal, state or local office, such as donations to assist in paying the debts of a previous campaign, may trigger application of the Rule. Application of the Rule would also be triggered by contributions to pay a portion of the expenses associated with an inauguration or organizing a fundraiser for a candidate or officeholder.

Rule 206(4)-5 contains a "look back" provision, which applies the two-year time out to the investment adviser where the contributor worked at the time of the donation but also to any adviser with which the contributor is employed within two years from the time of the donation, except that if the contributor is a natural person who does not solicit clients, the "look back" provision is only six months. An adviser must therefore be aware of the donations made by a prospective employee if the adviser seeks to solicit government clients.

Not all political contributions are necessarily covered by the Rule. The Rule applies only to incumbents, candidates or successful candidates for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the selection of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of an investment adviser. Under the Rule, a contribution to a candidate for an office may be triggered if the candidate currently is an elected officeholder for a government entity that is responsible for the selection of an adviser. For example, while the Rule does not ordinarily apply to contributions to federal officials, a donation to a candidate for the U.S. Senate would likely trigger the Rule if the candidate currently serves as state treasurer. The Rule also may be triggered by contributions to a candidate's or officeholder's political action committee. The Rule will not be triggered by non-financial political activities such as volunteering on a campaign, running for office or making political speeches.

Rule 206(4)-5 allows for a *de minimis* contribution of $350 per election by a covered associate who is a natural person for any election in which that covered associate is entitled to vote, and $150 for any election in which the covered associate is not entitled to vote, in either case without triggering the two-year time out. The proposed rule would have allowed only a *de minimis* contribution of $250 per election by a covered associate for any election in which the covered associate is entitled to vote.

Restrictions on Use of Placement Agents. In a change of course from the proposed rule, which would have banned the use of placement agents or other third parties for soliciting government clients, the Rule instead only restricts their use. Under the Rule, any placement agent or other third party retained to solicit government clients must be a "regulated person." "Regulated person" is defined as a person or entity subject to regulation by a national securities regulator, *e.g.:*

- a broker-dealer registered with the SEC and a member of a national securities association, which currently would include only the Financial Industry Regulatory Authority ("FINRA"), if the rules of the association prohibit members from engaging in

distribution or solicitation activities if certain contributions have been made and the SEC has found that the rules impose "substantially equivalent or more stringent" restrictions on broker-dealers than the Rule imposes on investment advisers and are consistent with the objectives of the Rule; or

- an investment adviser registered with the SEC that has not, and whose covered associates have not, within two years of soliciting a government entity, made a contribution to an official of that entity, other than a *de minimis* contribution, or coordinated or solicited any political contribution.

In the adopting release for Rule 206(4)-5, the SEC noted that the FINRA pay-to-play rule is in progress but not yet adopted. The SEC thus is delaying application of these restrictions on the use of placement agents for one year from the effective date of the Rule, in part to allow FINRA time to propose such a rule.

No Solicitation of Contributions. Rule 206(4)-5 bars advisers and covered associates from soliciting contributions or "bundling" contributions to officials of governmental entities with which the adviser seeks to do business. Additionally, advisers and covered associates may not solicit contributions or bundle contributions for a political party in a state or municipality in which the adviser seeks to provide investment advisory services to a government entity. This prohibition is similar to one contained in MSRB Rule G-37.

Catch-all. The Rule includes a "catch-all" provision similar to that contained in MSRB Rule G-37, which prohibits an adviser or a covered associate from indirectly doing what it may not do directly under the Rule. This provision is intended to prevent a person from evading the requirements of the Rule by, for example, coordinating his or her contributions with other parties, such as a spouse, family member, affiliated company, or a swap arrangement with another adviser.

Returned Contributions. In addition to the exception from the two-year time out for *de minimis* contributions, an adviser may claim an exception for inadvertent violations of the Rule in which a covered associate has made a contribution not exceeding $350, so long as the adviser discovers the contribution within four months of the date of the contribution and causes the contribution to be returned to the contributor within 60 days of learning of the contribution. An adviser may use this exemption no more than three times within any calendar year if the adviser has reported on its Form ADV registration statement that it had more than 50 employees who perform investment advisory functions; all other advisers may use this exemption no more than twice within any calendar year.

Exemptions. The SEC may exempt an adviser from the two-year "time out" requirement when such an exemption is necessary or appropriate in the public interest and the adviser has met certain criteria. Included among these criteria:

- the adviser must have adopted and implemented policies and procedures to prevent violations of the rule; and
- the adviser had no knowledge of the contribution in question and after learning of the contribution has taken steps for the contribution in question to be returned.

In these cases, the SEC will look to other factors such as the nature of the election, the motive of the contributor, and the contributor's status with the adviser at the time of the contribution. At the meeting at which the Rule was adopted, one Commissioner underscored the need for the exemptive process to be quick and efficient to ensure that this exemption is meaningful.

Monitoring Compliance. In order to assist the SEC in enforcing compliance with Rule 206(4)-5, the SEC also amended Rule 204-2 to require an adviser that has or seeks government clients, or provides investment advisory services to

a covered investment pool in which a government entity investor invests or seeks to invest, to maintain certain records of contributions made by the adviser and its covered associates. Pursuant to amended Rule 204-2, an adviser must keep records of, among other things, all covered associates; all government entities for which the adviser has provided investment advisory services for the past five years; all government entities that invest, or have invested in the past five years, in a covered investment pool; and all direct or indirect contributions or payments by an adviser or any of its covered associates. Unlike MSRB Rule G-8, amended Rule 204-2 requires the retention of records of even *de minimis* contributions. However, unlike MSRB Rule G-37, amended Rule 204-2 does not contain a reporting requirement. In addition, an adviser is only required to keep the above records relative to political contributions if it provides investment advisory services to a governmental entity or if a governmental entity is an investor in an investment pool covered by the Rule.

If you have additional questions, please call on the Sidley Austin lawyer with whom you have regular contact.

BEIJING BRUSSELS CHICAGO DALLAS FRANKFURT GENEVA HONG KONG LONDON LOS ANGELES NEW YORK PALO ALTO SAN FRANCISCO SHANGHAI SINGAPORE SYDNEY TOKYO WASHINGTON, D.C.

www.sidley.com

Sidley Austin LLP, a Delaware limited liability partnership which operates at the firm's offices other than Chicago, London, Hong Kong, Singapore and Sydney, is affiliated with other partnerships, including Sidley Austin LLP, an Illinois limited liability partnership (Chicago); Sidley Austin LLP, a separate Delaware limited liability partnership (London); Sidley Austin LLP, a separate Delaware limited liability partnership (Singapore); Sidley Austin, a New York general partnership (Hong Kong); Sidley Austin, a Delaware general partnership of registered foreign lawyers restricted to practicing foreign law (Sydney); and Sidley Austin Nishikawa Foreign Law Joint Enterprise (Tokyo). The affiliated partnerships are referred to herein collectively as Sidley Austin, Sidley, or the firm.

SIDLEY AUSTIN LLP
SIDLEY