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Political Contributions and State Lobbyist Registration

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Introduction

Private equity advisers that are either registered with the Securities and Exchange Commission (SEC) or 'exempt but reporting' are also subject to Rule 206(4)-5 under the Investment Advisers Act of 1940 (Advisers Act). The rule, more commonly known as the 'pay-to-play rule', effectively limits the ability of an investment adviser and its high-level employees to make political contributions or provide gifts to political figures and candidates that could award the adviser business contracts.

Since the rule was first adopted in July 2010, it has been interpreted by SEC staff, amended and, most recently, the focus of no-action relief. Numerous state and local governments have also proposed and/or adopted similar legislation or regulations that either prohibit investment advisers and their employees from making contributions to political figures, or require advisers and their soliciting personnel to register as lobbyists prior to competing for government contracts. As a result, before a private equity adviser seeks to do any business with or manage any assets for a government entity, it must assure itself that it is in compliance with both the SEC's pay-to-play rule (a complicated enough task in its own right) and any applicable state or local statutes or rules.

This article will provide an overview of the SEC's pay-to-play rule, highlighting guidance on the rule from SEC staff, the June 2011 amendments to the rule and the no-action relief given to registered investment companies under the rule's related recordkeeping requirements. Importantly, as will be further described below, the SEC staff's no-action relief from the rule's related recordkeeping requirements does not apply to private equity funds with government entity investors. This article will also briefly discuss related rulemakings from the Municipal Securities Rulemaking Board (MSRB) and the Financial Industry Regulatory Authority, Inc. (FINRA) and provide an overview of the state and local regulatory framework relevant to private equity advisers. Finally, this article will provide an overview of key points and practice tips for private equity advisers when structuring their compliance programs.

The SEC's pay-to-play rule

On July 1, 2010, the SEC adopted rule 206(4)-5 under the Advisers Act[1] aimed at curtailing pay-to-play practices by investment advisers that seek to manage assets of state and local governments. In general, the rule seeks to protect state and municipal pension plans and prevent the distortion of the selection process by curtailing the ability of investment advisers to use political contributions to influence governmental officials responsible for the hiring of investment advisers. According to the SEC, pay-to-play practices potentially result in higher fees paid to advisers (under the theory that advisers would attempt to recoup political contributions) for advisory services provided to government entities that may not be negotiated at arm's-length. Further, the SEC has reasoned that pay-to-play practices could effectively block the most suitable adviser for a

1. See Political Contributions by Certain Investment Advisers, Advisers Act Release No. 3043 (July 1, 2010) (Adopting Release), available at http://www.sec.gov/rules/final/2010/ia-3043.pdf; and Political Contributions by Certain Investment Advisers, Advisers Act Release No. 2910 (August 3, 2009) (Proposing Release), available at http://sec.gov/rules/proposed/2009/ia-2910.pdf

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mandate from consideration if such an adviser either refuses or cannot afford to make such contributions.

The rule essentially has three prongs. First, it restricts the ability of investment advisers and certain of their employees from directly making political contributions to certain political candidates. Second, to prevent circumvention of the first prong, the rule also prohibits investment advisers from using solicitors that are not subject to the rule (or a similar rule) to procure government contracts and from coordinating contributions from others that it cannot make itself (that is, fundraising). Third, the rule includes a final 'catch-all' that generally prohibits advisers from doing anything indirectly that they would otherwise be prohibited from doing directly. The rule also has correlated recordkeeping requirements under Rule 204-2, which are the primary focus of the SEC staff's recent grant of no-action relief.

Prong 1: Political contributions

The rule prohibits advisers from providing investment advisory services to a government entity for compensation for a two-year period after the adviser or any of its covered associates makes a contribution to an official of that government entity.

In order to more fully understand this effective restriction on political contributions, each of the defined terms under the Rule needs to be more fully explained.

'Advisers'

The rule applies to investment advisers registered (or required to be registered) under the Advisers Act and unregistered advisers relying on any of the venture capital fund adviser, private fund adviser or foreign private adviser exemptions from registration.[2] The rule will typically not apply to small advisers registered with a state securities authority, advisers that are unregistered in reliance on another exemption (that is, advisers with only insurance company clients), or advisers excepted from the definition of 'investment adviser' under Section 202(a)(11) of the Advisers Act (that is, a broker-dealer whose performance of advisory services is solely incidental to his broker-dealer business and who receives no special compensation for such incidental advisory services).

Under the rule, advisers to 'covered investment pools' in which a government entity invests or is solicited to invest in are treated as though they provided or solicited services directly to that government entity. Therefore, the prohibited practices under the rule apply not only when advisers seek to be hired to manage government assets directly, but also when advisers seek to obtain government entities as investors in certain investment vehicles managed by the adviser.

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2. As originally proposed, the pay-to-play rule would have only applied to advisers relying on the *de minimis* exception under what was then Section 203(b)(3) of the Advisers Act. Shortly after the rule was adopted, the Dodd-Frank Act was enacted, which effectively replaced Section 203(b)(3) of the Advisers Act with an exception for 'foreign private advisers', effective July 21, 2011. Other exemptions from SEC registration were also mandated by the Dodd-Frank Act, including exemptions for 'private fund advisers' (Section 203(m) of the Advisers Act) and 'venture capital fund advisers' (Section 203(l) of the Advisers Act). To clarify these differences between the rule and the Dodd-Frank Act, the SEC adopted amendments to the rule on June 22, 2011 that, among other things, clarified that advisers relying on any of these three exemptions would still be subject to the rule. See Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3221 (June 22, 2011), available at http://www.sec.gov/rules/final/2011/ia-3221.pdf.

'Covered investment pool'

The rule defines a covered investment pool as either a registered investment company that is an investment option of a participant-directed plan or program of a government entity, or any company that would be an investment company but for the exclusion from the definition of 'investment company' set forth under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act of 1940 (the Investment Company Act).[3] The latter would include most private equity funds. It is worth nothing that private equity funds need not be investment options in a plan or program of a government entity to be deemed covered investment pools for purposes of the rule. Therefore, an adviser to a private equity fund in which a government entity invests or is solicited to invest with is treated as though it provides (or solicited) services directly to that government entity.

'Advisory services'

There is no real guidance on the meaning of advisory services in the context of the rule itself. However, the definition of 'investment adviser' set forth in Section 202(a)(11) of the Advisers Act and prior SEC guidance[4] provide some gloss its meaning. The definition of investment adviser, to paraphrase, is any person who is in the business of advising others as to the value of securities or the advisability of investing in securities or issues analyses/reports concerning securities.

'Covered associates' of an adviser

An adviser's covered associates include any:

- High-ranking owners or employees of the adviser, such as:
    - The adviser's general partner (if it is structured as a limited partnership) or managing member (if it is structured as a limited liability company).
    - Executive officers,[5] which includes the adviser's president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer of the adviser or other person who performs a policymaking function for the adviser.
    - Other individuals with a similar status or function.
- Employee who solicits a government entity for the adviser.
- Supervisor of an employee who solicits a government entity for the adviser.

3. Sections 3(c)(1), 3(c)(7) and 3(c)(11) provide exclusions from the definition of 'investment company' set forth in Section 3(a) of the 1940 Act. Specifically, Section 3(c)(1) excludes from the definition of investment company private funds with fewer than 100 beneficial owners that are not publicly offered, Section 3(c)(7) excludes private funds solely with 'qualified purchaser' investors that are not publicly offered and Section 3(c)(11) excludes certain employee investment trusts, government plans and collective trusts. Private equity funds typically rely on Section 3(c)(1) or 3(c)(7).

4. See Advisers Act Release No. 1092 (October 8, 1987).

5. With respect to executive officers, the SEC noted that whether a person is an executive officer depends on his or her function, not title, so advisers cannot simply change the titles of high-ranking employees to avoid the rule.

- Political action committee (PAC) controlled by the adviser or by any of its covered associates.

The SEC staff clarified the application of the definition of covered associated in its March 2011 guidance, which was supplemented on both April 28 and November 8, 2011. It is worth noting, however, that advisers should consider whether certain employees that may not be covered associates under the rule, and the staff's interpretations of the rule, should be included in the adviser's compliance program. This is to prevent indirect violations of the rule and to include those employees who may later become covered associates as a result of a change in work responsibilities.

The SEC staff noted that, in its view, only certain natural persons described in the rule (or PACs controlled by an adviser or its covered associates) can be covered associates under the rule. Therefore, a parent company of an adviser or employees of the parent company cannot be a covered associate. However, the prohibition on indirect violations under the third prong of the rule would still apply if contributions were channeled through a parent company or its employees with the intent of circumventing the rule.

The SEC staff also noted that under the rule, the PAC of an adviser's managing member would not be a covered associate unless the adviser or its covered associates had the ability to direct or cause the direction of governance or operations of the PAC.

An adviser's affiliated companies and personnel of those affiliated companies cannot be covered associates of the adviser. The staff noted, however, that if an affiliate or its employees are paid by an adviser to solicit government business, then the affiliate must be a 'regulated person' under the second prong of the rule (discussed below). Finally, the staff stated that a firm's broker-dealer employees who solicit government clients on behalf of the firm could be covered associates.

'Employee'

In its March 2011 guidance, the SEC staff stated that independent contractors acting on behalf of an adviser should be treated as employees of the adviser. By citing prior SEC guidance, the staff seemed to limit this treatment to independent contractors who perform 'investment advisory functions for the adviser [and] whose activities are controlled by the adviser.'[6] This clarification could have the following effects on the rule:

- An adviser's independent contractors who solicit government clients for the adviser would be covered associates.
- Supervisors of an adviser's independent contractors who solicit government clients for the adviser would be covered associates.
- An adviser or its covered associates may pay independent contractors of the adviser to solicit government entities, subject to the other requirements of the second prong of the rule.
- An adviser may have to count its independent contractors when determining whether the exception for returned contributions under the rule is available to the adviser, as further discussed below.

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6. See Investment Advisers; Uniform Registration, Disclosure and Reporting Requirements; Staff Interpretation, Advisers Act Release No. 1000 (Dec. 3, 1985).

- When determining whether to grant exemptive relief under the rule, the SEC may consider whether a contribution was made by an independent contractor, among other factors.

'Government entity'

A government entity is any state or political subdivision of a state, which includes agencies, authorities or instrumentalities of the state or municipality, and any of their (i) sponsored or established pools of assets (that is, defined benefit and pension plans), (ii) plans or programs (that is, retirement plans) and (iii) officers, agents or employees acting in their official capacity. In other words, providing investment advisory services to a state employee on an individual basis would not be contemplated by the rule, because in entering into the advisory relationship, he or she would not be acting in his or her 'official capacity'.

In the staff's view, the management of assets of non-US governments is not covered under the rule. However, political contributions in connection with the award of advisory services with non-US governments would still be subject to other applicable laws and regulations, such as the Foreign Corrupt Practices Act of 1977. This may be of particular importance to private equity advisers, which may have a number of overseas portfolio companies.

'Plan or program'

The rule specifies that a plan or program of a government entity is any participant-directed investment program or plan established by a state or municipality (or an agency, authority or instrumentality of the state or municipality). Examples of such plans or programs are qualified tuition plans (commonly called '529 plans') or retirement plans.

'Contribution'

A contribution is any gift, subscription, loan, advance or deposit of money or anything of value made for (i) the purpose of influencing any election for federal (if the candidate is a state incumbent), state or local office, (ii) the payment of election debt or (iii) transition or inaugural expenses incurred by a successful candidate for state or local office. Charitable donations and contributions to a PAC or local political party will not, by themselves, trigger the time out, although they may violate the third prong of the rule, which prohibits an adviser and its covered associates from doing anything indirectly that, if done directly, would violate the rule.

The SEC has indicated that, in the context of a fundraising meeting or conference, expenses incurred by an adviser that is hosting the event would be a contribution by the adviser. This would trigger the two-year ban on the adviser receiving compensation for providing advisory services to the government entity over which that official has influence. The SEC further clarified that '[s]uch expenses may include, but are not limited to, the cost of the facility, the cost of refreshments, any expenses paid for administrative staff, and the payment or reimbursement of any of the government official's expenses for the event. The *de minimis* exception under Rule 206(4)-5(b)(1) would not be available with respect to these expenses because they would have been incurred by the firm, not by a natural person.'

The SEC has also indicated that advisers and covered associates who make 'direct expenditures for the expression of their views' or give speeches, solicit votes, write books or make appearances at fundraising events would not be deemed to be making contributions. Further, the SEC has noted that 'a covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the adviser is not otherwise paying the employee's salary (for example, an unpaid leave of absence).' To summarize, whether something would be deemed a contribution depends on the particular facts and circumstances and is far from clear.

An 'official' of a government entity

An official of a government entity is any person in the office of a government entity that is responsible for, or can influence the outcome of, hiring an investment adviser or has the authority to appoint any person who is responsible for, or can influence the outcome of, the hiring on an investment adviser. This portion of the rule is quite broad and includes both direct and indirect 'responsibility.' In addition, the definition covers incumbent officials, candidates and elected (but not yet inaugurated) officials. The test for whether a person who receives a contribution is an official, thereby triggering the two-year timeout, is as of the time of the contribution.

The staff interprets the rule to include within the definition of official any member of a public pension plan board that is elected by plan participants. The staff noted in its March 2011 guidance that the rule 'does not differentiate between popularly elected officials and participant-elected officials.' Although a technical reading of the rule supports this interpretation, it is not contemplated in the rule's releases. It also seems to be inconsistent with most discussion of 'contributions' set forth in the rule, such as payment for debt incurred in connection with an election (that is, campaign expenses) or transitional or inaugural expenses, which would seem to not apply to most participant-elected positions in a plan's governance structure. In any event, regardless of the application of the rule, a contribution by an adviser to such a participant-elected person – which may not otherwise be subject to campaign reporting laws and regulations – may have the connotation of a bribe, which would be otherwise regulated under the Advisers Act and the rules thereunder, as well as other laws. For that reason, it is unlikely that this interpretation by the staff will have much effect on advisers' compliance programs.

To recap, under the first prong of the rule, if an adviser or a covered associate of the adviser makes a contribution to an official of a government entity who is in a position to influence the award of the government entity's business, then the adviser is prohibited from receiving compensation for providing advisory services to that government entity for two years thereafter, otherwise known as a 'time-out' period. Contributions by non-executive employees of an adviser (unless they are soliciting government entity clients) would not, in and of themselves, trigger the time-out provision, but may otherwise be prohibited indirect violations of the third prong of the rule).

The SEC noted that the rule does not prohibit contributions or the provision of advisory services after making a contribution. Instead, the rule prohibits the receipt of compensation for advisory services within two years after making a proscribed contribution. The SEC stated that it took this approach to prevent an adviser from having to abandon a government entity client after the adviser or its covered associate makes a contribution. After making a prohibited contribution, an adviser would, at a minimum, be obligated under its fiduciary duty to 'provide uncompensated advisory services for a reasonable period of time' until its government entity client could find a replacement

adviser. According to the SEC, what constitutes a reasonable period of time will depend primarily on the amount of time a client may need in good faith to find and engage a successor to the adviser.

The rule also requires an adviser to 'look back' for a two-year period for all newly hired covered associates who will solicit clients (but only six months for newly hired covered associates who will not solicit clients). This look-back period will follow covered associates who change investment advisory firms so that a prohibited contribution by a covered associate will result in a time out for the covered associate's new firm for the remainder of the two-year or six-month period, as applicable. Further, to prevent advisers from channeling contributions through departing covered persons, if a covered person makes a prohibited contribution and then leaves the employ of that investment adviser, the adviser will still be subject to the two-year time out period, despite the departure of the covered associate who made the contribution. (The SEC adopted this provision despite receiving comments that departing or terminated employees could make a contribution in an effort to seek retribution against an adviser.)

The rule does, however, permit two narrow exemptions from the two-year timeout from compensated advisory services following a triggering contribution: *'de minimis'* and 'returned contributions.'

De minimis *exception*

The *de minimis* exception allows a covered associate of an adviser to contribute (i) up to $350 to an official per election (with primary and general elections counting separately) if the covered associate is entitled to vote for the official at the time of the contribution, and (ii) up to $150 to an official per election (with primary and general elections counting separately) if the covered associate is not entitled to vote for the official at the time of the contribution.

Returned contributions exception

Under the returned contribution exception, if a covered associate of an adviser makes a contribution that triggers the two-year time-out period solely because he or she was not entitled to vote for the official at the time of the contribution, the adviser can effectively undo the contribution. To be eligible, the contribution must be less than $350, the adviser must discover the contribution within four months of the date of such contribution and the adviser must cause the contributor to re-collect the contribution within 60 days after discovery. The specificity of the requirements significantly limits the availability of the exception. Further, an adviser with fewer than 50 employees can only rely on the returned contribution exception twice in a 12-month period (three times for advisers with more than 50 employees) and an adviser can never use the returned contribution exception for the same covered associate twice. However, according to the SEC staff, a covered associate who no longer has the one-and-done returned contribution exception obtains a fresh start at his or her subsequent firm.

The rule also allows an adviser to apply for an order exempting it from the two-year time out requirement in the event of an inadvertent violation that falls outside of the exceptions set forth above when, according to the SEC, the imposition of the time out provision is unnecessary to achieve the rule's intended purpose.

Prong 2: Third-party solicitations and fundraising

To prevent circumvention of the first prong of the rule, the rule also imposes limitations on the ability of advisers and their covered associates to use third-party solicitors or to engage in political fundraising. Specifically, advisers and covered associates cannot pay any person to solicit a government entity for advisory services on its behalf unless such person is either an employee, executive officer or general partner/managing member of the adviser, or is a 'regulated person'.

'Solicitation'

Solicitation, for purposes of the rule, is defined as communicating, directly or indirectly, for the purpose obtaining or retaining a client for, or referring a client to, an adviser, or obtaining or arranging a contribution or payment. Notably, Rule 206(4)-3 under the Advisers Act, which governs cash payments for client solicitations, was amended to add sub-part (e), which points out that solicitation of government clients are subject to the additional limitations of the rule.

'Regulated person'

As amended in June 2011, the rule defines regulated person to include not only other advisers subject to the rule, but also registered broker-dealers and registered municipal advisers that are themselves subject to a pay-to-play rule that the SEC has deemed equivalent.

The MSRB proposed Rule G-42 in January 2011, which was originally scheduled for adoption in September 2011, but withdrawn from the SEC on September 12, 2011 pending the SEC's adoption of a permanent definition of the term 'municipal advisor' under the Securities Exchange Act of 1934. Once re-proposed, and on its adoption, the SEC will have to determine that the MSRB rule is substantially equivalent to and consistent with the objectives of the SEC rule. FINRA has also informally indicated that it is in the process of preparing a pay-to-play rule that would apply generally to all member firms that solicit advisory business from a government entity.

In the June 2011 amendments to the rule, the SEC extended the compliance date for the ban on third-party solicitation from September 13, 2011 to June 13, 2012, to provide the MSRB and FINRA additional time to adopt pay-to-play rules that would cover broker-dealers and municipal advisers.

According to the SEC staff, trailing payments made to a third-party solicitor who is not a 'registered person' under the rule in connection with the prior solicitation of a client for the adviser (that is, for the period during which the client remains with the adviser) would be permitted so long as the solicitor does not solicit the government client 'after the compliance date'. The rule, as amended, does not prohibit an adviser from paying a third-party solicitor that is not a regulated person for soliciting government clients until June 13, 2012. As such, advisers could enter into third-party solicitation arrangements with entities that are not regulated persons under the rule prior to June 13, 2012 and continue paying them after June 13, 2012, provided the solicitation of government clients does not occur after June 13, 2012. Further, the staff's interpretation would seem to permit increased payments to a solicitor that result from an additional capital contribution of a solicited government client, even if the additional capital was contributed after June 13, 2012, so long as the solicitor does not engage in further solicitation of the client, although there is

some uncertainty on this point due to conflicting past interpretations from the MSRB on analogous rules. The staff noted, however, that 'solicitation' is broadly defined under the rule and that compensation arrangements structured to avoid the rule would violate the rule's prohibition on indirect violations of the rule. Given these warnings from the staff, solicitation arrangements with entities other than registered investment advisers, broker-dealers or municipal securities brokers entered into before June 13, 2012 should be carefully considered.

If an adviser's employee is also employed by an affiliated broker-dealer (that is, a 'shared' or 'dual' employee) to solicit government clients on behalf of the adviser, then the broker-dealer would have to be an SEC-registered broker-dealer subject to equivalent pay-to-play rules (that is, a 'regulated person') if the adviser pays the broker-dealer for the employee's solicitation services. Further, according to the staff, the dual employee would be a covered associate of the adviser because of his or her solicitation activities, even if these activities were performed in his or her capacity as an employee of the broker-dealer.

Solicitation, coordination and fundraising activities

The rule limits an adviser's and its covered associates' abilities to engage third-party solicitors and participate in other political fundraising activity. Because of the First Amendment implications of any such limitations on political activity, the rule and its related guidance is particularly murky when it comes to these second-prong restrictions.

The SEC has stated that an adviser that consents to the use of its name on fundraising literature for a candidate would be deemed to be soliciting contributions for that candidate and that an adviser that sponsors a meeting or conference that features a government official as an attendee or guest speaker and which involves fundraising for such official would be deemed to be soliciting contributions for that government official.

Advisers and their covered associates are also prohibited from coordinating or soliciting any person or PAC to make any contribution to an official of a government entity or any payment to a political party where the adviser is providing or seeking to provide investment advisory services to a government entity. According to the SEC, this provision seeks to eliminate 'bundling' practices (whereby a person acting on behalf of the adviser collects small contributions from several employees of the adviser to create one large contribution) and 'gatekeeper' practices (whereby an intermediary, such as a pension consultant, collects and distributes political contributions in such a way that advisers not meeting a minimum aggregate contribution are eliminated from consideration for advisory contracts and the contributions are obscured so as to minimize public disclosure).

The SEC has also stated that the restrictions on solicitation and coordination activities under the second prong of the rule only relate to 'fundraising activities' and would not prevent advisers and their covered associates from expressing support for candidates in other ways, such as volunteering their time. Nonetheless, the prohibition on solicitation/coordinating contributions and payments does not have a minimum threshold. In other words, a covered associate that coordinates contributions of as little as $1 to a local political party in a jurisdiction where the adviser manages government assets or is seeking to do so would trigger the rule.

Whether a particular activity involves a solicitation or coordination of a contribution or payment for purposes of the rule will depend on the particular facts and circumstances

and the limited guidance made available by the SEC in the rule's releases is somewhat hard to follow. Finally, there is no scienter (that is, 'state of mind' or 'intent') requirement under the solicitation/contribution prong of the rule, so even if a covered associate has no intent of influencing the award of an advisory contract by, for example, hosting events at his or her home, if the adviser is providing or seeking to provide advisory services to a government entity in the jurisdiction, the rule could be triggered. Importantly, violations of the second prong of the rule do not result in two-year timeouts but would instead likely result in SEC enforcement actions.

Prong 3: The catch-all

Finally, the rule specifically includes a blanket prohibition restricting all advisers and their covered associates from doing 'anything indirectly which, if done directly' would violate the rule. This extra layer of prevention signals the SEC's heightened concern about indirect payments and puts advisers on notice that the SEC will not tolerate attempts to 'game' the rule.

There is a scienter requirement under this prong of the rule, which requires a showing of intent to circumvent the rule in order for such persons to trigger the time out. In prohibiting an adviser from doing anything indirectly that it would not be allowed to do directly, the rule references Section 206(4) of the Advisers Act, which gives the SEC the authority to 'prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive or manipulative.' The importance of this catch-all provision might be demonstrated by the SEC's justification for it under two different statutory provisions: Section 206(4) prohibits fraudulent, deceptive, or manipulative acts, practices and courses of business and Section 208(d) makes it a violation of the Advisers Act to indirectly do an act that would be prohibited if done directly.

Recordkeeping requirements of the rule

Coupled with the Rule are amendments to the general books and records rule (Rule 204-2 under the Advisers Act), which impose additional recordkeeping obligations on advisers that provide investment advisory services to a government entity or a covered investment pool (such as a private equity fund) in which a government entity is an investor. Such advisers must collect and maintain:

- The names, titles and business and residence addresses of all covered associates of the adviser.
- All government entities to which the adviser provides or has provided investment advisory services (directly or indirectly through a covered investment pool) in the past five years.
- All direct and indirect contributions made by the adviser or its covered associates to an official of a government entity or direct or indirect payments made to a political party or PAC.
- The name and business address of each regulated person to which the adviser agrees to provide direct or indirect payment to solicit a government entity.

As of March 14, 2011, advisers subject to the rule (with one exception) were required to begin keeping records of all government entities to which they provide or have provided

advisory services. The one exception is for advisers to registered investment companies that are covered investment pools under the Rule.

Because many of these shareholders hold their interests though an omnibus account held at a broker-dealer or bank, these recordkeeping requirements were particularly burdensome for covered investment pools, which includes registered investment companies that are investment options in participant-directed government plans or programs and private funds (regardless of their status as investment options in such plans or programs). Heightening the difficulty from the funds' perspective was the issue that omnibus accountholders receiving requests from funds for shareholder information to comply with Rule 204-2 have no legal obligation to provide such information. For example, FINRA issued a rather simplistic regulatory notice that essentially asked broker-dealer members to 'play nice' when asked for information from funds, but imposed no requirement on members.

As a result, the SEC staff issued no-action relief to the Investment Company Institute (ICI) on September 12, 2011 that permits advisers to registered investment companies to keep an alternative set of records to that specifically required by Rule 204-2. The alternative record set would include a list of each government entity:

- Investor in the fund that can be reasonably identified as being held in the name of or for the benefit of the government entity on the records of the fund or its transfer agent.
- The account of which (at its initial investment) was identified to the adviser, its covered associates, regulated persons or 'client servicing employees' as that of a government entity.
- That sponsors or establishes a 529 plan and has selected the fund as an option offered by the plan.
- That has been solicited to invest in a fund either (i) by a covered associate or regulated person of the adviser, or (ii) by an intermediary or affiliated of the fund if a covered associate, regulated person or client servicing employee of the adviser 'participated in or was involved in such solicitation.'

As a result of the fourth item in the alternative record set, registered investment company advisers choosing to rely on the staff's no-action relief will have to create a system to track the solicitation activities of its covered associates and regulated persons with respect to government entities, including through intermediaries. Advisers will also have to be able to be notified when government entity accounts are opened or identified. According to the ICI, the staff indicated that advisers will have a reasonable period of time to implement these system changes.

Importantly, covered investment pools that would be investment companies under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the 1940 Act – which includes most private equity funds – were expressly carved out of the staff's no-action relief.

State laws and regulations

Alongside the evolution of the SEC's pay-to-play rule, state and municipal statutes and regulations were enacted, some of which govern similar pay-to-play practices and others that potentially impose lobbyist registration requirements on advisers or their employees.

This regulatory framework is separate and apart from that of the SEC's Rule. In fact, in its March 2011 guidance, the SEC staff noted that the rule does not preempt state and local laws regarding campaign contributions and pay-to-play activities. Therefore, private equity advisers' compliance policies and procedures should be designed to comply with the laws, rules and regulations regarding campaign contributions, lobbying and placement agent activity and registration and other pay-to-play requirements in each jurisdiction in which the adviser is registered with a securities regulatory authority or conducts or is seeking to conduct business. Although many jurisdictions have an exception from lobbying and placement agent requirements for participation in a competitive bidding process, some jurisdictions do not. Others are unclear. Further, although the rule is equivalent to or more restrictive than many state or local pay-to-play requirements, certain jurisdictions impose restrictions greater than those in the rule. Advisers should also note that other state and local laws, such as privacy laws, laws limiting employer restrictions on political activity, antidiscrimination laws, and at-will employment laws (and exceptions thereto) may also apply to their activities.

The state and municipal regulatory framework in the area is a tangled web with many proposed restrictions and others that have been enacted and are in judicial limbo after being partially struck down by state courts for state constitution violations. Although it is impossible to succinctly address the plethora of existing regulations, a summary of the New York and California frameworks is set forth below. It is also worth noting that due to changes implemented under Section 926 of the Dodd-Frank Act, violations of such state or municipal regulations that result in misdemeanor convictions could preclude an adviser from participating in Rule 506 offerings under Regulation D of the 1933 Act. Such violations would also likely have to be reported on an adviser's Form ADV.

New York

New York City has long included a lobbying law within its City Administrative Code, but it was not until recently that its application to investment adviser firms was overtly contemplated. In a March 31, 2010 advisory opinion to the New York City Clerk, the City of New York Law Department's Corporation Counsel concluded that placement agents and fund advisers that solicit the City's five pension systems were 'lobbyists' under the city's code. However, it was not until December 29, 2010 that this opinion was publicized by the City Clerk.

In general, placement agents, advisers and their personnel who attempt to influence New York City pension plans' investment decisions are required to register as lobbyists if their annual compensation for such activities exceeds $2,000. On registration, such lobbyists are then subject to frequent reporting requirements (bi-monthly), are required to maintain records and fulfill continuing education requirements, and are also unable to accept contingent compensation, which would effectively prohibit traditional solicitation arrangements. Lobbyists are also prohibited from making political contributions to certain New York City officials beyond *de minimis* thresholds.

Certain advisory personnel are permitted to communicate with non-elected officials without triggering the lobbyist registration requirements if their activities and communications are part of the regular course of procuring or developing a contract (that is, a request for proposal (RFP) process), but the availability of this exception is unclear and would not extend to the advisory firm itself. To date, the City Clerk's office has not provided any additional clarity on this, or any other, issues surrounding the application of the lobbyists registration requirements to investment advisers.

Of particular importance to private equity fund sponsors, the New York City Comptroller's Office prohibits such sponsors from using placement agents to secure investments from New York City retirement plans. Fund sponsors must also maintain records of, and disclose to the City Comptroller's Office, all contacts with employees of the City Comptroller's Office and all individuals involved in the investment decision processes of New York City plans.

California

California state laws were amended by California Assembly Bill No. 1743, effective January 1, 2011, such that a person acting as a 'placement agent' in connection with any investment made by a state public retirement plan (such as the California State Public Employees' Retirement System (CalPERS) or the California State Teachers' Retirement System (CalSTRS)) would violate California state law if such person failed to register as a lobbyist with the California Fair Political Practices Commission. Furthermore, the changes to state law mandated that a person acting as a placement agent in connection with any local public retirement plan would violate California state law (in additional to applicable local law) if such person failed to file any applicable reports or register under any applicable lobbyist registration requirement as required by the applicable municipal laws and regulations. The new laws also prohibited placement agents from accepting contingent fees for investments by state public pension systems.

Under California law, placement agent was defined to include persons hired, engaged or retained by, or serving for the benefit of, an 'external manager' who acts for compensation as an intermediary in connection with the offer or sale of the services of an external manager to a public retirement system board or an investment vehicle. The law further defined external manager to include persons retained (or seeking to be retained) by a board to manage a portfolio of securities or assets for compensation or who is engaged in the business of investing, reinvesting, owning, holding or trading securities or other assets or offers or sells securities to a board. Under these definitions, private equity fund advisers, their employees and the private equity funds themselves are all subject to the California law. However, employees who spend at least one-third of their time managing assets or securities are carved out of the definition. Also carved out are employees of external managers who were SEC-registered, selected through a competitive bidding process (that is, RFP), providing services pursuant to an executed contract and subject to a fiduciary standard of care. This second exception, as originally enacted, however, was only available in connection with state pension plan activities.

Absent the availability of these exemptions, placement agents (and therefore external managers) are subject to lobbyist registration and reporting requirements with the California Fair Political Practices Commission, prohibited from making gifts in excess of $10 per month to officials of government agencies in the jurisdiction, required to undergo continuing education requirements and subject to other requirements.

Under California Assembly Bill No. 1743, advisers seeking to do business with local pension systems in California were faced with navigating the particular regulations of each local jurisdiction. The local regulations vary in their scope and definitions. Many municipalities have no lobbyist regulation at all whereas others, particularly larger municipalities like San Francisco, Oakland, San Diego and San Jose, have more robust requirements, which are often set forth in on the local ethics commission website.

On October 9, 2011, however, several amendments to the California law were enacted when Senate Bill No. 398 was signed into law. Effective immediately, the amendments clarified that routine brokerage activities in connection with a pension system's investments did not classify an entity as an external manager or placement agent, but also added a definition of 'investment funds' to make it clear that solicitation of sales of investment fund shares managed by external managers would subject a person to lobbyist registration requirements, absent a definitional exception. Senate Bill No. 398 also clarified that the 'competitive bidding' exception was not limited to those entities selected (past tense) through a competitive bidding process, but also to those entities participating in such a process (present tense). However, communications occurring before the competitive bidding process begins would not be covered and may subject a person to registration if such communications rise to the level of solicitation. Finally, Senate Bill No. 398 expanded the availability of the 'competitive bidding process' exception from state-only pension systems to local pension systems, thus making any local requirements inapplicable for persons who otherwise meet the requirements of the exception. Nonetheless, because of the variety and nuances of local laws, private equity advisers seeking business from local pension plans in California should proceed cautiously.

Practice tips

The laws surrounding political contributions and lobbyists registration are multi-tiered and difficult to navigate. Certain practices that have become common in the private equity industry could now lead to violations of the rule or other state or local regulations, such as interaction with representatives of a government pension plan during a due diligence meeting or hosting an annual investors meeting at which attendees are provided with food or gifts. Private equity firms should ensure that business representatives are well trained in advance of any due diligence meetings with current or prospectus government entity clients. If not prohibitively expensive, compliance and/or legal personnel should also be present at such meetings. When compliance and/or legal personnel cannot attend, business representatives should later provide them with a debriefing of any issues that arose during the meeting. Business representatives should not communicate with representatives of the government client or prospective client outside of the meeting. In general, due diligence meetings that are conducted strictly as a matter of course and in connection with an RFP, a contract that is in the process of being negotiated or an ongoing contract should not trigger concerns. Firms should not provide indirect benefits to government client representatives disguised as components of the diligence meeting, such as travel expenses to an offsite location where the meeting is held. With respect to annual investor meetings, firms with known government entity clients should not provide lavish gifts and should treat all investors in attendance equally. When it comes to compliance with the federal pay-to-play rule and similar state and local regulations, it is wise to employ common sense and good faith.

Another issue facing firms is how to design their procedures for investigating and reviewing political contributions to PACs or state and local political parties. This is also a concern for the politicians because candidates and parties do not want to lose vital campaign contribution revenue due to fears of violating pay-to-play rules. As a result, many state, federal and local political parties have altered their contribution forms so contributors can direct their donations to a general fund and not toward a particular candidate. Some PACs and political parties are beginning to provide certifications to such effect to contributing persons. Private equity firms may want to consider building into their compliance policies and procedures that their employees undertake a reasonable

investigation before making any such contribution and/or obtain such certification from the PAC or political party. From a practical perspective, firms will generally know in what states and municipalities they are managing government assets (or seeking to), so firms may want to provide periodic notices to employees in those jurisdictions that remind and reeducate them of the firm's policies and procedures, particularly during election season.

Private equity funds must, at a minimum, implement changes to their compliance policies and procedures that account for the various requirements under the SEC's pay-to-play rule, including the recordkeeping provisions under Rule 204-2. In order to avoid inadvertent violations of the rule, advisers may want to consider broadening the scope of their compliance programs beyond the narrow constraints of the rule, but advisers should be aware that more restrictive policies may not make available a federal preemption defense against certain claims brought under state law. Advisers must also carefully navigate state and local pay-to-play rules and lobbyist registration requirements. Many state and local jurisdictions have useful websites that disclose relevant regulations, and representatives of prospective government clients could be contacted (preferably on a no-names basis) to inquire whether any local rules or regulations apply to solicitation of government business.

Private equity fund advisers may also want to consider:

- Imposing pre-clearance requirements on all political contributions by all employees (including soliciting employees) so that the adviser is able to assess whether they would trigger compliance with the rule. In this regard, it would also be advisable to identify covered associates and make sure such persons are aware of their status.
- Reviewing and amending existing third-party solicitation and placement agent agreements for compliance with the rule.
- Engaging intermediaries to assist the adviser in identifying government entities invested in its existing funds.
- Adopting new pre-hire and termination procedures designed to ensure that political contribution activities by new or departing employees do not trigger a time out under the rule.
- Adopting new policies and procedures to govern compliance with the rule and providing training programs to educate employees about the new requirements.
- Developing a surveillance process for political contribution activities by employees, possibly including checking names of associated persons, including employees, that the adviser has identified as 'covered associates' against public databases of political contributions.
- How the adviser would approach a time-out, including possible escrow arrangements for fees (assuming an adviser seeks SEC exemptive relief) and contractual provisions obligating governmental entity clients to hire a successor adviser on a prompt basis.
- Requiring quarterly certification from employees that they have complied with the firm's pre-clearance requirements as a preventive measure to make available the application for an exemption.

- Periodically and particularly during an election cycle sending a reminder memorandum to employees about the firm's political contribution approval and certification procedures.
- Disbanding any PAC that they control or forego pitching business to any candidate getting money from the PAC. Advisers should also collect information from employees as to whether they or an immediate family member are an officer or board member of any PAC.

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