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KIRKLANDPEN
Private Equity Newsletter

July 7, 2010

SEC Adopts Rule Prohibiting "Pay to Play" for Investment Advisers, their Principals and Employees, Including Private Fund Managers

PENpoints

On June 30, 2010, the SEC adopted a rule prohibiting "pay-to-play" practices for virtually all SEC-registered and unregistered investment advisers and many of their employees.

On June 30, 2010, the SEC adopted a rule designed to proscribe "pay-to-play" practices by investment advisers (covering virtually all investment advisers, whether or not registered under the Investment Advisers Act—the "IAA") and many of their employees (called "covered associates").[1]

In summary, the rule prohibits:

(1) A private fund's investment adviser from receiving compensation (e.g., management fees or carried interest) from a state or local government agency[2] investment plan or program (e.g., a government employees retirement plan or apparently some state university endowment funds) (referred to herein as a "government plan") for two years after the fund or a covered associate has made a political contribution to a state or local government official or candidate (referred to herein as "an influential government official or candidate") who could influence the government plan to invest in the private fund.

(2) A private fund's investment adviser and its covered associates from soliciting a political contribution to such an influential government official or candidate or to a political party of a state or locality where the investment adviser provides (or seeks to provide) advisory services to a government plan.

(3) A private fund's investment adviser and its covered associates from paying a third-party placement agent or other solicitor to solicit a government plan to invest in the private fund, unless such third party is an SEC-registered broker-dealer or investment adviser subject to comparable "pay-to-play" restrictions.

The restrictions in rules (1) and (2) are effective in March 2011 (i.e., cover a political contribution or solicitation beginning in March 2011) and the restriction in rule (3) is effective in September 2011 (i.e., covers a payment to a third-party placement agent beginning in September 2011).[3]

Private fund advisers should implement policies and procedures to ensure that these new pay-to-play restrictions are followed.

New Rule

In more detail, the new rule contains three prohibitions applicable to an (SEC-registered or unregistered) investment adviser (including a private equity fund's or other private fund's general partner ("GP")/management entities and their covered associates):

(1) Making political contributions. They are prohibited, beginning March 2011, from receiving compensation (such as carried interest or management fees) from a government plan that is a limited partner ("LP") of the private fund for a period of two years after a prohibited contribution (broadly defined to include anything of value) to an influential government official or candidate.[4]

- An influential government official (to whom a contribution is proscribed) is a state or local officeholder, candidate or election winner if the officeholder (a) is directly or indirectly responsible for, or could influence a government plan's hiring of an investment adviser, including selecting a private fund in which to invest, or (b) has

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authority to appoint a person described in (a).

- The prohibition applies to the private fund's GP/management entities and its "covered associates," defined as:
  - The GP/management entity's (a) general partners or managing members, (b) president, (c) vice president in charge of a principal business unit, division or function, (d) any other officer performing a policy-making function, and (e) any other person performing similar policy-making functions as the persons described in (b) through (d).
  - An employee soliciting a governmental plan for the adviser and his or her supervisors.
  - A political action committee controlled by the investment adviser and/or persons listed in the above two bullet points.

This compensation forfeiture continues to apply for two years after the proscribed political contribution, even if the covered associate who made the contribution (a) was thereafter fired or otherwise ceased to be employed by the investment adviser or (b) made such contribution within six months before becoming a covered associate (two years for a covered associate who solicits clients for the investment adviser). Thus, before hiring or promoting anyone who could become a covered associate, an investment adviser must review all of his or her political contributions during the prior six months (or two years).[5]

(2) Coordinating or soliciting political contributions. They are prohibited, beginning March 2011, from soliciting a contribution (or coordinating the solicitation of contributions) to an influential government official or candidate described in rule (1) above or to a political party of a state or locality where the investment adviser is providing or seeking to provide advisory services to a government plan.[6]

(3) Restriction on using placement agents. They are prohibited, beginning September 2011, from paying a third-party placement agent, solicitor, finder or similar third party to solicit a government plan, unless such third party is an SEC-registered broker-dealer or investment adviser subject to comparable "pay to play" rules.[7]

The rule also prohibits an investment adviser and its covered associates from doing anything indirectly that would violate the rule if done directly.

Prohibition on Compensation, Not Contribution

The SEC release makes clear that rule (1) above does not prohibit political contributions (attempting to blunt a constitutional free-speech argument against the rule's validity), but rather the rule prohibits the private fund's adviser from receiving compensation from the government plan (i.e., such compensation must be waived or rebated to the government plan) for a two-year period after the proscribed political contribution is made.[8]

SEC Penalties

Violation of either the no-solicitation-of-political-contributions rule or the no-third-party-placement-agent rule (rules (2) and (3) above) by an investment adviser or its covered associate would not result in compensation forfeiture, but could result in administrative action including penalties and adverse disclosures.

In addition to the two-year compensation forfeiture, a violation of rule (1) might also result in administrative action including penalties and adverse disclosure, particularly if the violation is intentional or repeated.

Rule Covers Both SEC-Registered Advisers and Advisers Exempt Under Fewer-Than-Fifteen Client Exemption

The new rule applies to an SEC-registered investment adviser as well as an investment adviser currently exempt from IAA registration under the fewer-than-fifteen-client exemption.[9]

An SEC-registered investment adviser must also adopt compliance policies and procedures to meet the requirements of the new rule and keep records necessary to demonstrate to SEC examination staff its compliance with the rule.

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1 SEC IAA Rule 206(4)-5.

2 The rule applies to state and local government plans and officials, but does not apply to U.S. government plans or officials because no federal plan (e.g., Social Security) invests in assets other than U.S. Treasury debt. Nor does the rule apply to foreign government plans although many foreign government plans do invest in private funds.

3 The specific dates in March 2011 and September 2011 will be set on publication of the final rule in the Federal Register.

4 The compensation forfeiture described in rule (1) applies whether the government plan LP directly pays carried interest and management fees to the GP/management entity or the private fund pays such amounts to the GP/management entity with LPs bearing the cost either through a reduction in distributions or through capital calls.

5 There are several *de minimis* exceptions for contributions by a covered associate: (a) a contribution to a candidate of $350 or less per election if the contributor is entitled to vote in that election or $150 or less per election if the contributor is not entitled to vote in that election, and (b) subject to certain restrictions, a contribution of $350 or less per candidate if the contributor is not entitled to vote in the election but the violation was inadvertent and the contribution is promptly refunded. The SEC may waive compensation forfeiture on a case-by-case basis.

6 SEC's release states that rule (1)—prohibiting a contribution of anything of value—"imposes no restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches and other conduct," subsequently states that "a donation of time by an individual [is not] … a contribution, provided the adviser has not solicited the individual's efforts and adviser's resources, such as office space and telephones, are not used," and then states that "volunteering … during non-work hours, if the covered associates were using vacation time, or if the adviser is not otherwise paying the employee's salary (e.g., an unpaid leave of absence)" is not prohibited.

However, SEC's release does not discuss whether such activities may violate rule (2) prohibiting the fund or its covered associates from "soliciting" a contribution. Hence caution in this regard is advisable.

7 FINRA plans to propose such rules for registered broker-dealer placement agents in the near-term.

8 A hedge fund adviser would be required to waive fees and performance allocations, or alternatively to redeem the governmental plan.

9 However, the rule does not apply to most small advisers registered with state securities authorities (rather than with the SEC) or to advisers not SEC-registered in reliance on exemptions other than the fewer-than-15 client exemption, because the SEC believes few of these firms manage public pension plans or other public funds.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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Health Reform Law Significantly Increases Risk of Protracted Fraud and False Claims Act Investigations in the Health Care Industry

While the media coverage of the recent health care reform act largely focused on its impact on the insurance industry, the act includes provisions relating to healthcare fraud, abuse and program integrity. These provisions make significant amendments to existing criminal, civil and administrative anti-fraud statutes, including to the Anti-Kickback Statute and the False Claims Act. These amendments significantly increase companies' potential legal exposure under each statute and the risk of protracted fraud investigations or litigation. To learn more about these changes, please see our recent *Kirkland Alert*.

PENnotes

Kirkland & Ellis Advertising & Trademark Law Seminar
Chicago, Illinois
July 20, 2010

The Kirkland & Ellis Advertising & Trademark Law Seminar will be held on Tuesday, July 20, 2010. The seminar, hosted by Kirkland attorneys Paul R. Garcia, P.C., Ross M. Weisman, P.C., Robin A. McCue and Tom M. Monagan, will be live in Chicago with video-conferencing to Los Angeles and New York. The seminar will include discussions on advertising and trademark law 101, the new rules for endorsements and testimonials, recent developments in private advertising litigation, and preventing (and preparing for) advertising and trademark disputes. For more information, please visit www.kirkland.com.

Kirkland & Ellis, PEI Media and Probitas Partners Panel Discussion on Distressed Debt
New York, New York - July 27, 2010
London, UK - July 29, 2010

Kirkland & Ellis, PEI Media and Probitas Partners will host a panel discussion in Kirkland's New York and London offices on the distressed debt and restructuring markets. Each event will bring together a panel of deal and regulatory professionals, including Kirkland partners David Eaton and Partha Kar, who will discuss current and future trends, opportunities and risks in this market. Topics will include credit-bidding purchased debt in sales of distressed companies, voting problems for investors in loan-to-own situations, and UK pension claims and related cross-border issues. For more information please contact Suzanne Svendsen at suzanne.svendsen@kirkland.com or (312) 862-4427.

Kirkland & Ellis Private Fund Manager Advisers Act Registration Seminars
Chicago, Illinois - September 14, 2010
New York, New York - September 21, 2010
London, UK - September 28, 2010
San Francisco, California - October 5, 2010

Join Kirkland & Ellis at one of our Private Fund Manager Advisers Act Registration Seminars, chaired by partner Scott A. Moehrke, P.C. Panelists at the seminars will focus on how the Private Fund Investment Advisers Registration Act of 2010 will affect private fund managers and the steps private fund sponsors need to take to plan for SEC registration and operate as a registered adviser. The seminars will allow interactive dialogue with our panels and are designed to give practical, hands-on advice for private fund managers. These seminars will take place in Kirkland's Chicago, New York, London and San Francisco offices. For more information please contact Elizabeth Elliott at elizabeth.elliott@kirkland.com or (312) 862-6273.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook," and was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2009 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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