

## SEC Proposes Rule Prohibiting “Pay to Play” for Investment Advisers, Including Private Equity and Other Private Fund Principals

### PENpoints

*A newly proposed rule from the SEC prohibits “pay-to-play” practices for investment advisers and their “covered associates.”*

### Proposed Rule

On August 3, 2009, the SEC published its proposed rule designed to proscribe “pay-to-play” practices for investment advisers (whether or not registered under the Investment Advisers Act—the “IAA”) and their “covered associates.” In summary, the proposed rule would prohibit a private fund’s principals and most of its other employees from (1) making a political contribution to a government official (or candidate) who could influence a governmental agency (e.g., a government employees retirement plan or apparently a state university’s endowment fund) to invest in the private fund; (2) soliciting a political contribution for such a government official (or candidate); or (3) paying a placement agent to solicit a governmental agency to invest in the private fund.

In more detail, the proposed rule contains three prohibitions applicable to an investment adviser (including a private equity fund’s or other private fund’s GP/management entities, their principals and most of their other employees):

- (1) Making political contributions. They would be prohibited from receiving compensation (such as carried interest and management fees) from a state or local governmental agency (including a government employees retirement plan or apparently a state university’s endowment fund) that is a limited partner (an “LP”) of the private fund for two years after the private fund’s GP/management entity, principal or other employee contributed (broadly defined) to a designated government official or candidate.
  - A designated official or candidate (to whom a contribution is proscribed) is an officeholder, candidate or election winner if the office (a) is directly or indirectly responsible for, or could

influence a governmental agency’s hiring of an investment adviser, including selecting a private fund in which to invest or (b) has authority to appoint a person described in (a).

- The prohibition would apply to the private fund’s GP/management entity and to its “covered associates,” broadly defined.<sup>1</sup> Although ambiguous, the covered associates definition could be read as covering all significant employees involved in investment advisory activities or LP relations. Thus, unless the definition is clarified, most of the GP/management entity’s employees would need to be monitored.

This compensation forfeiture would continue to apply for two years after the proscribed political contribution, even if the principal or employee who made the proscribed contribution (a) was fired or otherwise ceased to be employed or (b) made the contribution before becoming an employee, so that, before hiring a new employee, all of his political contributions during the prior two years would need to be reviewed.<sup>2</sup>

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- (2) Soliciting political contributions. They would be prohibited from soliciting a contribution (or coordinating the solicitation of contributions) to a designated official or candidate described in rule (1) above.
- (3) Using placement agent. They would be prohibited from paying a third-party placement agent, solicitor, finder or similar party to solicit a governmental agency described in rule (1) above. This prohibition would clearly be breached if a private fund or its GP/management entity or other covered personnel paid a success fee to a third party (e.g., 1%) based on all money raised for the private fund (including from governmental agencies) and the third party communicated with a governmental agency for the purpose of raising money. The rule could, however, be read as allowing the third party to receive a fee based on all money raised so long as the third party did not communicate with any governmental agency for the purpose of raising money.

The proposed rule also prohibits an adviser from doing anything indirectly that would violate the rule if done directly.

### Prohibition on Compensation

The SEC's release makes clear that political contributions would not be prohibited by rule (1) above, but that the private fund's advisors would be prohibited from receiving compensation from the governmental agency (i.e., such compensation must be waived or

rebuted to the governmental agency) for a two-year period after the proscribed political contribution is made.<sup>3</sup>

Violation of either the no-solicitation-of-political-contributions rule or the no-third-party-placement-agent rule (rules (2) and (3) above) would not result in compensation forfeiture, but would violate SEC's antifraud rule, which could result in administrative action including penalties and adverse disclosures.

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

### Proposed Rule Applies to Both Registered Adviser and Exempt Adviser with Fewer Than Fifteen Clients

The proposed rule would apply to an SEC-registered adviser as well as an adviser exempt from IAA registration under the fewer-than-fifteen-client exemption. A registered adviser would also be subject to additional recordkeeping obligations necessary to demonstrate to SEC examination staff the adviser's compliance with the rule's requirements.

### Comment Period and Timing for Final Rule

The public comment period ends October 6, 2009, and the proposing release suggests that a final rule may be promulgated quickly, possibly in early 2010.

1 The proposed rule defines "covered associate" as:

- The GP/management entity's general partners, managing members and executive officers, with executive officers in turn defined as (a) president, (b) vice president in charge of a principal business function, and (c) any other executive officer performing (or supervising a person performing) investment advisory duties, soliciting (or supervising a person soliciting) advisory clients or investors, or a person with similar status.
- An employee soliciting a governmental agency for the adviser.
- A political action committee of the adviser and/or persons listed in above two bullet points.

2 The compensation forfeiture described in (1) applies whether the governmental agency 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.

There are several *de minimis* exceptions: (a) a contribution of \$250 or less per election if the contributor is entitled to vote in that election, (b) a contribution of \$250 or less per election if the contributor is not entitled to vote in the election but the violation was inadvertent and the contribution is refunded, and (c) a contribution which SEC in its discretion exempts.

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

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

**Jack S. Levin, P.C.**

[www.kirkland.com/jlevin](http://www.kirkland.com/jlevin)

+1 312-862-2004

**Scott A. Moehrke, P.C.**

[www.kirkland.com/smoehrke](http://www.kirkland.com/smoehrke)

+1 312-862-2199

**Nabil Sabki**

[www.kirkland.com/nsabki](http://www.kirkland.com/nsabki)

+1 312-862-2369

**Joshua P. O'Donnell**

[www.kirkland.com/jodonnell](http://www.kirkland.com/jodonnell)

+1 312-862-2159

## Executive Compensation Rules for TARP Recipients

On June 15, 2009, the U.S. Department of the Treasury's recent guidance on the standards for compensation and corporate governance for companies participating in the government's Troubled Asset Relief Program (TARP) became effective.

Highlights from the Treasury's guidance can be found in our recent [Kirkland Alert](#).

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## Data Security Issues for Portfolio Companies and Private Equity Firms

Three recent developments in data security law underscore the evolving and complicated legal patchwork applicable to businesses (including portfolio companies and private equity firms) that handle personal information about individuals.

To read more on these developments, please view our recent [Kirkland Alert](#).

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## “The Impact of New CFIUS Reform on Foreign Investments,” *Financier Worldwide*

The June 2009 edition of *Financier Worldwide*, a UK-based magazine serving the international financial and legal communities, published this article discussing the impact of U.S. foreign direct investment regulations on the global business environment. Laura Fraedrich, a partner in Kirkland's International Trade practice, contributed to the article, which is available in its entirety [here](#).

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## Recent Developments Impacting the Energy Industry

Two recent developments may impact companies and investors in the energy industry. First, the House of Representatives passed The American Clean Energy and Security Act, which includes measures addressing greenhouse gas reduction, renewable energy production, energy efficiency, transmission investment and upgrades, energy derivatives and market reform, and a nationwide building efficiency code.

An overview of the new Act can be found in our recent [Kirkland Alert](#).

Second, the February 2009 stimulus bill created a cash grant program for qualified renewable energy facilities of up to 30 percent of the tax basis of the property. On July 9, 2009, the U.S. Department of the Treasury released application guidance and related documentation, including a sample application.

To read more on eligibility requirements for the program and application procedures, please read our recent [Kirkland Alert](#).

## PENnotes

**The Fourth Annual Kirkland & Ellis LLP Real Estate Private Equity Forum**  
**New York, New York**  
**September 24, 2009**

This Kirkland seminar will explore creative responses to today's market and its likely effects on the real estate private equity business. Kirkland real estate partners, including Stephen G. Tomlinson, P.C., keynote speaker Sam Zell, chairman of Equity Group Investments LLC, and other guest panelists, representing both the GP and LP communities, will look at issues and opportunities for real estate funds in the current market, focusing on the current real estate private equity model, whether it needs fixing, and what those fixes might be, as well as future opportunities for real estate funds.

**The Practising Law Institute's Mergers and Acquisitions 2009: What You Need to Know Now**  
**Chicago, Illinois**  
**September 24-25, 2009**

This seminar, hosted by the Practising Law Institute, will focus on the continuing effects of uncertainty in the credit and equity markets, the impact of government intervention in financial markets, how contract terms are changing in light of current risks and uncertainties and trends and tactics in hostile bids and takeover battles. Kirkland partner R. Scott Falk, P.C., is a co-chair of this event and will participate in a panel discussion on "The Current M&A Landscape." Partner Marc Kieselstein, P.C., will participate in a panel discussion on "Acquisitions of Distressed Businesses."

***Private Equity International's* Infrastructure Investor Seminar**  
**New York, New York**  
**September 29-30, 2009**

This seminar, hosted by *Private Equity International*, is targeted to infrastructure investors, fund managers, government officials and other stakeholders, and will focus on the growing opportunities in infrastructure, developing viable fund structures and securing capital amidst current financial conditions. Kirkland partner Sean Patrick Maloney, former First Deputy Secretary to the Governor of New York and architect of the Governor's multi-billion dollar proposal to monetize the New York State Lottery and the New York State Commission on State Asset Maximization, will discuss "The Future of PPPs in the U.S." Partner Bruce Gelman will lead a "Fund Terms & Conditions" workshop.

**NYU's 68th Institute on Federal Taxation**  
**New York, New York**  
**October 18-23, 2009**

The NYU Institute on Federal Taxation, presented by New York University's School of Continuing and Professional Studies, addresses all areas of taxation and attracts attorneys, both general tax practitioners and specialists; accountants; corporate treasury and compliance executives; tax managers; and financial planners seeking discussion of the latest technical, legislative, and planning developments. Kirkland partner Todd Maynes will speak on October 20 regarding "Corporate Debt Restructurings."

**The 9th Annual IVCA CFO Summit**  
**Chicago, Illinois**  
**October 22, 2009**

Kirkland is a sponsor of the Illinois Venture Capital Association's annual CFO Summit. Partner Bruce Ettelson will speak.

# Private Equity Practice at Kirkland & Ellis

## Chicago

Kirkland & Ellis LLP  
300 North LaSalle  
Chicago, IL 60654  
+1 (312) 862-2000  
+1 (312) 862-2200 fax

## Hong Kong

Kirkland & Ellis LLP  
26th Floor  
Gloucester Tower  
The Landmark  
15 Queen's Road Central  
Hong Kong  
+852-3761-3300  
+852-3761-3301 fax

## London

Kirkland & Ellis  
International LLP  
30 St Mary Axe  
London, EC3A 8AF  
United Kingdom  
+44 20 7469 2000  
+44 20 7469 2001 fax

## Los Angeles

Kirkland & Ellis LLP  
777 South Figueroa Street  
Los Angeles, CA 90017  
+1 (213) 680-8400  
+1 (213) 680-8500 fax

## Munich

Kirkland & Ellis  
International LLP  
Maximilianstrasse 11  
80539 Munich  
Germany  
+49 89 2030 6000  
+49 89 2030 6100 fax

## New York

Kirkland & Ellis LLP  
601 Lexington Avenue  
New York, NY 10022  
+1 (212) 446-4800  
+1 (212) 446-4900 fax

## Palo Alto

Kirkland & Ellis LLP  
950 Page Mill Road  
Palo Alto, CA 94304  
+1 (650) 859-7000  
+1 (650) 859-7500 fax

## San Francisco

Kirkland & Ellis LLP  
555 California Street  
San Francisco, CA 94104  
+1 (415) 439-1400  
+1 (415) 439-1500 fax

## Washington, D.C.

Kirkland & Ellis LLP  
655 Fifteenth Street, N.W.  
Washington, D.C. 20005  
+1 (202) 879-5000  
+1 (202) 879-5200 fax

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 worldwide.

Kirkland has been widely recognized for its preeminent private equity practice. In 2009, Kirkland received the awards for Best Law Firm (Private Equity Deals) and Best Law Firm (Fund Formation) in North America from *Private Equity International*. Mergermarket has ranked Kirkland first by volume for Global and North American Buyouts in its "Global M&A Round-up for Year End 2008," and Pitchbook named Kirkland the most active law firm representing private equity firms in its "Private Equity Breakdown" for Q2 2009.

For the second year in a row, *The Lawyer* magazine recently recognized Kirkland as one of the "The Transatlantic Elite," 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." In addition, Kirkland's London office was recently named the 2008 "Banking Team of the Year" at the Dow Jones Private Equity News Awards for Excellence in Advisory Services.

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To subscribe to *KirklandPEN*, please e-mail [kirklandpen@kirkland.com](mailto:kirklandpen@kirkland.com).

### EDITORS

**Jack S. Levin, P.C.**

[www.kirkland.com/jlevin](http://www.kirkland.com/jlevin)

+1 (312) 862-2004

**Margaret A. Gibson, P.C.**

[www.kirkland.com/mgibson](http://www.kirkland.com/mgibson)

+1 (312) 862-2223

**Norbert B. Knapke II**

[www.kirkland.com/nknapke](http://www.kirkland.com/nknapke)

+1 (312) 862-3350

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