THOMPSON COBURN LLP

Investment Adviser Newsletter

October 2009

November 2009 Deadline for Amending Form U4

The SEC recently approved amendments to Form U-4. The amendments, among other things, make significant changes to disclosure questions on the Form, including the addition of questions about certain regulatory actions. Even if they have not experienced any regulatory actions, advisers must amend the Forms U-4 for each of their representatives to answer these new regulatory action disclosure questions. The amendments must be completed through the Web CRD system no later than November 14, 2009.

SEC, State of New York Target "Pay to Play" Practices.

The Securities and Exchange Commission ("SEC") recently proposed a new Rule 206(4)-5 (the "Rule") under the Investment Advisers Act of 1940. The Rule is designed to curtail what is commonly referred to as "pay to play" practices by investment advisers hired to manage state and local government funds, including retirement and pension plans and investment accounts of government programs. In a pay to play arrangement, investment advisers make political contributions or payments to elected officials who are responsible for the appointment of the trustees that ultimately select the investment advisers. SEC Chairman Mary Schapiro has observed that "fairness can be undermined" where contributions can influence the advisory selection process, where officials or candidate request contributions, or where officials suggest to advisers that appointments are limited to those who make such contributions.

The proposed pay to play measures are designed to ensure that the selection of investment advisers for government clients is based on merit and the best interests of the plans and their beneficiaries. The proposed Rule covers all SEC-registered investment advisers that provide advisory services to state and local government programs, including public pension plans that pay retirement benefits to government employees, retirement plans for teachers and other government employees, and 529 plans that allow families to invest money for college. The proposed Rule also applies to an adviser's "covered associates" – its general partner, managing member, executive officers, any employee with a similar status or function, any employee soliciting government entities on behalf of the client, and any political action committee controlled by the adviser or a covered associate. The proposed Rule addresses four primary areas with respect to contributions made by such advisers and their covered associates:

Political Contribution Restrictions – The proposed Rule would prohibit an adviser from receiving compensation for providing advisory services to a governmental entity, either directly or through a fund, for a two-year period from the date the adviser, or its covered associate, makes a political contribution to any official, whether an incumbent or a candidate, that is capable of influencing the adviser's selection. The two-year prohibition would continue to apply to an adviser after the covered associate responsible for making a contribution leaves the adviser and will apply to any adviser that a contributor joins as a covered associate. The proposed Rule provides for two exceptions from the prohibition. First, a *de minimis* exclusion is provided for contributions of $250 or less, for each election and each candidate for whom an individual is entitled to vote. Second, a limited exception is allowed for contributions by covered associates to candidates for which they are not entitled to vote, provided that the contribution is identified within four months of the contribution date and returned by the official within 60 days of being identified. The second exception may not be claimed more than once for any covered associate and no more than twice in any given year.

Interestingly, after making a restricted contribution, advisers are not prohibited from providing advisory services to government entities, merely from receiving compensation for such services. In fact, the adviser may be required to continue providing advisory services to such government clients without compensation for a reasonable period until the government entity can engage a replacement adviser.

Ban on the Solicitation or Coordination of Contributions – An adviser and its covered associates would be barred from coordinating or soliciting contributions to elected officials and candidates that are capable of influencing their selection as adviser to a government client. The proposed Rule would also prohibit payments to any political party of the state or locality where the adviser is seeking to provide advisory services to the government and advisers would be barred from soliciting another person or political action committee to do the same.

Ban on Third-Party Solicitations – The proposed Rule would prohibit payments to unrelated third parties, such as solicitors, finders, and pension consultants, for the purpose of soliciting government clients on the adviser's behalf.

Restrict Indirect Contributions and Solicitations – An adviser would be restricted from doing indirectly any activity that would violate the Rule if done directly. These activities would include the use of third parties such as spouses, lawyers or companies affiliated with the adviser, to direct or fund contributions.

Although the prohibitions of the proposed Rule apply to advisers managing assets of a government entity in an investment pool, the two-year compensation prohibition also would apply to advisers managing a publicly offered, registered investment company if the investment company fund is an option for participants in a government plan or program. The two-year compensation prohibition does not apply to an adviser merely because a government plan or program is a shareholder in an investment company managed by that adviser.

In addition to proposed SEC Rule 206(4)-5, New York State Comptroller Thomas P. DiNapoli recently signed an executive order banning investment advisers from contributing to the political campaigns of an incumbent state comptroller (or a candidate therefor), which acts as the sole trustee of the state's Common Retirement Fund (the "CRF"). The New York state rules will be in effect from October 7 until the SEC makes final its own rule and, subject to certain exceptions, will prohibit the CRF from engaging, hiring, or investing with any outside investment adviser within two years of the adviser (or certain associate individuals) making a political contribution to a state comptroller incumbent or candidate. Contribution is defined as "any gift, subscription, loan, advance, deposit of money or anything of value." The New York rules also prohibit the CRF from dealing with an individual who coordinated or solicited any such contribution and provides or seeks to provide services to the CRF. Advisers to the CRF will be required to submit a "Political Contribution Representation" as set forth in the rules, the full text of which may be viewed here: http://www.osc.state.ny.us/reform/politicalcontribution.pdf

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Registration of Private Fund Advisers Proposed

The SEC and Congress have been increasingly concerned with the lack of regulation of private funds, including hedge funds, private equity funds and venture capital funds, and their advisers. The SEC has noted reports that hedge funds constitute only about 5% of assets under management in the U.S., but account for more than 85% of the distressed debt market, more than 80% of certain derivatives markets, and about 30% of U.S. equity markets. Additionally, hedge funds act as counterparties with respect to many over-the-counter derivatives and financing transactions. The SEC's concern is that hedge funds have a significant market impact without a corresponding appropriate level of transparency.

Currently, private funds operate under exemptions from registration under the Investment Company Act of 1940. However, Congress seems determined to regulate such advisers and/or the funds they manage. Specifically, Congress has entertained at least three proposals this year with respect to registration of advisers to private funds or the funds themselves. The progress of these three bills will likely give way to the most recent registration proposal introduced by the current Administration in July - the **Private Fund Investment Advisers Registration Act of 2009** (the "Proposal"). If passed, the Proposal would require investment advisers, but not the private fund, to register with the SEC if the adviser:

1. advises any investment fund that is exempt from registration under either Section 3(c)1 or Section 3(c)7 of the 1940 Act; *and either*
2. is organized or otherwise created under federal or state law; or
3. has 10% or more of its outstanding securities owned by U.S. persons.

The Proposal eliminates the exemptions from registration under the Adviser's Act for private advisers under Section 203(b)3 and for certain commodity traders registered with the Commodity Futures Trading Commission, but creates a more limited exemption for foreign private advisers. Foreign private advisers are defined as advisers that fall under the current Section 203(b)3 exemption, have no U.S. place of business, do not hold themselves out as an adviser in the U.S., and have assets under management of less than

$25 million attributable to U.S. clients during the prior 12 months.

Advisers required to register under the Proposal would be subject to increased recordkeeping, disclosure and reporting requirements. The Proposal would permit the SEC to prescribe the records to be kept by such advisers, to examine the books and records of advisers registered under the Proposal, and to regulate disclosures made to private fund investors, counterparties and creditors. Additionally, for each private fund managed by such advisers, an adviser would be required to disclose to the SEC on a confidential basis the fund's assets under management, its use of leverage, counterparty credit risk exposures, trading and investment positions, and trading practices.

The SEC would have the authority to provide the disclosed information to the Board of Governors of the Federal Reserve System and the Financial Services Oversight Council for the purpose of assessing the systemic risk of a private fund or assessing whether a private fund should be designated a Tier 1 financial holding company. A Tier 1 financial holding company is any company whose material financial distress could threaten the economy or financial stability of the country. Under proposed legislation, Tier 1 financial holding companies would be subject to additional disclosure requirements, as well as higher capital and liquidity requirements.

Information about our attorneys

Our Investment and Financial Services Group represents various financial services companies, including investment advisers, financial planners, broker/dealers, and registered investment companies with respect to federal and state regulations, FINRA and SEC registration, compliance and enforcement issues. We also represent investment advisers and institutional investors in connection with investments in private equity, venture capital, real estate and hedge funds.

If you have any questions related to the topics in this newsletter, or, would like to receive previous issues of our Investment Adviser Newsletter, please contact the Investment and Financial Services Group.

Amanda E. White	314-552-6124
Dee Anne Sjögren	314-552-6295
Gregory A. Patterson	314-552-6219
Edward J. Buchholz	314-552-6377

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