

NAIC
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& Convention
2011



The Regulatory Landscape for Private Equity

Moderator:

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Panelists:

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Pay to Play – Rule 206(4)-5 of ‘40 Act

- Enacted in response to perceived misconduct – *i.e.* investment advisers’ “buying” the business of public pension funds by making political or other contributions to public officials who could influence where their business was directed – prosecutions in New York and Connecticut

The Rule: Four Prohibitions

1. An Adviser **cannot be compensated** by a Government Entity for advisory services within two years (the “time-out” period) after it or a Covered Associate makes a contribution to an Official of a Government Entity.

NOTE: “compensation” not services

2. An Adviser or Covered Associate **cannot pay** someone to solicit a Government Entity unless the person is a “Regulated Person” or an executive or employee of the adviser.

3. An Adviser or Covered Associate **cannot coordinate** (or solicit a person or PAC to make):
- Contributions to an Official of a Government Entity; or
 - Payments to a state or local political party, when the Adviser is providing or seeking to provide advisory services.

4. An Adviser and Covered Associate **cannot** do anything indirectly that, if done directly, would violate the Rule.

Definitions

Adviser:

- SEC registered
- Unregistered if relying on exemptions for venture capital advisers, private fund advisers and foreign private advisers.

Definitions

Covered Associate:

- General Partner of LP
- Managing Member of LLC
- Executive Officer or persons in “similar” role
- Soliciting Employee
- Supervisor of Soliciting Employee
- Controlled PAC

i.e. those incentivized to increase business

Definitions

Executive Officer:

- President
- VP in charge of principal business unit, division or function
- Someone with policy-making function

Definitions

Official:

- Incumbent, candidate or successful candidate who:
 - is responsible for or can influence the hiring of investment advisers; or
 - has the authority to appoint a person who is responsible for or can influence the outcome of hiring advisers.

Definitions

Government Entity:

- State or political subdivision
- Agency or instrumentality of a state or political subdivision
- Pool of assets, plan or program sponsored by a state or political subdivision (including participant-directed – 403(b), 457, 529)
- Officers, agents and employees

Definitions

Contribution:

- Anything of value
- Made for the purpose of:
 - influencing an election
 - paying election debts or expenses
 - paying transition or inaugural costs

Definitions

Regulated Person:

- Registered investment adviser
- Registered broker-dealer

Exceptions

\$350 – Natural person Covered Associates can contribute \$350 per Official, per election, to Official they can vote for

\$150 – Covered Associates can contribute \$150 per Official, per election, to Official they cannot vote for

Exceptions

New Covered Associate – new Covered Associates (by hiring or promotion) who will not solicit clients are subject to only 6-month “look-back.”

Exceptions

Corrected Contribution – if prohibited contribution of no more than \$350 is made, mistake discovered within 4 months, funds re-allocated within 60 days of discovery; 2-year time-out lifted

Adviser can only rely on exception 3 times per year (2 if less than 50 employees) and each Covered Associate only gets 1 opportunity.

Violation Sanctions

Regulatory sanctions

- Cease and desist orders
- Penalties
- Waiver of compensation and rebate of past compensation
- Industry bars

Reputational

Considerations in Designing Compliance Policy

1. How to monitor contributions:
 - Ban them all
 - Require pre-clearance of all
 - Require pre-clearance of all beyond *de minimus* amount
 - Require pre-clearance of certain employees' contributions, *i.e.* Covered Associates and their supervisors

Considerations in Designing Compliance Policy

2. Require periodic certifications from employees
3. Consider conducting “spot checks” of employees who report “no contributions”

Considerations in Designing Compliance Policy

4. Incorporate into hiring process
 - Employment/promotions conditioned on no violations or no political contributions during “look back” period
 - Certifications from potential employees

Considerations in Designing Compliance Policy

5. Training

- Formal sessions (in person or on-line)
- How often?
- Circulation of Q&A flier with examples with policy

Considerations in Designing Compliance Policy

6. Who has responsibility?
 - Compliance function
 - Human resources

Third Party Solicitors/Placement Agents – Policy Considerations

- Decide not to use them – bring the function totally in-house and bar all payments.

Third Party Solicitors – Policy Considerations

- If going to use them:
 - Require Regulated Persons to provide their qualifications and history with public pension/retirement boards
 - Generate an approved list of solicitors
 - Investigate a solicitor’s background
 - Get certifications with respect to past contributions
 - Get certifications will not make contributions without prior disclosure and approval
 - Ban on sharing fees with third parties or employing third parties without prior consent
 - Include in contract solicitor’s agreement to disclose contract, fees and principals
 - Include in contract solicitor not authorized to make contributions on behalf of Adviser

Record Keeping – Rule 204-2(a)(18)

- Registered advisers with government clients or who advise an investment pool in which a government entity invests **must** maintain records to ensure/demonstrate compliance
- These include records identifying
 - All Covered Associates by name, title, business and resident addresses
 - Contributions by Adviser and Covered Associates to Government Officials, state and local political parties and PACs
 - All Government Entities to which advisory services were provided within the past 5 years, but not prior to 9/13/2010
 - All direct and indirect contributions to an Official of a Government entity or a political party of a state or its political subdivision
 - Name and title of each contributor
 - Name and title of each recipient
 - Amount and date
 - Whether subject to exception for returned contributions
 - Name and business address of each Regulated Person to which Adviser agreed to provide payment for solicitation of a Government Entity for advisory services

Whistleblower Bounty – Section 21F of Exchange Act

- Perceived need for a better bounty program
- Substantially expands SEC's authority and obligation to pay whistleblowers
 - Not limited to insider trading claims
 - Includes 40 Act violations
 - Includes non-registered investment advisers
- Mandatory awards of at least 10% but not more than 30% of monetary sanctions in excess of \$1 million

Whistleblower Award Requirements

- Provide the SEC with original information
 - Must provide information before authorities ask
 - Independent knowledge or analysis
 - Not already known to SEC
 - Information does not have to be first hand or personal
 - Whistleblower does not have to be employee
 - Whistleblower anonymous at reporting stage

Whistleblower Award Requirements

- Information must lead to successful enforcement action by the SEC in court or administrative action leading to monetary sanctions in excess of \$1 million
 - Results in a new examination or investigation and significantly contributes to success; or
 - Contributes to success of existing examination or investigation and information would not have been obtained otherwise

Exclusions

- Individuals with pre-existing duty to report
 - attorneys who obtain information in the course of representation
 - accountants who obtain information through engagement
 - Internal compliance employees (somewhat)
- Foreign government officials
- Whistleblowers convicted of related crime

Anti-retaliation Provisions

- Provide whistleblowers with an express private right of action against employers who retaliate
- New right to bring action directly in court/bypass administrative process
- New SOL
 - 6 years from occurrence
 - 3 years from discovery of facts that should have lead to discovery
 - No greater than 10 years
- Remedies:
 - Reinstatement
 - 2 times back pay
 - Reimbursement of attorney's fees and expenses

Impact on Companies

- Can undermine internal compliance programs
 - Includes provisions to discourage employees from bypassing internal compliance programs
 - preserves “place in line” – but only for 120 days
 - permits higher percentage awards for whistleblowers who first report through compliance program/lower for those who interfere with internal process
- Nonetheless, incentive for whistleblowers to bypass company procedures

Response to WB Program

Evaluate quality of controls designed to deter illegal conduct.

Continue to inculcate a culture of ethics and integrity.

- e.g. Revise code of ethics to cover preservation of documents relevant to pending investigations.

Evaluate reporting processes (e.g. hotlines).

Implement new processes for termination of employment.

- Obtain employee acknowledgment of compliance with reporting processes.
- Ensure that releases and non-disparagement clauses do not conflict with strong public interest in fostering identification of corporate wrongdoing.

Increase communication and training regarding existing policies and reporting options.

Be ready to investigate allegations quickly and thoroughly.

Investigation

- Involve the right people – counsel, experts.
- Consider value of self-reporting to regulators.
- Document extent of company investigation.
- Ensure secure storage of documentation.
- Preserve privileges

In the News

- ***U.S. House Republicans Embrace Obama's Push to Ease SEC Rules on Capital*** – Bloomberg News
- ***SEC Announces Formation of Advisory Committee on Small and Emerging Companies*** – U.S. Securities and Exchange Commission

Pending Legislation

- **H.R. 2167:** Private Company Flexibility & Growth Act, Rep. David Schweikert (R-AZ)
- **H.R. 2940:** Access to Capital for Job Creators Act, Rep. Kevin McCarthy (R-CA).
- **H.R. 2930:** Entrepreneur Access to Capital Act, Rep. Patrick McHenry (R-NC).
- **Small Company Job Growth and Regulatory Relief Act:** draft legislation to be introduced by Rep. Stephen Fincher (R-TN).
- **H.R. 1965:** Rep. Jim Himes (D-CT).
- **H.R. 1070:** Small Company Capital Formation Act, Rep. Schweikert (R-AZ), approved by the Financial Services Committee.
 - Senator Jon Tester (D-MT), with co-sponsor Senator Pat Toomey (R-PA), introduced a bill similar to H.R. 1070 as S. 1544.
- **H.R. 1082:** Small Business Capital Access & Job Preservation Act, Rep. Robert Hurt (D-VA), approved by Financial Services Committee

Upcoming Hearing

- **House Financial Services Committee –**
Wednesday, October 5 (10 a.m.): The
Capital Markets and Government
Sponsored Enterprises Subcommittee will
mark up legislative proposals to promote
small business capital formation and job
creation.

Revenue-Raising Proposals in Administration's Recommendations to Super Committee

- Tax reform (\$866B – 10 years)
- Measures included in *American Jobs Act* (\$478.65B – 10 years)
- Close business loopholes, broaden business tax base (\$62.23B – 10 years)
- Reform treatment of insurance companies, products (\$11.97B – 10 years)
- Reform the U.S. international tax system (\$112.69B – 10 years)
- Other revenues (\$41.03B – 10 years)
 - Reinstate Superfund taxes
 - Make permanent UI surtax of 0.8% retroactive as of 6/30/2011
 - Increase certainty with respect to worker classification
- Selected revenue items from mandatory spending accounts
 - Increased Passenger Security Fee: (\$15B to be directed to General Fund)
 - New \$100 per flight surcharge payable to FAA for flying in controlled airspace (\$10.88B – 10 years)
 - Increase Pension Benefit Guaranty Corporation premiums for single employer plans (\$16B – 10 years)

Super Committee 101

