

Review of Significant Decisions from the U.S. Supreme Court's Last Term

By John P. Elwood and Douglas D. Geysler

The United States Supreme Court decided four cases in the securities law area this term, with, on balance, defendant-friendly results. We discuss the highlights of these cases below.

Breach of a Mutual Fund Adviser's Duty Regarding the Receipt of Compensation

Section 36(b) of the Investment Company Act of 1940 imposes on a mutual fund adviser a "fiduciary duty with respect to the receipt of compensation for services."¹ In *Jones v. Harris Associates L.P.*,² a unanimous Court likely made it more difficult for a plaintiff to succeed on a claim for breach of this duty, holding that the party claiming breach must prove that the adviser has "charg[ed] a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."³

As to what factors inform that determination, the Court emphasized that "all relevant circumstances" must be considered.⁴ The Court discussed the relevance of two factors in particular. First, reviewing courts may consider "comparisons between the fees that an adviser charges a captive mutual fund and the fees that it charges its independent clients."⁵ But, because different clients might require different services, "courts must be wary of inapt comparisons" and reject any that are "sufficiently different [so] that

¹ 15 U.S.C. § 80a-35(b).

² 130 S. Ct. 1418 (2010).

³ *Id.* at 1426.

⁴ *Id.* at 1427, 1428.

⁵ *Id.* at 1428.

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a comparison is not probative."⁶ Second, "courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers" because those fees also may not have resulted from arm's length bargaining.⁷

Finally, leaving what may be the most important point for last, the Court held that the decision by the mutual fund's board of directors to approve the adviser's fee merits deference – the level of deference, however, varies with the thoroughness of the board's decision-making process.⁸ If the process was "robust" and the board "considered the relevant factors," the decision "is entitled to considerable weight, even if a court might weigh the factors differently."⁹ On the other hand, if the "process was deficient or the adviser withheld important information," the court "must take a more rigorous look."¹⁰ Regardless, a reviewing court may not substitute its own judgment for that of "disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's-length range."¹¹

⁶ *Id.*

⁷ *Id.* at 1429.

⁸ *Id.* at 1429-30.

⁹ *Id.* at 1429.

¹⁰ *Id.* at 1430.

¹¹ *Id.*

The Court thus fashioned a sliding scale of deference that requires essentially a two-step analysis. First, a court must examine the process through which the adviser's compensation was approved. Second, keeping in mind the thoroughness of that process and thus the corresponding level of deference, the court must evaluate, using all relevant circumstances, the substantive reasonableness of the fee outcome.

Discovery of Facts Triggering the Limitations Period for a Private Securities Fraud Action

Under 28 U.S.C. Section 1658(b)(1), a private securities fraud action must be brought no later than "2 years after the discovery of the facts constituting the violation." Although there was a consensus among the courts of appeals that "actual discovery" was not necessary to start the statute of limitations running, they were deeply divided about whether and how "inquiry notice" – "the point where the facts would lead a reasonably diligent plaintiff to investigate further" – sufficed to commence the limitations period. In a more plaintiff-friendly decision than the other cases this term, the Court in *Merck & Co. v. Reynolds* held that the two-year period begins to run "(1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, 'the facts constituting the violation,' whichever comes first."¹² And the Court decisively held that the limitations period was not triggered simply by discovering that the defendant had made inaccurate statements; at a minimum, it does not begin until a reasonably diligent plaintiff would have discovered facts establishing scienter, or intent to defraud.

The Court's opinion resolved three distinct issues. First, the Court addressed the meaning of the word "discovery" in Section 1658(b)(1), holding that it "refers not only to a plaintiff's *actual* discovery of certain facts, but also to the facts that a reasonably diligent plaintiff would have discovered."¹³ This conclusion followed from recognition that "discovery" is a term of art Congress used to incorporate the "discovery rule," under which a claim accrues "when the litigant first knows *or with due diligence should know* facts that will form the basis for an action."¹⁴ Courts had long used this rule in examining fraud claims,

including securities fraud actions, and so the Court concluded that when Congress enacted Section 1658(b)(1), it was "aware of relevant judicial precedent."¹⁵

Second, the Court held that the "facts constituting the violation" include "facts showing scienter" because scienter must be proved for a plaintiff to recover.¹⁶ Facts showing merely a false or misleading statement are not alone enough; the Court explained that simply because the defendant made a false or misleading statement "does not automatically tell us whether the speaker deliberately lied or just made an innocent (and therefore nonactionable) error."¹⁷

Finally, the Court addressed whether the limitations period begins to run when a plaintiff is on "inquiry notice."¹⁸ The Court held that the plain text of the statute answered that question: because the statute states that the period runs "only after the 'discovery' of" facts constituting the violation, the period can only begin when the plaintiff discovers those facts, not before.¹⁹ The same reasoning defeated the defendant's argument that, even if inquiry notice generally does not suffice, it is enough in the specific situation "where the actual plaintiff fails to undertake an investigation once placed on 'inquiry notice.'"²⁰ The Court explained that, though the concept of "inquiry notice" may inform the determination of the moment when a reasonably diligent plaintiff would have discovered the facts constituting the violation, the limitations period does not begin to run until that time, "irrespective of whether the actual plaintiff undertook a reasonably diligent investigation."²¹

Securities Fraud Lawsuits Based on the Purchase of Securities Traded on Foreign Exchanges

In *Morrison v. National Australia Bank*, the Court held that Section 10(b) of the Securities Exchange Act of 1934 does not apply extraterritorially, sharply curtailing the availability of securities fraud lawsuits based on purchases of securities traded on *foreign* exchanges.²²

¹⁵ *Id.* at 1795.

¹⁶ *Id.* at 1796. The Court expressed no opinion on other facts relating to a private securities fraud claim, like reliance, loss, and loss causation. *See id.*

¹⁷ *Id.* at 1797.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* at 1798.

²¹ *Id.*

²² No. 09-1191 (June 24, 2010).

¹² 130 S. Ct. 1784, 1789-90 (2010) (quoting 28 U.S.C. § 1658(b)(1)).

¹³ *Id.* at 1793.

¹⁴ *See id.* at 1793-94.

Morrison involved a so-called “f-cubed” lawsuit – an action by *foreign* purchasers of *foreign* company stock bought on *foreign* exchanges. The courts of appeals had resolved Section 10(b)’s applicability to such lawsuits using some combination of a “conduct” test – focusing on whether wrongful conduct occurred domestically – and an “effects” test – focusing on whether the conduct had a substantial effect in the United States or on United States citizens.²³ If the domestic conduct or effects were significant enough, then the lawsuit could proceed.

Justice Scalia, along with the four other conservative Justices, flatly rejected that approach. The Court began with the longstanding presumption against extraterritoriality, holding that “unless a contrary intent appears, [federal legislation] is meant to apply only within the territorial jurisdiction of the United States.”²⁴ After criticizing the courts of appeals for disregarding that principle, the Court turned to the text of the Exchange Act and Section 10(b) to determine whether there were sufficient indicia of “contrary intent.” The Court held that the presumption against extraterritoriality was not overcome by (1) a “general reference to foreign commerce in the definition of ‘interstate commerce,’” (2) a “fleeting reference [in the description of the purposes of the Exchange Act] to the dissemination and quotation abroad” of domestic securities’ prices, and (3) a provision in the Exchange Act “imposing a condition precedent to its application abroad.”²⁵ The Court thus concluded that “there is no affirmative indication” of Section 10(b)’s extraterritorial application.

The petitioner-plaintiffs tried to avoid the effect of that conclusion by arguing that they were seeking only domestic application of the statute – they had alleged that the defendants had engaged in the deceptive conduct out of offices in Florida.²⁶ This argument, however, fared no better. Justice Scalia wrote that “the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever *some* domestic

activity is involved in the case.”²⁷ Because “the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States,” the Court concluded that Section 10(b) applies only to “transactions in securities listed on domestic exchanges[] and domestic transactions in other securities.”²⁸

The Court did not elaborate on what makes a transaction a “domestic transaction,” and so the opinion leaves an opening for purchasers of foreign securities to argue that the “transaction” occurred in the United States. But this opening plainly is far smaller than what was available under the courts of appeals’ tests.

The Survival of Sarbanes-Oxley and the Public Company Accounting Oversight Board

In one of the more anticlimactic decisions of the term, the Court held unconstitutional part of the Sarbanes-Oxley Act of 2002 but did so on such narrow grounds that the opinion is unlikely to have much practical effect.²⁹ Sarbanes-Oxley created the Public Company Accounting Oversight Board (the “Board”) to regulate and oversee the accounting industry.³⁰ The Board’s members are appointed by the U.S. Securities and Exchange Commission (SEC) and the statute provides that they can be removed by the SEC “only ‘for good cause shown.’”³¹ Because the SEC commissioners themselves can be removed by the President only for “inefficiency, neglect of duty, or malfeasance in office,” the Board’s members were insulated from the President by two levels of good-cause protection.

Joined by the four more conservative Justices, Chief Justice Roberts held that this multilayer protection violated the Constitution’s separation of powers by “subvert[ing] the President’s ability to ensure that the laws are faithfully executed” and thus violating the Constitution’s “vesting of the executive power in the President.”³² The nub of the problem is that “[n]either the President, nor anyone directly responsible to him, nor even an officer whose

²³ See slip op. at 8-10. The courts of appeals had long framed the issue in terms of subject-matter jurisdiction. The Court explained, however, that “to ask what conduct § 10(b) reaches is to ask what conduct § 10(b) prohibits, which is a merits question.” *Id.* at 4-5.

²⁴ *Id.* at 5.

²⁵ *Id.* at 13-15.

²⁶ *Id.* at 17.

²⁷ *Id.*

²⁸ *Id.* at 17-18.

²⁹ No. 08-861 (June 28, 2010).

³⁰ Slip op. at 3.

³¹ *Id.* at 3, 5 (quoting 15 U.S.C. § 7211(e)(6)).

³² *Id.* at 17.

conduct he may review only for good cause, has full control over the Board.”³³

The Court went on to reject easily the petitioners’ broader arguments: that the Board members can be appointed only by the President with the Senate’s advice and consent; that the SEC is not a “Departmen[t]” under the Appointments Clause in which Congress may vest the power to appoint inferior officers; and that only the SEC Chairman, not the full SEC, may appoint inferior officers because only the Chairman is the “Hea[d]” of the “Departmen[t].”³⁴

Because the Court found that the Board’s good-cause removal provision was severable from the rest of Sarbanes-Oxley, the decision will have little practical effect other than the SEC will be able to remove Board members at will.³⁵ The Court made clear that Sarbanes-Oxley “remains ‘fully operative as a law’ with these tenure restrictions excised.”³⁶

Looking Ahead to October Term 2010

The Court has granted *certiorari* in two securities law cases for next term:

- *Matrixx Initiatives, Inc. v. Siracusano*, (No. 09-1156): The Court will address materiality under Section 10(b) and Rule 10b-5, answering whether a plaintiff can state a claim based on a pharmaceutical company’s nondisclosure of adverse event reports even though the reports are not alleged to be statistically significant. The Ninth Circuit held that statistical significance is not necessary to state a securities fraud claim. *Amicus* briefs supporting petitioner are expected to be due August 27, 2010.
- *Janus Capital Group, Inc. v. First Derivative Traders*, (No. 09-525): The Court will address the contours of primarily liability under Section 10(b) and Rule 10b-5, reviewing a Fourth Circuit decision that held that the defendant company could be held liable if it “helped draft the misleading prospectuses” of another company “by participating in the writing and dissemination of [those] prospectuses,” even though “the statement on its face is not directly attributable to the [defendant].”

³³ *Id.* at 15.

³⁴ *Id.* at 29-33.

³⁵ In fact, the Court itself noted that “[t]he parties have identified only a handful of isolated positions in which inferior officers might be protected by two levels of good-cause tenure.” *Id.* at 25.

³⁶ *Id.* at 28 (citation omitted).

Amicus briefs supporting petitioner would be due September 10, 2010. ■

Recent Developments Concerning the PSLRA’s Safe Harbor Provision

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A “safe harbor” provision was included in the Private Securities Litigation Reform Act³⁷ to encourage companies to give future-looking guidance without fear of liability if that guidance turned out to be incorrect.³⁸ It works as an important tool both for investors seeking guidance from public companies about a company’s future business prospects and for companies who are encouraged to provide guidance but who may otherwise have feared costly investor litigation if a company’s results fail to meet expectations.

The Second Circuit recently issued an important opinion regarding safe harbor protection in *Slayton v. American Express Company*.³⁹ At issue in *Slayton* was the breadth of the safe harbor’s protection for identified forward-looking statements accompanied by meaningful cautionary language. In this article, we will address two primary aspects of *Slayton*’s analysis:

- First, we address *Slayton*’s discussion of whether actual knowledge of the speaker is relevant to determining whether the cautionary language accompanying a forward-looking statement is meaningful. While the Second Circuit noted that the Conference Committee Report states that actual knowledge is not relevant to this issue, it questioned whether this made sense and noted that other circuits, including the Fifth Circuit, had reached opposite conclusions.
- Second, we address *Slayton*’s holding that the cautionary language at issue in the case was

³⁷ Private Securities Litigation Reform Act (PSLRA), 15 U.S.C. §§ 77z-1 and § 78u-4.

³⁸ See H.R. Conf. Rep. No. 104-369 (1995), 1995 U.S.C.C.A.N. 730, 742 (safe harbor was enacted because “[f]ear that inaccurate projections will trigger the filing of securities class actions has muzzled corporate management.”); *id.* (“The Conference Committee has adopted a statutory ‘safe harbor’ to enhance market efficiency by encouraging companies to disclose forward looking information.”)

³⁹ 604 F.3d 758 (2d. Cir. 2010).

not sufficiently specific to qualify as “meaningful.” Plaintiff’s lawyers will likely seize on this holding and argue that it further raises the bar for the specificity required by the safe harbor’s “meaningful cautionary language” requirement.

After discussing these portions of the Second Circuit’s opinion, as well as other relevant safe harbor case law, including the Fifth Circuit’s opinion in *Lormand v. US Unwired, Inc.*,⁴⁰ we will then address a handful of practical steps disclosure counsel and management can take to ensure that forward-looking statements qualify for safe harbor protection.

Overview of the Safe Harbor

The safe harbor is divided into two prongs. The first prong addresses whether a forward-looking statement can suffice as a misstatement for purposes of a securities fraud claim, while the second prong provides the requisite scienter applicable to forward-looking statements.

Under the first prong, a forward-looking statement will be protected if it is either (i) “identified as a forward-looking statement, and is accompanied by meaningful cautionary statements that could cause actual results to differ materially from those in the forward-looking statement,” or (ii) “immaterial” on a stand-alone basis, e.g., statements of corporate puffery. The second prong provides a stricter scienter requirement for forward-looking statements than for statements of current or historical fact, stating that liability for a forward-looking statement shall only attach upon a showing that it “was made with actual knowledge by that person that the statement was false or misleading”⁴¹ This limitation makes good sense because combining a recklessness standard with the inherently subjective and speculative nature of forward-looking statements is a recipe for the type of fraud-by-hindsight lawsuits the PSLRA was designed to prevent.

Key Decisions in the Second and Fifth Circuits

In *Slayton*, the plaintiffs alleged that the defendant American Express should not have stated that losses on a subsidiary’s high-yield debt portfolio “[we]re expected to be substantially lower than in the first quarter” because some executives had been advised that the company faced

additional losses. The plaintiffs alleged that, at the time American Express made this prediction, management knew that its subsidiary faced mounting defaults on its high-yield debt portfolio, including on its investment-grade instruments and that the amount of exposure could not be estimated. American Express argued that the statement was a forward-looking statement protected by the safe-harbor’s first prong because it was identified as such and was accompanied by a risk factor explaining that “potential deterioration in the high-yield sector . . . could result in further losses in [the subsidiary’s] portfolio.”

The district court dismissed the complaint and the Second Circuit affirmed the dismissal. In doing so, however, the Second Circuit disagreed with defendants that the statement was protected by the first prong of the safe harbor, but found that the statement was nevertheless protected by the second prong because the plaintiffs had failed to allege facts giving rise to a strong inference that the defendants made the statement with actual knowledge of its falsity.

With respect to the first prong, the Second Circuit held that American Express’s cautionary language was “vague” and “verge[d] on the mere boilerplate,” and thus could not qualify as meaningful. The court pointed to the fact that the “defendants’ cautionary language remained the same even while the problem changed.” While the court concluded that a “defendant need not include the particular factor that ultimately causes its projection not to come true to be protected by the meaningful cautionary language prong,” the court did hold that defendants bore the burden to show that “other factors [it] identified were important factors that could realistically cause results to differ materially.”⁴² Because American Express failed to disclose rising defaults on investment-grade instruments, the court held it failed to include meaningfully cautionary language.

In so holding, the Second Circuit declined to answer whether the first and second prong are interdependent, that is, whether a meaningfully cautionary statement can provide a shield from liability in the fact of allegations that the defendants had actual knowledge that the statements were false or misleading at the time they were made. The court did, however, devote significant discussion to the question. Here, the defendants

⁴⁰ 565 F.3d 228 (5th Cir. 2009).

⁴¹ 15 U.S.C. § 78u-5(c).

⁴² *Slayton*, 604 F.3d at 773.

omitted a major risk (rising defaults on bonds would cause deterioration in the subsidiary's portfolio) about which they knew at the time of the statement. The court asked: should the first prong preclude liability under such circumstances? Unlike the "actual knowledge" prong, where the court *must* inquire into the defendants' state of mind, direction from Congress — as well as the Sixth, Ninth and Eleventh Circuits⁴³ — indicated that courts should *not* inquire into the defendants' state of mind when applying the "meaningful cautionary statements" prong. Nonetheless, because Congress required the disclaimer to warn of risks that realistically could alter projections, courts may in fact need to inquire into the defendants' state of mind to determine "the major factors that the defendants faced at the time the statement was made." The Second Circuit invited Congress "to give further direction on . . . the reference point by which [the court] should judge whether an issuer has identified" the relevant factors.⁴⁴

The Fifth Circuit has gone further than the Second Circuit. In *Lormand*, the Fifth Circuit reversed the district court's decision to grant the defendants' motion to dismiss, holding that the first prong did not apply when "the plaintiff adequately allege[d] that the defendants actually knew that their statements were misleading at the time they were made." Had the plaintiff failed to plead actual knowledge, however, the first prong "still would not apply . . . because the alleged misrepresentations are not accompanied by 'meaningful cautionary language.'"

The Fifth Circuit held that neither US Unwired's general disclaimer, which accompanied *all* alleged forward-looking statements, nor disclaimers that varied by *each* alleged forward-looking statement constituted meaningful cautionary statements. First, the court held that US Unwired's general disclaimer did not qualify as meaningful cautionary statements because it was boilerplate. In so determining, the court found it

compelling that the disclaimer "was used in conjunction with each alleged misrepresentation" with only slight variations. Instead, each alleged misrepresentation "must be addressed individually" by a disclaimer, which must provide "'substantive' company-specific warnings based on a realistic description of the risks applicable to the particular circumstances" described in the alleged misrepresentation.

Second, the Fifth Circuit held that disclaimers that varied by alleged forward-looking statements were not meaningful cautionary statements because they provided a "very vague and general warning" and/or misstated a historical fact. US Unwired had entered into an affiliate agreement with Sprint whereby it ceded control of customer care, billings, and cash flow and was forced to implement subprime subscriber programs. Although US Unwired "knew from past experience" that both actions "posed an imminent threat of business and financial ruin and that some damage from these risks had already materialized," its disclaimers did not "disclose the specific risks and their magnitude" and did not reveal that the risks had begun to materialize. For the disclaimers to constitute meaningful cautionary statements, the court held that they needed to provide "specific, concrete explanations that clearly identified and quantified the clearly present financial dangers to US Unwired, *i.e.*, the disastrous effects of the [subprime subscriber] programs and US Unwired's loss of control of customer care, billings and cash flow."

Lormand is a departure from prior Fifth Circuit jurisprudence, including *Southland Securities Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004), and has been directly criticized by the Eleventh Circuit⁴⁵ and at least one secondary source.⁴⁶ Courts in the Sixth, Ninth, and Eleventh Circuits have held that the Safe Harbor should be read "in the disjunctive" such that the defendant's state of mind is irrelevant when the allegedly false statements were identified as forward-looking statements and accompanied by meaningful cautionary statements.⁴⁷

⁴³ See *id.* at 771 n.7 (citing *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 795 (11th Cir. 2010) and *Miller v. Champion Enters. Inc.*, 346 F.3d 660, 678 (6th Cir. 2003) as supporting the proposition that "[t]he Eleventh and Sixth Circuits have held that courts may not inquire into a defendant's state of mind"); see *In re Cutera Sec. Litig.*, — F.3d —, 2010 WL 2595281, *7 (9th Cir. June 30, 2010) ("The investors' proposed conjunctive construction of the safe harbor is not only inconsistent with the statutory language, but has been rejected by all of our sister circuits to consider the question.")

⁴⁴ *Id.* at 772.

⁴⁵ *Goodman*, 594 F.3d at 795 (holding that "an allegation of actual knowledge of falsity will not deprive a defendant of protection by the statutory safe harbor if his forward-looking statements are accompanied by meaningful cautionary language.")

⁴⁶ Floyd & Pirnazar, at 6-53 n.218.

⁴⁷ *Cutera*, — F.3d —, 2010 WL 2595281, *7 (9th Cir.); *Miller*, 346 F.3d at 678 (6th Cir.) ("No investigation of defendants' state of mind is required.")

This rule furthers the protective purposes of the safe harbor.

Slayton and *Lormand* are important for disclosure counsel and management because they indicate the strict standard against which some courts have judged a company's cautionary language. While some may argue that *Slayton* represents a growing trend in the courts to narrow the application of the safe harbor, at a minimum *Slayton* identifies important, practical steps disclosure counsel and management can take to maximize the chances that cautionary language will be found to be meaningful.

Practical Advice

In order to maximize a company's chances that its cautionary language will accomplish its goal, it is important for those in charge of a company's disclosures to fully understand what forward-looking statements are being made at a given time and what specific factors may cause actual results to differ from those statements. This process can be tedious, but given the potential to minimize exposure to costly securities litigation, it should be done routinely, and certainly in connection with any Form 10-Q, 10-K, conference call, or other major disclosure event. Although, as the Seventh Circuit has stated, "investors would like to have . . . a full disclosure of the assumptions and calculations behind the projections . . . this is not a sensible requirement" and that level of disclosure is not required.⁴⁸ However, companies should avoid cautionary language that remains fixed even as the risks change. Cautionary language should be extensive and specific and companies should avoid "vague or blanket (boilerplate) disclaimer[s] which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation."⁴⁹ And if there are known facts that suggest that a forward-looking statement will not materialize, companies should consider including specific risk factors disclosing those facts.

* *The authors received substantial research assistance from Lauren Barrows, summer associate at Vinson & Elkins.* ■

⁴⁸ *Asher v. Baxter Int'l. Inc.*, 377 F.3d 727, 733 (7th Cir. 2004) ("Many of the assumptions and calculations would be more useful to a firm's rivals than to its investors . . . [and] Baxter's shareholders would have been worse off.")

⁴⁹ *Inst. Investors Group v. Avaya, Inc.*, 564 F.3d 242, 256 (3d Cir. 2009).

The SEC Adopts New Rule to Curtail "Pay-to-Play"

By Ari M. Berman and Nikolay V. Vydashenko

Money and politics are old bedfellows whose combination has resulted in "pay-to-play" practices that impact investment decisions by entities controlled by public officials. These entities often include public pension funds, some of the largest of which hold over \$100 billion in assets, and that increasingly have become an important source of capital for private equity firms and hedge funds. In the most recent attempt to curb pay-to-play practices, on June 30, 2010, the U.S. Securities and Exchange Commission (SEC), adopted a rule that will govern investment advisers who manage assets on behalf of public pension funds.

The SEC's new rule,⁵⁰ discussed in further detail below, limits campaign contributions by investment advisers who provide services to public pension funds,⁵¹ restricts the use of placement agents in connection with soliciting investments from public pension funds, and imposes new books and records requirements on investment advisers. As a result, investment firms should take the opportunity to review and enhance their compliance materials to guard against even the appearance of impropriety in connection with fundraising from public sources.

The SEC and Several States Investigate the Use of Placement Agents

Private equity firms and hedge funds often use placement agents (or "finders") to assist in fundraising efforts, including obtaining investments from public pension funds. In a typical arrangement, the firm pays a placement agent a percentage of the amount invested with the firm. When placement agents are used to obtain investments from public entities, these arrangements can present additional risks because of the possibility that an investment might be obtained as a result of pay-to-play practices — either through contributions made by the firm or by the placement agent to decision-makers at a public pension fund.

⁵⁰ Investment Advisers Act Rule 206(4)-5.

⁵¹ The new rule applies to pension funds controlled by state and local public officials. The new rule does not apply to foreign government entities.

The SEC and New York Attorney General (NYAG) Andrew Cuomo have been conducting parallel investigations into an alleged scheme involving payments made by investment firms to a placement agent who was a close confidant of former New York Comptroller Alan Hevesi. In civil and criminal proceedings arising from these investigations, the SEC and the Attorney General allege that the investment decision process at the New York State Common Retirement Fund (CRF), of which the State Comptroller is sole trustee, became corrupted through campaign contributions made to the former Comptroller and through finders' fee payments made to a confidant of the former Comptroller. At its height, CRF was valued at \$150 billion and, today, it is the third largest pension fund in the country. The NYAG's and SEC's investigations have resulted in guilty pleas by, among others, CRF's Chief Investment Officer and a placement agent, and in civil settlements with the Attorney General by several well-known private equity firms. These firms have agreed to abide by the NYAG's Code of Conduct, which includes a ban on using placement agents in connection with soliciting investments from government entities, including public pension funds.

Other states are conducting similar investigations. For example, in New Mexico, the state's pension fund fired an investment adviser whose founder pleaded guilty to charges brought by the NYAG arising out of the adviser's involvement with pay-to-play at CRF. In his guilty plea, the investment adviser admitted to recommending investments to a New Mexico public pension fund based on pressure from people with political connections in New Mexico. Moreover, California's Attorney General has been investigating pay-to-play practices at the California Public Employees Retirement System (CALPERS), the nation's largest public pension fund with over \$200 billion in assets. That investigation has resulted in charges against several placement agents, and, today, CALPERS requires disclosure by funds into which it invests of any fees paid to placement agents in connection with the investment. Proposed legislation in California, if enacted, also will require placement agents to register as lobbyists, report gifts, fees, and other compensation on a quarterly basis, and adhere to gift limits and restrictions and reporting requirements on campaign contributions. The proposed legislation would prohibit the payment of contingency fees

to finders, *i.e.*, fees calculated as a percentage of the investment obtained by the placement agent.⁵²

The SEC Adopts the New Rule

In the municipal securities market, political contributions by municipal securities dealers to public officials responsible for awarding bond business have long been recognized for their potential to create conflicts of interest. In 1994, in response to allegations of widespread pay-to-play practices in the municipal securities market, the Municipal Securities Rulemaking Board (MSRB) promulgated rules that prohibit broker-dealers from engaging in business with issuers if political contributions were made to officials of such issuers.⁵³ The SEC's new pay-to-play rule is modeled on the MSRB's rules, and it applies to any investment adviser registered or required to be registered with the SEC.

The SEC's new rule contains three key components.

First, the SEC's rule bars, with certain limited exceptions, an investment adviser from providing public pension funds with investment advice for two years if the adviser (or certain of its employees defined in the rule as "covered associates") makes a campaign contribution to an elected official or candidate who is in a position to influence the selection of the adviser.

- The investment adviser and covered associates are prohibited from directing third parties to make contributions that would otherwise trigger the bar if made by the adviser or covered associates;
- The investment adviser and covered associates may not, without triggering the two-year bar, solicit another person or a political action committee to (1) make a contribution to an elected official or candidate who can influence the selection of the adviser; and (2) make a payment to a political party of the state or locality where the adviser is seeking to provide investment advisory services to the government entity;
- The rule has a look-back period that attributes to an adviser contributions made by a person within two years or six months of becoming a covered associate of that adviser. Accordingly, the investment adviser will not be permitted to advise government entities if a new covered associate made campaign contributions

⁵² On June 2, 2010, the bill passed in California's State Assembly and is now pending in the State Senate.

⁵³ See MSRB Rules G-37 and G-38.

within two years of becoming a covered associate of the investment adviser. If the covered associate does not solicit for the investment adviser, then the look-back period is six months.

Second, the SEC's rule imposes limits on paying third-party placement agents to solicit a government entity on behalf of the investment adviser. Specifically, an investment adviser is prohibited from paying a third party, such as a placement agent, to solicit a government entity on behalf of the investment adviser, unless the placement agent is a (1) SEC-registered investment adviser or broker-dealer; and (2) member of a registered national securities association that has a rule prohibiting members from engaging in pay-to-play, and that rule has been found by the SEC to impose restrictions that are equivalent to the SEC's pay-to-play rule. It is expected that FINRA will enact rules that satisfy this provision, which will make broker-dealers registered with FINRA eligible to solicit public pension funds on behalf of investment advisers.

Notably, the SEC's initial proposed draft of this rule sought to prohibit investment advisers from using placement agents entirely. Private equity firms and hedge funds, along with placement agents, strongly opposed this proposal, and the SEC indicated it was persuaded by some of the arguments in their comment letters.

Third, the SEC's rule creates a new books and records provision that obligates investment advisers to maintain records related to (1) government entities to which the investment adviser provides or has provided investment advice; (2) political contributions made by the investment adviser and covered associates; and (3) third-party placement agents used by the investment adviser to solicit business from a government entity.

Investment advisers must be in compliance with the new rule's restrictions on campaign contributions and the recordkeeping provisions by March 14, 2011, except investment advisers to registered investment companies that are covered investment pools must comply by September 13, 2011. All investment advisers must comply with the restrictions on payments to placement agents by September 13, 2011.

Practical Advice

In light of these developments, private equity firms and hedge funds should consider the following:

- Review and enhance compliance materials and fundraising guidelines to guard against even the appearance of impropriety in connection with fundraising from public sources;
- Consider regulating employees' political contributions through an established pre-clearance procedure, including the creation of record-keeping systems to facilitate compliance;
- Identify covered associates, government entity clients, and third parties paid to solicit investments from government entities;
- With respect to hiring or promotion of employees, implement screening procedures to ensure that persons hired or promoted to a covered associate position do not disqualify the adviser from advising government entities because of contributions made by the covered associate during the applicable look-back period;
- Increase diligence efforts with respect to placement agents, such as engaging outside providers to conduct background checks on potential placement agents and to ensure proper registration of placement agents and their representatives;
- Revisit engagement letters with placement agents to ensure comfort with representations made by placement agents; and
- Ensure proper disclosures to public pension funds or others regarding retention and payment to placement agents. ■

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