

## CORPORATE AND SECURITIES LAW

*Alert*

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY &amp; SIMS PLC

SEC Proposes Anti Pay-to-Play Rules;  
Reminder to Update Indemnification Arrangements

August 24, 2009

The Securities and Exchange Commission released additional details on August 3, 2009 for a proposed rule which seeks to end so called “pay-to-play” practices by investment advisers (or placement agents) seeking to obtain (or solicit) private equity fund commitments from government entities, such as public pension funds. The new rule would apply to registered and unregistered investment advisers alike and would only exempt investment advisers with less than \$25 million in assets under management. As a result, this rule would cover most private equity fund managers.

The proposed rules would:

- Prohibit receiving compensation (i.e. management fees or the GP’s carried interest) from a government entity<sup>1</sup> for advisement services for two years if the investment adviser or any “covered associate”<sup>2</sup> makes a contribution to an official of the entity. (Note: An investment adviser to pooled funds in which a government entity invests would be treated as though the investment adviser were advising the government entity directly.)
- Prohibit an investment adviser from using third-party solicitors (i.e. placement agents) to obtain government entity clients. The proposed rule does not prohibit such activities by an employee (in-house marketing/sales), general partner, managing member, or an executive officer of the investment advisor. As a practical matter, this exception may be of limited use to smaller funds without in house marketing personnel.

<sup>1</sup> “Government entity” is defined in the proposed rule as any State or political subdivision of a State, including any agency, authority, or instrumentality of the State or political subdivision, a plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof; and officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

<sup>2</sup> “Covered associates” under the proposed rule include the investment adviser's (i) general partners, managing members, executive officers, and other individuals with similar status or function; (ii) any employee who solicits advisory clients for the adviser; (iii) and any political action committee controlled by the adviser or its covered associates.

- Prohibit an adviser and his covered associates from soliciting a person or political action committee to make any contribution to an official of a government entity or political party of a state or locality to which the adviser is providing or seeking to provide investment advisory services.
- Prohibit indirect actions, which if done directly would result in a violation of the rule, i.e. disallows directing or funding contributions through third parties.

Finally, the proposed rule would require investment advisers with government entity clients, either directly or through a covered investment pool, to maintain detailed records of (i) all covered associates of the investment adviser, (ii) all government entities to which services are being provided, are sought to be provided, or have been provided in the past five years and (iii) all direct or indirect contributions or payments to government officials.

### **Reminder to Update D&O Indemnification and Insurance Arrangements**

We would also like to take this opportunity to remind our private equity clients and friends that it is critical that any supplemental contractual indemnification arrangements with director-representatives of private equity firms serving on the boards of its portfolio companies provide clearly that the private equity firm's indemnification and advancement obligations to its director-representatives are secondary to the indemnification and advancement obligations of the portfolio companies. Otherwise, such obligations may be found to be co-equal. This possibility has been confirmed by recent Delaware case law.<sup>3</sup> This could be an expensive (and unintended) result for the private equity fund or management company.

Relatively recent cases from Delaware also illustrate the need to review D&O "excess" liability policies and the policies of your portfolio companies. The goal is to ensure that, when claims arise, the priorities and procedures reflect the intent of the parties and to ensure that your portfolio company's carrier may not seek access to (or sharing by) your firm's excess policy. The excess policy should only apply once the primary insurance is exhausted.

Accordingly, if you have not done so in response to the recent Delaware case law, we recommend the following:

1. Review the indemnification arrangements at your firm and at the portfolio company level to ensure the intended priorities are clearly articulated;
2. Seek to amend or modify any contractual agreements as soon as possible to the extent clarification is appropriate;
3. Review any D&O insurance at the fund level in connection with the insurance at the portfolio company to clarify priorities and procedures when claims arise; and
4. As needed, clarify any policy terms with your carrier (or that of the fund or portfolio company), and consider taking the opportunity to review the entire binder and coverage levels in respect of the current market and increasing litigation and exposure directors are facing in the current environment.

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<sup>3</sup> *Levy v. HLI Operating Co. Inc.*, 924 A.2d 210 (Del. Ch. 2007); *Schoon v. Troy Corp.*, 948 A.2d 1157 (Del. Ch. 2008); *Sodano v. AMEX LLC*, 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008).

Bass, Berry & Sims PLC's Private Equity and Venture Capital subgroup is comprised of corporate attorneys who monitor and advise on developments in venture capital and private equity in connection with their governance, fundraising and investment activities. Our attorneys have a wide array of expertise and provide advice to portfolio companies, institutional investors, and sponsors in matters ranging from mezzanine financing, fund formation, capital raising activities and investments and acquisitions. If you have any questions regarding the issues addressed in this Private Equity and Venture Capital Law Alert please feel free to contact any of your regular contacts in our Corporate and Securities Group or any of the attorneys in our Private Equity and Venture Capital Subgroup listed below.

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### Bass, Berry & Sims PLC Corporate and Securities Group

The Corporate and Securities Group includes the following subgroups comprised of our attorneys with a particular expertise who are focused on current trends and developments in these areas of the law. This Alert has been brought to you courtesy of the Private Equity/Venture Capital subgroup.

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